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An Accountant's Guide to Trusts (Course #5565E/QAS5565E)

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Glossary

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Chapter 1: Trusts: The Who, What and Why

I. Elements of a Trust

A. COMMON USES

A valid trust is a legal arrangement creating a separate legal entity. The duties, powers and responsibilities of the parties to this arrangement are determined by state statute and the trust instrument. To create a trust, legal title to property is conveyed to a trustee, who is then charged with the responsibility of using that property for the benefit of another person, called the beneficiary, who really has all the benefits of ownership, except for bare legal title. The trustee manages the trust, holds legal title to the trust assets, and exercises independent control.

Trusts can be used to accomplish many goals, including tax planning, estate planning, and charitable giving. This course will discuss all aspects of trusts, including the "who, what and why." The "who" refers to the person who creates the trust and the persons for whose benefit the trust is created. The "what" is the property or assets placed in the trust. The "why" is the purpose for which the trust is established, such as for a charitable cause or for the care of a dependent adult or minor child. The circumstances that make a trust a good option are too many to list. Here are some examples of situations that often give rise to a trust:

Example 1.

William is a 73-year-old widower and the father of a 40-year old man, Roger, who is mentally retarded. Roger lives in a group home with other retarded men. Years ago, William established a trust in which he placed money to be used for the care and support of Roger. William is the trustee of the trust. Upon his death, William's son Clark will become the new trustee and will continue to manage the proceeds of the trust for the benefit of his brother. This type of trust is sometimes referred to as a support trust or a special needs trust.

Example 2.

Kyle divorced his first wife ten years ago and remarried. He had two children with his first wife, Lisa and Daniel. Kyle has a will that, upon his death, creates a trust to be used for the benefit of Lisa and Daniel. The will calls for $250,000 to be placed in the trust to be used for the education and other benefit of the children. The trust calls for Kyle's brother, Martin, to act as trustee and invest and distribute the assets according to the specifications in the trust.

Example 3.

Andrea is an eccentric old woman who never married and has no children. She wishes to leave the bulk of her estate to her favorite cause, the American Humane Society. Andrea has her lawyer create an irrevocable trust for the benefit of the Society. During her life, Andrea will act as trustee and invest and distribute the money according to the terms of the trust. Upon her death, a financial institution will manage the funds.

Example 4.

Henry and Norma are a married couple with one adult child, Catherine. Norma and Henry each have a valid will in which they leave all of their separate property to each other in trust. The surviving spouse will have use of the income from the trust property during his or her lifetime. Upon the death of the second spouse, the proceeds of the trust are to be distributed outright to Catherine.

B. REQUIRED PARTIES

A trust may be created during the life of the donor (called an *inter vivos* trust) or at the death of the donor (called a *testamentary* trust). The person who creates the trust is most commonly referred to as *trustor* of the trust. In addition to the trustor, there are two other persons who must be identified in a trust.

1. Trustee

The trustee is the individual who is in charge of executing the terms of the trust. Every trust must have a trustee. A trustee can be an individual or an institution such as a bank. For practical reasons, institutions serve as trustees only in the case of a very large trust. The trustee owes a fiduciary duty to the trustor. The powers of the trustee are either set forth in the trust document or provided for in accordance with applicable state law.

2. Beneficiary

Every trust must have a beneficiary or beneficiaries. This is the person, persons or entity for whose benefit the trust was created. Without a beneficiary, a court cannot ascertain who should benefit from the trust and there is no person or entity that can enforce the obligations of the trustee. Without a designated beneficiary, therefore, a purported trust will fail.

Example 1.

Addison, a wealthy widow, creates a trust for the benefit of "all the wonderful people in my life that have helped me over the years." While there would probably be people lined up down the street to be beneficiaries of this trust, no one is identified specifically to make this a valid trust, and it would fail for lack of a beneficiary.

Example 2.

Constance is a widow with a large fortune. She wants to provide support to her nephews as well as to make a gift to her favorite charity, the American Red Cross. Constance established two trusts, a testamentary trust that will provide income to her nephews upon her death, and a charitable trust which will give her income during her lifetime and make a large gift to the American Red Cross upon her death. Her nephews and the American Red Cross are the beneficiaries of the trusts.

Table 1.1 Table of Trust Terminology

Term	Alternate Term	Meaning
Trustor	Donor / Settlor / Grantor	Person who establishes a trust, either for his or her own benefit or for the benefit of another individual, individuals or entity.
Beneficiary	None	Person for whose benefit a trust is created; the individual, individuals or entity who receive some or all of the proceeds of the trust.
Trustee	None	Individual or entity (such as a bank) charged with executing the trust. This person or entity generally invests or manages the proceeds of the trust as instructed by the trustor and makes distributions to the beneficiaries according to the terms of the trust.
Trust Property	Corpus / Body of the Trust	To be valid, every trust must contain some identifiable trust property, i.e. a specific piece of real property or the proceeds in a specifically identified bank account.
Living Trust	Inter Vivos	A trust created during the life of the trustor, generally for the benefit of the trustor with the contingent beneficiaries receiving the proceeds upon the death of the trustor.

3. Trust Property

In addition, to be valid a trust must have some identifiable trust property, sometimes referred to as the “corpus” of the trust. No formal transfer of the property is required (with the exception of real property); a declaration is sufficient to change the nature of the property.

Example.

Michael executes a writing in which he establishes a trust for the benefit of his minor children. The document calls for $500,000 to be placed in a trust for the benefit of the children and for his brother, Steve, to serve as the trustee. The document is effective to create a trust for the benefit of his minor children.

Remember, however, that state law plays an important role in governing the use of trusts. The formalities of trust creation differ from state to state and, to some extent, based upon the type of property that is the subject of the trust. For example, in California and many other states, a trust that contains real property is not valid unless the trust is in writing.

II. Common Types of Trusts

There are few limits to the type of trusts that can be created or to the purposes for which they can be created. Accordingly, this section will provide a look into some of the more common types of trusts.

A. TESTAMENTARY TRUST

A testamentary trust is one that is created at the time of an individual's death through a will. An individual may provide in his or her will that certain assets in his or her estate be used to establish a trust at the time of his or her death. The will typically details the beneficiaries of the trust, its trustees and the way it is to be administered.

Example.

Nick's will contains a provision that, upon his death, the proceeds from the sale of his house are to be used to provide financial support to his nephews while they are in college. Any remaining proceeds are then to be distributed equally to the nephews. This is a classic testamentary trust. It does not become operational until after Nick's death and is governed by the terms of his will.

B. REVOCABLE LIVING TRUST

A revocable living trust (also referred to as an "inter vivos" trust) has become a popular probate avoidance tool. A revocable living trust can, as the name suggests, be revoked by the trustor. This means it is not a permanent distribution or transfer of assets. If an individual's circumstances change, so too can the trust.

Example.

Mitchell creates a living trust in which he placed all of his assets. The trust document makes Mitchell the trustee and the beneficiary during his lifetime. Upon his death, the trust will become irrevocable and the assets will be distributed to his designated beneficiaries, which in this case are his adult children.

Living trusts are commonly used to transfer the assets of the trustor after his or her death without the necessity of probate, which is the court supervised process of distributing the assets of a deceased. Any competent adult can establish a living trust. There is no minimum asset requirement, although the benefits typically increase with the size of an individual's estate or net worth. The trustor can either designate a trustee or serve in that capacity themselves. In some states, including California, a living trust can only be created by the participation of both spouses because the transfer of the property is merely gratuitous. An elective share is not applicable in California because of the community property laws. The pros and cons of living trusts are discussed in more detail in Chapter 7.

C. SUPPORT AND DISCRETIONARY TRUSTS

This type of trust is often used to provide for the needs of children, grandchildren or other family members without distributing the assets themselves. In some cases, the trustee is given discretion to determine the needs of the beneficiary.

> **Example.**
>
> *Mark is a 76-year-old man in failing health. He is the father of a 42-year-old son, Richard, who is mentally retarded. Mark wants to ensure that there are sufficient funds to continue to pay for Richard's group home and for all of his medical and other expenses. He creates a trust for the benefit of Richard and appoints Richard's brother, Michael, a CPA, as trustee. Michael has authority to make distributions from the trust as he deems necessary for the care and support of his brother. At Richard's death, the remaining funds are to be distributed to Michael and his other siblings evenly.*

D. CHARITABLE TRUSTS

This is the only type of trust that can be created to last forever. It is created to provide support for a cause or causes selected by the trustor.

> **Example.**
>
> *Linda is a wealthy woman who has a fondness for the arts. She establishes a trust to provide support for inner city art programs. The trust provides that an annual grant will be made to a local school that presents the best program. There is no duration for the trust. It will continue as long as there are proceeds available to make the annual grant.*

1. Tax Consequences

A charitable gift is 100% tax deductible. (Note, however, that certain taxpayers who donate a high percentage of their income to charity may be limited in how much can be deducted in one year.) Thus, the giving of a charitable gift saves both the amount of the gift in income from the donor's other income sources as well as the extinction of the tax that would have been owed had the donor retained the charitable sum in his or her estate.

2. Charitable Purposes

A charitable trust must have a valid charitable purpose. States have adopted legislation requiring the trustee of a charitable trust to file documentation regarding the trust with the state. Likewise, the statutes generally require the trustee file periodic statements of the transactions of the trust.

Table 1.2 Comparison of Common Types of Trusts

	Living Trust	**Testamentary Trust**	**Charitable Trust**
Description	Established during the lifetime of the trustor. It is managed by the trustor during his or her lifetime. Gives the trustor control of assets during their lifetime and directs their distribution after death.	Established at death by the terms of the trustor's will. Managed by trustee designated by the trustor. Allows trustor to designate how proceeds are to be distributed.	Established during the lifetime of the trustor. Gives control of the proceeds to a designated trustee or under the direction of the trustor. Gives income to charity and, if desired, can be distributed as a lump sum upon trustor's death.
Advantages	Gives the trustor control over assets in the trust both during their lifetime and after their death. Trust can be amended or revoked if circumstances change. Assets in trust generally do not go through probate after death of testator.	Useful tool to distribute assets at time of death and to control how assets are used through appointment of designated trustee. Can be used to ensure ongoing needs of beneficiaries are met after death.	Can be used to provide income for the trustor during his or her lifetime and then make contribution to designated charitable cause without probate and with some tax savings.

E. QTIP TRUSTS

A Qualified Terminable Interest Property Trust, or so-called QTIP trust, is generally for more wealthy persons. A provision of the Internal Revenue Code allows, as a marital deduction, a gift tax exemption of transfers of certain life estates to a spouse. For the exemption to apply, the donor must create a QTIP trust.

Remember that, generally, transfers between spouses qualify for a marital deduction and thus are exempt from gift or estate tax. However, if the transfer is in the form of a life estate or other terminable interest, the marital deduction is generally not allowed. These provisions notwithstanding, a further exception is allowed under the gift tax for qualified terminable interest property.

QTIP trusts are therefore often used to provide lifetime income for the surviving spouse and an estate for specified children after the spouse's death. In addition, the QTIP trust can minimize estate taxes by ensuring that the full value of the surviving spouse's Unified Tax Credit can be applied upon his or her death. The mechanics of this, and other types of more specialized trusts geared to wealthy clients, are discussed in detail later in the course.

F. RESIDENCE TRUSTS

1. Personal Residence Trust

A personal residence trust involves the transfer of a personal residence to a trust with the grantor retaining the right to live in the residence for a fixed term of years. Upon the shorter of the grantor's death or the expiration of the term of years, title to the residence passes to beneficiaries of the trust. This is an irrevocable trust with gift tax implications.

2. Qualified Personal Residence Trust

A qualified personal residence trust (QPRT) involves the transfer of a personal residence to a trust with the grantor retaining a qualified term interest. If the grantor dies before the end of the qualified term interest, the value of the residence is included in the grantor's estate. If the grantor survives to the end of the qualified term interest, the residence passes to beneficiaries of the trust. A QPRT is a grantor trust, with special valuation rules for estate and gift tax purposes, governed under Internal Revenue Code § 2702.

G. LIFE INSURANCE TRUST

An insurance trust is generally an irrevocable trust that owns insurance on the life of the grantor or grantor and spouse. The trust is designed to avoid federal estate taxation of the insurance proceeds on the deaths of the grantor or spouse. When premium payments or other gifts to the trust are made, the trust instrument grants specified beneficiaries Crummey withdrawal rights over the gifts so that they will qualify for the federal gift tax annual exclusion. These trusts would generally file a Form 1041 as a complex trust, if the $600 income requirement were met.

H. QUALIFIED SUBCHAPTER S TRUST (QSST)

A QSST is a statutory creature established by IRC § 1361(d)(3). By meeting the requirements of a QSST, a trust may own S Corporation shares. An election must be made to be treated as a QSST and once made is irrevocable.

I. LESS COMMON TRUSTS

1. Electing Small Business Trust (ESBT)

An ESBT is a statutory creature established by IRC §641(d). By meeting the requirements of an ESBT, a trust may own S Corporation shares. ESBT's must file Form 1041 and the S Corporation income is taxed at the trust's highest marginal rate. No income distribution deduction is allowed to beneficiaries. To be treated as an ESBT, an election must be made.

2. Funeral Trust

This is an arrangement between the grantor and funeral home/cemetery to allow for the prepayment of funeral expenses. The funeral trust is a "pooled income fund" set up by a funeral home/cemetery to which a person transfers property to cover future funeral and burial costs. These are grantor trusts with the grantor responsible for reporting income. The trustee may make an election on qualified pre-need funeral trusts to not be treated as a grantor trust, with the tax being paid by the trustee.

3. Rabbi Trust

An irrevocable trust that functions as a type of retirement plan or deferred compensation arrangement that offers a limited amount of security to the deferring employee.

4. Grantor Retained Trusts

a. Grantor Retained Income Trust

In a grantor retained income trust, the grantor creates an irrevocable trust and retains the right to all trust income for: (a) the earlier of a specified term or the death of the grantor; or (b) a specified term. If the grantor survives the specified term, the trust principal passes to others according to the terms and provisions of the trust instrument. For federal tax purposes, this trust is treated as a grantor trust.

b. Grantor Retained Annuity Trust

In a grantor retained annuity trust, the grantor creates an irrevocable trust and retains the right to receive, for a specified term, an annuity based on a specified sum or fixed percentage of the value of the assets transferred to the trust. A grantor retained annuity trust is specifically authorized by Internal Revenue Code §§ 2702(a)(2)(B) and 2702(b). For federal tax purposes, this trust is treated as a grantor trust.

c. Grantor Retained Unitrust

A grantor retained unitrust is similar to a grantor retained annuity trust. However, in a grantor retained unitrust, the grantor creates an irrevocable trust and retains, for a specified term, an annual right to receive a fixed percentage of the annually determined net fair market value of the trust assets (Treasury Regulation Section 25.2702-(c)(1)). For federal tax purposes, this trust is treated as a grantor trust.

5. <u>Business Trust</u>

The term "business trust" is not used in the Internal Revenue Code. The regulations require that trusts operating a trade or business be treated as a corporation, partnership, or sole proprietorship, if the grantor, beneficiary or fiduciary materially participates in the operations or daily management of the business. If the grantor maintains control of the trust, then grantor trust rules will apply. Otherwise, the trust would be treated as a simple or complex trust, depending on the trust instrument.

6. <u>Illinois Land Trust</u>

In Illinois, and in five other states, legislation has been enacted that creates a special type of trust, commonly referred to as an "Illinois Land Trust". These trusts are designed to house real estate within a grantor trust and provide limited access to grantor or beneficiary information contained in the trust instrument or known to the trustee. Once a land trust is established, the ability to trace property transactions becomes limited as state law establishes the right of the trustee not to disclose the true owner of the property or those with a beneficial interest.

7. <u>Delaware Business Trust or Alaska Business Trust</u>

These are trusts established to hold and invest assets with greater flexibility than allowed by most trusts. They permit limited liability, creditor protection, and valuation discounts. These trusts are a creation of the Delaware and Alaska legislatures and have no impact on taxation of trusts for federal purposes. These "business trusts" have no special distinction in the Internal Revenue Code and would be a simple, complex, or grantor trust depending on the terms of trust instrument. The regulations require that trusts operating a trade or business be treated as a corporation, partnership, or sole proprietorship, if the grantor, beneficiary or fiduciary materially participates in the operations or daily management of the business. Filing requirements would depend on this classification.

8. <u>Unincorporated Business Organization</u> (UBO)

A term used by trust promoters to identify trusts they sell and to disguise the fact that it is a trust. This term and the term "Massachusetts Business Trust" are often used interchangeably. These are not terms used by the Internal Revenue Code.

J. NOTE ON FOREIGN TRUSTS

Through 1996, a trust was foreign if the trustee, corpus, and administration were foreign. Since 1996, a trust is foreign unless a U.S. court supervises the trust and a U.S. fiduciary controls all substantial decisions. U.S. taxpayers are subject to filing Form 3520, *Creation of or Transfer to Certain Foreign Trusts,* Form 3520-A, *Annual Return of Foreign Trust With U.S. Beneficiaries*, and Form 926, *Return by a Transferor of Property to a Foreign Estate or Trust*, when contributing property to a foreign trust. These trusts are usually U.S. tax neutral and are treated as grantor trusts with income taxed to the grantor.

Foreign trusts that have income attributable to U.S. sources and are not grantor trusts are required to file Form 1040NR, U.S. Nonresident Alien Income Tax Return. Foreign trusts that have income attributable to U.S. sources and are grantor trusts would have that income directly attributable to the grantor (if U.S. grantor income, it must be included on Form 1040; if nonresident alien grantor income, it must be included on Form 1040NR).

III. Basic Trust Taxation Rules

A. OVERVIEW

All income a trust receives, whether from foreign or domestic sources, is taxable to the trust, to the beneficiary, or to the grantor of the trust unless specifically exempted by the Internal Revenue Code (IRC).

Foreign trusts to which a U.S. taxpayer has transferred property are treated as grantor trusts as long as the trust has at least one U.S. beneficiary. The income the trust earns is taxable to the grantor under the grantor trust rules. Grantor trusts are not recognized as separate taxable entities, because under the terms of the trust, the grantor retains one or more powers and remains the owner of the trust income. In such a case, the trust income is taxed to the grantor, whether or not the income is distributed to another party.

A legitimate trust is allowed to deduct distributions to beneficiaries from its taxable income, with a few modifications. Therefore, trusts can eliminate income by making distributions to other trusts or other entities as long as they are named as beneficiaries. This distribution of income is key to understanding the nature of the abusive schemes. In the abusive schemes, bogus expenses are charged against trust income at each trust layer. After the deduction of these expenses, the remaining income is distributed to another trust, and the process is repeated. The result of the distributions and deductions is to reduce the amount of income ultimately reported to the IRS.

B. FILING REQUIREMENTS

1. Domestic Trusts

A domestic trust must file a Form 1041, U.S. Income Tax Return for Estates and Trusts, for each taxable year. If the trust is classified as a Domestic Grantor Trust, it is not generally required to file a Form 1041, provided that the individual taxpayer reports all items of income on his own Form 1040, U.S. Individual Income Tax Return. Thus, the individual pays the total tax liability upon the filing of his return for that taxable year. All income received by a trust, whether from foreign or domestic sources, is taxable to the trust, to the beneficiary, or to the grantor unless specifically exempted by the Internal Revenue Code.

2. Foreign Trusts

Foreign trusts are subject to special filing requirements. If a trust has income that is effectively connected with a U.S. trade or business, it must file Form 1040NR, U.S. Nonresident Alien Income Tax Return. Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Foreign Gifts, must be filed on the creation of or transfer of property to certain foreign trusts. Form 3520-A, Annual Information Return of Foreign Trusts With U.S. Owner, must also be filed annually. Foreign trusts may be required to file other forms as well.

In addition to filing trust returns as just described, a taxpayer may be required to file U.S. Treasury Form TD F 90-22.1, Foreign Bank and Financial Accounts Report, if the taxpayer has an interest of over $10,000 in foreign bank accounts, securities, or other financial account. Also, a taxpayer may be required to acknowledge an interest in a foreign bank account, security account or foreign trust on Schedule B, Interest and Dividend Income, that is attached to Form 1040.

CHAPTER 1 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. What term is used to describe a trust created during the life of the donor:

   a) testamentary trust
   b) inter vivos trust
   c) grantor trust
   d) QTIP trust

2. Which of the following types of trusts can be created to last forever:

   a) residential trust
   b) QTIP trust
   c) charitable trust
   d) all of the above

3. All income a trust receives, whether from foreign or domestic sources, is taxable to the trust, to the beneficiary, or to the grantor of the trust unless the Internal Revenue Code specifically exempts it.

   a) true
   b) false

CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A testamentary trust is one that is created upon the death of the grantor or trustor.

   B: Correct. Inter vivos is Latin for “during life” and refers to a trust which a trustor creates to take affect during his or her lifetime rather than after death.

   C: Incorrect. A grantor trust is a generic term and is not the correct answer.

   D: Incorrect. A QTIP trust is a type of estate planning tool.

   (See page 1-2 of the course material.)

2. A: Incorrect. A personal residence trust involves the transfer of a personal residence to a trust with the grantor retaining the right to live in the residence for a fixed term of years. It cannot last in perpetuity.

   B: Incorrect. A QTIP trust is designed to provide income to the surviving spouse. It cannot last forever.

   C: Correct. A charitable trust is the only type of trust that can be established to last in perpetuity.

   D: Incorrect. Only one response is correct.

   (See pages 1-5 to 1-7 of the course material.)

3. **A: True is correct.** A domestic trust must file a Form 1041, U.S. Income Tax Return for Estates and Trusts, for each taxable year.

   B: False is incorrect. A legitimate trust is allowed to deduct distributions to beneficiaries from its taxable income, with a few modifications. Therefore, trusts can eliminate income by making distributions to other trusts or other entities as long as they are named as beneficiaries.

   (See pages 1-10 to 1-11 of the course material.)

Chapter 2: An Introduction to Estate Planning and Probate

I. Probate: An Introduction

One of the basic rights American adults have is the right to decide how to distribute their assets at the time of their death. This doctrine, commonly referred to as "testamentary freedom," generally means people are free to dispose of their assets as they see fit, even if such disposition is "unfair" or "unjust" in the minds of some.[1] A decedent is free, for example, to disinherit a child he or she believes has become a spoiled brat or to leave all of his or her assets to the American Humane Society. Inherited wealth may be a fabric of this country, but it is by no means mandated by the law.

There are a number of ways that an individual can arrange for his or her assets to pass to the individual's heirs upon death. The most common and well-understood is a will, a document that conforms to the requirements of the applicable state law in which the decedent's desires are set forth. Dispositions of property made through a will are typically subject to probate. Probate refers to the court-supervised distribution of assets. This can be done either pursuant to a valid will or, in cases where a decedent has no valid will, according to the applicable state's law of intestate succession.[2]

Typically, transfers at death may be divided into those subject to probate (that which passes according to a decedent's will or the laws of intestate succession) and non-probate transfers. Probate refers to the process under which property would pass under a will, if any, and in the absence of a will, property that would pass under the intestacy laws of the state.

Non-probate covers all the rest of the property that is passed to heirs through a variety of legal mechanisms, often based in contract. Examples of common transfers of property at death that do not involve probate are:

- Property passed under the terms of a trust;
- Individual retirement accounts;
- 401K plans;
- Proceeds from a life insurance policy;
- Joint bank accounts; and
- Real property held in joint tenancy.

---

[1] There are some limited exceptions to this doctrine, particularly in the case of providing for a surviving spouse or minor child.

[2] The law of intestate succession governs the distribution of assets when a decedent dies without a will. Each state has a formula for dividing assets under such circumstances. The law tries to assume how a decedent would have wanted his or her assets distributed, i.e. to the surviving spouse, children and parents.

A. OVERVIEW OF PROCESS

The term "probate" generally refers to the court procedure for validating a will and passing ownership of property from a decedent to others. Probate is simply the process by which property of the decedent is collected. Debts and taxes are then paid. The remainder is distributed to the heirs. This process is overseen by the appropriate court in each state.

Probate costs depend on the complexity of the estate and amount of professional assistance required. In some states, attorneys and personal representatives are allowed to charge a percentage of the estate; in other states, they are limited to flat or hourly rates.

Factors that complicate probate include the existence of minor beneficiaries, disputes among heirs, insolvency and other circumstances requiring formal probate. It is both the cost and the time that make probate avoidance an important estate-planning goal of many people. In many states, it can take a year or longer to probate an estate, even if there are no legal challenges. While the formal probate process can vary somewhat from state to state, the process involves the following steps:

- Filing the will of the deceased with the appropriate court (in some states, individuals pre-file their wills with a court prior to their death) by the decedent's executor or personal representative;
- Taking an inventory of the property of the deceased;
- Appraising the property of the deceased (using professional appraisers in appropriate circumstances, e.g. real estate);
- Paying all debts of the decedent, including estate taxes;
- Proving to the court that the decedent left a valid will; and
- Distributing the property to the heirs.

In some cases, of course, an individual may die without ever having executed a will or executing a will that is, for a variety of reasons, not valid. In such cases, probate is still necessary. Rather than distributing the property according to the wishes of the decedent, a court in such a case will order distribution according to the laws of intestate succession in each particular state.

It is also important to note that probate is not necessarily something to dread. One advantage of probate, for example, is a shortened statute of limitations for creditors who have claims against the decedent's estate. A decedent's creditors generally have a very limited period of time to submit claims against the estate once a personal representative is appointed. If they are not made in a timely fashion, they are barred. If, however, there is no probate because assets are transferred through a living trust, these statutes do not apply. The estate will have to wait longer for creditor claims and has affirmative obligations to notify potential creditors through publication of notices in local newspapers.

B. PROBATE FEES

Time and expense are the two factors cited as reasons to try to avoid probate. Probate fees vary significantly from state to state.

II. Probate Avoidance

Executing a valid will does not mean the decedent's estate will escape probate. There are, however, many ways to avoid probate either totally or in part. These mechanisms are sometimes referred to as "will substitutes." They are simply ways to transfer property without the necessity of a will and, therefore, probate. Common mechanisms include living trusts, gifts and joint tenancies.

Table 2.1 Common Probate Avoidance Tools

Tool	How It Works
Life Insurance	Proceeds are paid directly to beneficiary following death of insured
Joint Tenancy	Decedent's interest in property passes automatically to surviving joint tenants
Pay-on-Death Accounts	Funds are immediately dispersed to survivor(s) beneficiary
Trusts	Flexible vehicle that vests interest in money or property in trust subject to conditions established by trustor
Gifts	Individual transfers title to property to another person before his or her death

A. GIFTS

Gifts made prior to the donor's death are not subject to probate. These gifts are commonly referred to as *inter vivos* (Latin for "during life") gifts. The reason such gifts are not subject to probate is obvious: once given, the subject matter of the gift is no longer part of the decedent's estate. In order to make a valid gift before death, all of the following elements must be present:

- The intent on the part of the donor to make a present transfer;
- Delivery of the gift, either actual or constructive; and
- Acceptance of the gift by the recipient.

Example 1.

John was recently diagnosed with terminal cancer. He is the owner of a prized guitar that he knows his nephew, Matthew, would love to have. John calls Matthew on the phone and says: "You have been a loving, loyal nephew. I have just found out that I am dying and I would like to give you my guitar before I die." Matthew says he accepts the gift and will cherish it always. John hangs up the phone and dies. Because the guitar was never delivered, it was not an effective gift and the guitar will be

disposed of according to the terms of John's will, if any, or through the laws of intestate succession.

Example 2.

Bill has nine grandchildren, and would like to give each one something special before he dies. He calls his grandson Robert and says: "I would like you to have my class ring from 1943. It means a lot to me." Robert says he appreciates the gesture, but would rather not take anything from his grandfather as long as he is alive. Bill dies and in his will leaves everything to his wife, Maria. Robert goes to Maria and demands the ring, which he claims was gifted to him by Bill. Because Robert did not accept the gift when offered, the gift was never completed and Maria is under no legal obligation to give him the ring.

Example 3.

Julian was planning on going backpacking for the weekend. Fearing his new expensive watch would be scratched, he asked his roommate Felix to hold it for him until he returned. Julian was tragically killed during the trip. When Julian's parents asked Felix to return the watch he refused, asserting that Julian had given it to him as a gift. However, because Julian never intended to give the watch to Felix permanently, there was no gift. Assuming Julian's parents are his heirs, Felix must hand over the watch.

One reason gifting is a common probate avoidance tool is that gifts up to a certain amount are not subject to federal gift tax. The limit for 2010 and 2011 is $13,000 per year, meaning that each person can give a gift to any other person up to $13,000 per year without tax consequences. Not only are such gifts without tax consequence, they reduce the size of the decedent's estate. This is important if the individual's estate is greater than the amount which is exempt from estate taxation.

In addition, even if an individual makes a gift that exceeds the yearly maximum, that gift will not be taxable until the death of the donor. And even then, tax is only due if the total value of the estate exceeds the current federal exemption level.

B. JOINT TENANCIES

Joint tenancy ownership is a terminable interest that terminates at death. When one joint tenant dies, the other joint tenant(s) succeed to the property without probate. Joint tenancy is an often overrated but sometimes useful probate-avoiding device. It is a way for two or more people to own property together. For estate planning, its most important feature is survivorship: When one joint owner dies, the surviving owners automatically inherit the property. No probate is necessary.

Joint tenancy can work well as a probate-avoidance method for property an individual acquires with someone else or if an individual transfers property he or she already co-owns (or is buying) with someone into joint tenancy. But making someone else a joint tenant of property an individual owns alone, just to avoid probate, is often a bad idea. The new owner could sell his or her half-interest, or the new owner's creditors could go

after it. And the individual may be in trouble if he or she changes his or her mind and decides he or she wants the property to go to someone else at his or her death.

For people in their seventies or eighties, there is another big disadvantage of adding someone as a joint tenant: The new owner misses out on the potentially huge income tax break. If an individual leaves property to someone upon death, the property gets a "stepped-up" tax basis. The basis is the amount from which taxable profit is figured if the new owner ever sells the property.

When property is transferred at death, the basis goes up to the value of the property at the decedent's death. This is good because the higher the tax basis, the lower the taxable profit if and when the property is sold.

On the other hand, if an individual gives away property while they are alive, by making someone a joint owner of his or her property, the tax basis of that half of the property is not "stepped up" at his or her death – it stays what it was when they acquired the property. This means that if the property goes up substantially in value before the person's death, the owner will owe a big tax when it is eventually sold.

Example.

The tax basis in Ellen's house is $120,000, the amount she paid for it years ago. She puts her house into joint tenancy with her daughter, which means her daughter already owns half the house before Ellen dies. When Ellen dies, the house is worth $200,000. But only the half that is transferred at death gets a stepped-up tax basis from $60,000 to $100,000. So the new basis is $160,000. If the daughter sells the house later for $230,000, she will owe tax on $70,000.

If, however, Ellen transfers the house to her daughter at death, her daughter's tax basis will increase to $200,000, its value at Ellen's death. If she sells the house later for $230,000, her taxable profit will be only $30,000.

Note also that when property is converted from sole ownership to a joint tenancy, it may result in gift tax to the donor. While there are exceptions, as a general rule a husband and wife should always hold title to real property as joint tenants.

C. PAY-ON-DEATH ACCOUNTS

Pay-on-death accounts (so-called POD accounts) allow an owner to have the proceeds disbursed to a beneficiary at death without any current right to withdraw funds. Pay-on-death accounts are also known as informal bank account trusts, Totten trusts, and bank trust accounts.

Using a payable-on-death (POD) or transfer-on-death (TOD) account is the simplest way to keep assets held in bank and brokerage accounts from becoming part of an individual's probate estate. The assets in the account pass directly to the owner's named beneficiary and bypass probate, the court proceedings that validates the owner's will after their death and transfers property to the owner's heirs after debts and taxes are paid.

Example.

William wants the money in his savings account to go to his son Rob upon his death. All William needs to do is put the account in his name, with a notation that he owns the account "as trustee for the benefit of Rob Stewart." Rob won't have any rights to the money in the account while William is alive. But when William dies, he will automatically own whatever funds are in the account. No probate will be necessary; the bank will turn over the funds to him when presented with a copy of William's death certificate and proper identification.

An individual's will does not control who inherits a POD or TOD account. With a POD/TOD account, the owner can name a new beneficiary at any time, the owner does not have to leave anything in it, and the beneficiary's creditors cannot grab the assets while the owner is still alive.

Not all states have a POD/TOD law. Even without a law, individuals can probably make use of the accounts by doing business with a broker or a bank based in a state that has one on the books.

D. RETIREMENT ACCOUNTS

Retirement accounts such as IRA's, Keoghs, and 401k plans were not intended to be probate-avoidance devices, but can be used that way. All an individual needs to do is name a beneficiary to receive any funds still in the account at his or her death. The beneficiary will get the funds without probate. The only restriction is that to avoid penalties, after age 70½, the individual must withdraw a certain amount from the account every year. The amount is recalculated every year, based on the individual's life expectancy.

E. LIFE INSURANCE

Life insurance is a contract purchased by an individual that stipulates that, upon his or her death, certain proceeds will be paid to a predetermined beneficiary or beneficiaries. These proceeds are paid directly to the beneficiary or beneficiaries and are not subject to probate. There are a number of different types of life insurance, each of which contains this probate-avoidance mechanism.

Gifting life insurance is a popular way of transferring wealth without significant tax implication. The gift tax is assessed on the value of the policy at the time of transfer (not on its cash value at the time of the insured's death). To be an effective gift for tax purposes, the policy must be given away at least three years before the donor's death.

III. <u>Probate Reform and Informal Probate</u>

A. PROBATE REFORM STATUTES

Given the expense and time sometimes involved in probate, a number of states are taking or have taken steps to reform or streamline the probate process. In addition, most states have some form of simplified or informal probate allowing many estates to be probated informally with minimal court supervision. In some states, this is called a Small Estate Probate, generally for estates under $25,000.

The California Probate Code, for example, provides that probate estates of $100,000 or less do not need to be probated. In some cases, the actual estate may be well in excess of $100,000, but this provision in the law can still be used. The reason is that many assets are not included in the definition of a probate estate, such as life insurance (unless it was payable to the estate), IRAs, 401Ks, assets held by a living trust, and joint tenancy assets.

Estates of less than $100,000 of probate assets are administered by preparing affidavits which are presented to the various institutions (banks, brokerages, etc.) that hold the assets. The assets are then turned over to the person named as executor in the will, and distributed according to the will. If there is no will, the assets are distributed according to the rules of intestate succession (in other words, to the nearest relatives of the deceased).

If the decedent is survived by a spouse, the spouse can file a spousal property petition with the court. The purpose of this petition is to change the titles of the assets to the surviving spouse's ownership. The petition is a simplified probate, and takes much less time than a full probate. Legal fees are usually much lower for this type of petition than a full probate.

B. UNIFORM PROBATE CODE

In states that have adopted the Uniform Probate Code, for example, an informal and independent probate administration is available. This informal probate process permits a probate administration to proceed unsupervised by any court.

The following states have adopted the Uniform Probate Code: Alaska, Arizona, Colorado, Florida, Hawaii, Idaho, Maine, Michigan, Minnesota, Montana, Nebraska, New Mexico, North Dakota, South Carolina, South Dakota, and Utah.

C. STEPS FOR INFORMAL PROBATE

Informal probate can generally be reduced to the following steps:

- One of the heirs or the Personal Representative (Executor) named in the will submits a written probate application;
- If the application is acceptable, the court appoints the Personal Representative;
- Court or Personal Representative publishes notice of probate;

- Personal Representative notifies heirs, beneficiaries and decedent's creditors of probate;

- Court issues a document authorizing the Personal Representative to act (usually called Letters Testamentary or Letters of Administration or Letters of Authority);

- Personal Representative verifies the deadlines for probate filings and for tax returns and determines who will do the work (personal representative, attorney or tax preparer);

- Personal Representative lists, values and collects decedent's property and may sell the decedent's home or other assets;

- Personal Representative files tax returns and pays tax and other debts of the decedent and estate;

- Personal Representative makes a full accounting to the beneficiaries and distributes the remaining property according to the will or, if none, according to state law; and

- Personal Representative notifies the court that probate is complete.

Every state's law is different, however, so financial planners need to work in concert with estate attorneys to provide their clients with the best plan of action.

D. ADMINISTRATIVE COSTS

The administration costs of an informal probate can be divided into three categories:

- Direct fees, including court filing fees and the cost of completing an inventory of the decedent's estate;

- Transfer costs associated with transferring assets to the beneficiaries such as transferring title to real property (these costs are normally the same regardless of whether the estate is subject to probate); and

- Costs associated with computing applicable estate and gift taxes, including appraisals of property (this cost is generally also the same whether or not an estate is subject to probate).

IV. Testamentary Trusts: The Elements of a Valid Will

One of the most common ways of establishing a trust is through a will at the time of death. These types of trusts are commonly referred to as testamentary trusts. To fully understand the rules involved in the creation of a testamentary trust, it is essential to understand the requirements involved in executing a valid will. First, as with a trust, there are a number of key reasons people execute a will.

A. THE VALUE OF A WILL

1. <u>Choosing Beneficiaries</u>

The intestate succession laws of the state in which an individual lives determine how that person's property will be distributed if he or she dies without a valid will. For example, in most states the property of a married person with children who dies intestate (i.e., without a will) generally will be distributed one-third to the spouse and two-thirds to the children, while the property of an unmarried, childless person who dies intestate generally will be distributed to his or her parents (or siblings, if the parents are deceased).

These distributions may be contrary to what the individual wants. In effect, by not having a will, the individual is allowing the state to choose his or her beneficiaries. Further, a will allows the individual to specify not only who will receive the property, but how much each beneficiary will receive. A will is also generally required if someone wishes to leave all or part of his or her estate to a charity.

2. <u>Minimizing Tax Liability</u>

Many people feel they do not need a will because their taxable estate does not exceed the amount allowed to pass free of federal estate tax (for those dying in 2011, for example, this amount was $5.0 million plus whatever goes to a surviving spouse or charity. However, an individual's taxable estate may be larger than he or she thinks.

For example, life insurance, qualified retirement plan benefits and IRAs typically pass outside of a will or estate administration. But, these assets are part of an individual's federal estate and can cause his or her estate to go over the threshold amount. Also, in some states an estate becomes subject to state estate or inheritance taxes at a point well below the federal threshold. A properly prepared will is necessary to implement estate tax reduction strategies.

3. <u>Appointment of a Guardian</u>

If for no other reason, individuals with minor children should prepare a will to name a guardian for minor children in the event of their death without a surviving spouse. While naming a guardian does not bind either the named guardian or the court, it does indicate the parent's wishes, which courts generally try to accommodate.

> **Example.**
>
> *William is a single parent. His wife died of cancer three years ago. He is raising his two daughters, ages 7 and 9, alone. William has one sister and one sister-in-law -- the sister of his deceased wife -- who he dislikes. William finds out he has prostate cancer and decides to draft a will. In it, he stipulates that he would like his sister to become guardian of his two daughters. Although a court must still review the appointment of his sister to determine if she would be an appropriate guardian, William's wishes will most likely be respected in the absence of evidence that she would be unfit. Without such a provision, a court could have granted guardianship to his sister-in-law.*

4. Naming an Executor

Without a will, an individual cannot appoint someone he or she trusts to carry out the administration of his or her estate. If the individual does not specifically name an executor in a will, a court will appoint someone to handle the estate, perhaps someone the person might not have chosen.

Example.

John has a sizeable estate consisting of real property, stocks and bonds and an impressive art collection. Concerned about effectuating his wishes upon death, John drafts a will in which he names his cousin, Phillip, to be executor of his estate. Although he has two brothers, John believes that Phillip is most likely to carry out his wishes. His two brothers only call John when they want money and have no understanding or appreciation for his art collection.

5. Establishing Domicile

An individual may wish to firmly establish domicile (permanent legal residence) in a particular state, for tax or other reasons. If a person moves frequently or owns homes in more than one state, each state in which he or she resides could try to impose death or inheritance taxes at the time of death, possibly subjecting the individual's estate to multiple probate proceedings. To lessen the risk of this, an individual in this position should execute a will that clearly indicates his or her intended state of domicile.

Example.

Esther is a wealthy widow with homes in Hawaii, California and Rhode Island. She lives at each home about one-third of the year. Concerned about state tax laws in California and Hawaii, Esther wants to ensure that the probate of her estate falls under Rhode Island law. As such, she drafts her will in compliance with the formalities of Rhode Island state law and in the document specifies that her permanent home is in Rhode Island.

B. FREEDOM OF DISPOSITION

There are very few restrictions on how a competent adult can choose to dispose of his or her estate. A widower with three adoring adult children and fifteen grandchildren is free to leave his entire estate to his third cousin. Freedom of disposition is a hallmark of American law and another key reason adults should draft a valid will – the laws of intestate succession may not distribute property in the way the decedent would have preferred. Nonetheless, there are a few types of restrictions common in the laws of most states.

1. <u>Charitable Donations</u>

Many states limit the right of a testator to make a bequest to charitable organizations if the will is executed within too close a time frame to the testator's death, e.g. 60 days as in the case of Florida law. The main purpose behind these types of restrictions is to limit the potential for undue influence on testators, particularly on those who are facing impending death. However, in some cases if there is evidence that the testator made a similar gift in a prior will, it will be given effect regardless of the statute.

Other states limit the right of a testator to give more than a certain percentage of his or her property to charities regardless of the time frame in which the will is drafted. Such limitations are designed to protect the interests of the decedent's surviving family. Once again, the key is to look to individual state law when formulating any estate plan.

Even if a state statute appears to restrict an individual's desired testamentary provisions, there may be alternatives available, including gifts to specific individuals rather than organizations as a whole, i.e. a gift left to a priest rather than the Catholic Church, or through the use of a trust established prior to the decedent's death.

2. <u>Conditional Dispositions</u>

Most states have express limits to the types of conditions that a testator can place on beneficiaries as a condition for inheriting property. Both as a matter of public policy and as a matter of the impracticability of oversight from-the-grave, restrictions are generally invalid.

Example.

Nathan has a beautiful daughter, Lois, whom he adores, but detests her husband, Martin. In his will, Nathan leaves his entire estate to Lois on condition that she divorce Martin within one year of his death. A court will invalidate this restriction on the grounds of public policy.

3. <u>Illegal Activities</u>

Provisions of a will to support or encourage illegal activities will not be enforced. For example, a bequest to Osama Bin Laden to support efforts to overthrow the United States government would be declared invalid. Likewise, it has long been the law that no individual can profit from misdeeds. This means that someone responsible for the death of the testator cannot be a beneficiary of that individual's estate.

Example.

Richard hates his father, Joseph, and cannot wait until he dies so he can inherit his property. Richard hires a hit man to kill his father. Because he is responsible for his father's death, Richard is not eligible to be a beneficiary of his father's estate.

4. Pets as Beneficiaries

Only human beings are entitled to be legal owners of property. As such, dispositions that name a pet as a beneficiary are not enforceable in this country. However, there are a handful of states that allow individuals to establish a trust for the benefit of a pet, including Alaska, Arizona, California, Colorado, Florida, Iowa, Michigan, Missouri, Montana, New Jersey, New Mexico, New York, North Carolina, Oregon, Tennessee, and Utah.

Other methods for ensuring the well-being of a pet include making informal arrangements to have a friend or relative take in a pet in the event of death and leaving that individual a gift to help provide for the needs of the pet. In such a case, the testator should make the gift outright and not condition it on the care of the pet, which would likely be an unenforceable provision.

C. TYPES OF BENEFICIARIES

1. Primary and Contingent

Simply put, a beneficiary is an individual (or institution, group, charity, etc.) who is designated to receive a gift through a will or trust. In many if not most cases, there is little need to discuss "types" of beneficiaries.

> **Example**.
>
> *In his will, Larry left his 1965 Porsche to his nephew, Robert, who loves cars. Robert is the beneficiary of the gift of the car.*

But what if Larry is concerned that Robert, who has cancer, might not recover and be able to enjoy the car. He still wants Robert to have the car, but wants to ensure that if Robert does not survive the cancer treatment, the car will go to someone else who appreciates fine automobiles. In such a case, Larry could revise his will to provide that in the event Robert does not survive him, the car should go to his grandson William. William is a "contingent" beneficiary. That means he is only entitled to receive the gift if a contingency occurs, in this case the death of Robert. Robert would be referred to as either the "primary beneficiary" or simply as the "beneficiary."

2. Income Beneficiary

In some cases, a testator or trustor may wish to make a gift that includes income from certain property but not the underlying property itself.

> **Example 1.**
>
> *Roger drafts a will in which he leaves income from his apartment complex to his sons Richard and Rob, while his wife, Rose, remains the owner of the apartments. Richard and Rob are "income beneficiaries," as they are entitled to the income only from the asset.*

Example 2.

Stanley establishes a trust for the benefit of his children, Susan, Emily and Alex. The three are entitled to income from the property during their lives, with the remainder of the assets being distributed to their children upon their death. Susan, Emily and Alex do not have any rights to distribute the property within the trust. They are only entitled to income during their lifetimes. They are therefore income beneficiaries.

D. POWER OF APPOINTMENT

In some cases, a testator may be unsure who should receive certain property upon his or her death. Rather than let the property pass through intestate succession, the testator can choose to establish a power of appointment. A power of appointment is the authority given to a person designated in a will or trust to distribute certain assets at his or her discretion. A power of appointment can be either general or special. Under a general power of appointment, the person appointed has total discretion as to whom should receive the gift.

Example.

Karen is a single woman who is unsure who should receive her mother's wedding ring. Karen includes a provision in her will giving her brother, Eric, the power to determine who should receive the heirloom. There are no restrictions placed on Eric, so this is referred to as a general power of appointment.

With a special power of appointment, on the other hand, the testator or trustor establishes guidelines that the person appointed must follow in choosing a beneficiary.

Example.

Connor leaves a valid will in which he appoints his wife, Lisa, to choose which of his six children should receive his prized coin collection. Because Lisa must choose between the children (she is not allowed to consider anyone else to receive the gift), she is said to have a special power of appointment.

This type of restriction is also referred to as a limited power of appointment.

E. TYPES OF ESTATES

In most cases, people own property in a form that is referred to using the archaic British terminology as "fee simple." This means that the owner has total ownership of the property in question. The owner may hold it and dispose of it during life or death in any manner he or she so chooses.

Example.

Brian dies with a will that leaves his one-half interest in his home to his wife, Linda. Linda is said to have a fee simple in the home. It is hers to live in or sell or otherwise dispose of as she wishes.

There are times a testator or trustor may want to leave the same property to more than one beneficiary. How can that be achieved? Through what is called a "life estate."

Example.

Brian dies with a will that leaves his farm to his wife, Linda, for as long as she should live, and then to his son Collin. Linda does not receive a fee simple to the farm; she receives a life estate only. When she dies, the farm passes to Collin, who will become the owner in fee simple. Collin is referred to in this scenario as a "remainderman," namely the individual who is to receive the remainder of the estate following the end of the life estate.

F. OVERVIEW OF WILL FORMALITIES

Each state has its own set of laws governing the formalities of a will. Many states, for example, do not recognize holographic (handwritten) wills. Some states require witnesses to the execution of a will to see the testator physically sign the document while others merely require them to witness the testator acknowledge the document as his or her will. A few of the most significant formalities will be discussed here. As always, however, refer to the laws of each particular state for definitive guidance.

1. <u>No Specific Language Required</u>

To be valid, a will is not required to begin with the language*: "I John Doe, being of sound mind and body, do hereby* …" That is largely the language of the movies. It does, however, incorporate a few important components about the laws of wills. In general, these laws are all designed to ensure a number of things all designed to protect the interests of the testator:

- That the person was competent at the time the document was executed;
- That the person intended the document to serve as his or her will; and
- That the document has not been tampered with and in fact contains the wishes of the decedent.

Table 2.2 Major Requirements for Drafting a Valid Will

Age	Testator must be of legal age to make a valid will; in most states the age is 18.
Mental State	An individual must be of "sound mind" to draft a valid will. This generally means he or she must understand the nature of his or her assets and the people who would normally be expected to receive them.
Intent	The testator must intend that the document he or she is executing be his or herr will.
Voluntarily Executed	The testator must voluntarily execute the will through his or her signature. A signature under duress does not create a valid will.
Writing	Most states require that to be valid a will be in writing and witnessed.
Form	All states have standards for a will to be valid, including a requirement that the executing of the will be witnessed, normally by at least two people.
Execution	To be valid, a will must be executed by the testator, which includes the testator's signature, attestation that the document is his or her will, date and place of signature.

There is no precise formula for drafting a valid will. Most people are competent to do so without the assistance of a lawyer. There are, however, a few formalities that are required in every state:

- The testator must be of legal age to execute a will. In most states, this is 18 years old;

- The testator must be of sound mind, i.e. he or she must possess testamentary capacity. Incapacity is one of the most common grounds for challenging the validity of a will;

- The purported will must make specific provisions for the distribution of property and must indicate that the testator intends the document to serve as his or her will. There are no precise words that are required. The intent of the testator can be gleaned from the document itself, and sometimes through the examination of extrinsic evidence as well;

- The will must be voluntarily signed by the testator. This requirement prevents documents from being valid when executed in the face of undue influence;

- Wills must generally be in writing and witnessed (oral wills are permitted in limited circumstances in some states). A few states, including New Hampshire, also require a will to be notarized; and

- Finally, wills must be properly attested at the end of the document. So-called attestation clauses appear at the end of the document and provide a statement that the document is indeed the will of the testator. This must be accompanied by the signature of the testator.

2. Holographic Will

Roughly 20 states allow testators to draft a will in their own handwriting, referred to as a holographic will. This type of will is normally unwitnessed and must be entirely in the handwriting of the testator to be valid.

In California, there is no requirement that the will be entirely in the handwriting of the testator. The material provisions are in the handwriting of the testator. The signature and the date must be in the testator's handwriting. The California Probate Code allows either the testator's handwriting *or* a commercially printed will but not a personally typed will. California often allows *letters* to be admitted as a holographic will. The court will merely strike the surplusage. The letter must identify the person or persons to whom the estate should go.

Under California law, extrinsic evidence is admissible to determine whether a document constitutes a will or to determine the meaning of a will or portion of a will.

G. TESTAMENTARY CAPACITY

To make a valid will, a testator must be of sound mind at the time the will is executed. The fact that the testator later becomes incompetent does not affect the validity of the will.

> **Example.**
>
> *John is a healthy 30-year old husband and father of three. Believing in the value of estate planning, John drafts a valid will leaving all of his estate to his wife and children. At the age of 40, John is involved in a tragic accident that renders him in a permanent vegetative state. He lives another year before finally dying. The fact that John was mentally incompetent for the one year prior to his death does not negate the validity of the will he drafted when he was 30. He was competent at the time and therefore his will is valid.*

What does it mean to be competent? For purposes of executing a valid will, competency normally requires the following:

- The testator knows that he or she is executing a will;
- The testator knows the nature and extent of his or her property (i.e. he knows that he owns a penthouse apartment in Manhattan and a collection of motorcycles); and

- The testator knows who his family members are, i.e. the people who would ordinarily be expected to inherit the testator's property.

H. WITNESSES

1. Presence of Witnesses

Most states require two witnesses for a formal will. The general rule is that both witnesses must be present at the same time – either when the will is signed or when the testator acknowledges the document as his or her will. Witnesses are required for several reasons:

- First and foremost, the witness serves an evidentiary function by being able to vouch for the genuineness of the document; and

- The witnesses provide some assurances that the document has not been executed under duress.

Some states require the witnesses to sign the will in the presence of the testator while others do not. In California, for example, there is a requirement that the witnesses be *together* when the testator signs or acknowledges the will, but neither witness has to be in the other's presence or in the testator's presence when they sign the will. Once again, it is critical that every individual consult his or her applicable state law before executing a will to ensure that all formalities have been complied with.

2. Requirement That Witness Be Disinterested

Witnesses to a will should be chosen with the thought that someone may challenge the validity of the will. Many states specifically require a witness to a will to be credible. Some take the view to mean that a witness cannot have a stake in the will, that is be a beneficiary of the estate.

3. Witness Fails to Sign Before Death

To be valid, a will must be properly executed, including witnessed, prior to the testator's death. Suppose, for example, that a testator requests two parties to witness the will and that those witnesses are secretaries in the law office where his will was drafted. The will is taken to another part of the office and one witness signed the document immediately but the other did not sign until the next morning. In the interim, the testator died. In such a case, a court is almost certain to find that the will is not valid.

I. DISINHERITING RELATIVES

One of the requirements for finding that a will is valid is that, at the time the will was executed, the testator had an understanding of the nature of his or her property and those people who would normally be expected to inherit it.

Generally, for example, a man with a wife and three children can be expected to leave at least the bulk of his estate to his spouse and offspring. In other words, it would be surprising for the family to discover, at his death, that his property is being left to the humane society or to a long-lost cousin he had not seen in over 40 years. Yet this does not mean that individuals are required to leave their property to their family, or even that they are required to divide it in equal amounts. Individuals who are otherwise competent have freedom to dispose of their assets in the manner they deem best.

In general, failing to mention a particular individual in your will means he or she is entitled to nothing. When a spouse or child is involved, however, the situation is slightly more complicated.

It is easy to disinherit anyone other than your spouse or a child. The rule is very simple: anyone not mentioned in your will won't inherit any of your property, but the rules for spouses and children are somewhat more complex.

1. <u>Disinheriting a Spouse</u>

State law generally precludes an individual from completely disinheriting his or her spouse. In community property states, for example, each spouse automatically has a one-half interest in the estate of the community. An individual can, however, dispose of his or her half of the community property as well as his or her separate property in any manner he or she wishes.

Other states provide that a spouse is entitled to between one-quarter and one-half of his or her mate's estate, regardless of what is contained in a will. Therefore, a spouse that has been disinherited can go to court and challenge the testator's disposition. It will then be recasted in accordance with the applicable state law.

> **Example.**
>
> *Marla drafts a will in which she leaves nothing to her drunken husband Alfred and everything to her three sons, divided equally. Alfred has the right to challenge the disposition. Depending on their state of residence, he will be entitled to a statutory minimum amount of the estate. The remainder will then be divided equally among Marla's sons, as her will directed.*

2. <u>Disinheriting Children</u>

Despite popular opinion to the contrary, a child has no right to receive the assets of his or her parents when the parents die. There are certain statutory restrictions in many states, but most of these are designed to protect the welfare of minor children.

In addition, state law protects the interests of a child who has been accidentally left out of a will, i.e. a child who was born after the decedent's will was executed.

J. THE ART OF DRAFTING

If a testator wants a court to enforce his or her wishes at death, the most important thing he or she can do is to very clearly draft the provisions of his or her will. While not required, it is also recommended that an explanation for each disposition be given. This will help a court enforce the wishes of the testator in the event the will is challenged. Beyond that, the following are recommendations that can help in the drafting of a clear and enforceable will.

1. Gifting Personal Property

Testators should clearly identify each beneficiary and each item that is being given. Language such as "I leave my piano to my favorite sister" may seem clear at the time it is drafted, but may be very unclear to a probate court several years later. Identification of the personal property should also be as detailed as possible. Leaving "my red convertible to my golf partner" is not clear if in fact the testator owns two red convertibles.

2. Class Gifts

Suppose that Mary is a widow with no children of her own but who has three nephews she loves very much. Mary would like to leave her property to the three nephews. How should she draft her will?

> **Example 1.**
>
> *"I hereby leave all of my property to my loving nephews."*
>
> **Example 2.**
>
> *"I hereby leave all of my property to be divided equally between my nephews Thomas Johnson, Richard Johnson and Lewis Johnson."*

Suppose that after execution of her will and prior to her death, Richard dies. What happens to his share of the estate? Under Example 1, the entire estate would be divided between Thomas and Lewis. The heirs of Richard would take nothing from the will. Under Example 2, however, Richard's heirs, i.e. a wife or a son, would normally be entitled to his one-third share of Mary's estate. The key with all testamentary dispositions is to be as precise as possible in describing the property as well as the beneficiaries and what should happen in the event an intended beneficiary dies prior to the death of the testator.

Likewise, if a testator wants a class to share in a gift, be sure to be clear how the gift is to be divided, especially if the testator does not want it shared in equal parts.

3. Residuary Clause

Every will should contain a residuary clause. This clause describes how the testator would like property disposed of that is not otherwise specifically devised elsewhere in the will. This is important for a number of reasons. What happens if the testator acquires property after the drafting of the will? In the absence of a residuary clause, it might be distributed according to the laws of intestate succession.

K. SURVIVORSHIP

Many people include a provision in their will that requires a beneficiary to survive them by a minimum period of time in order to be entitled to inherit property. (“I leave all of my property to my wife, Bethany, if she survives me for at least two weeks.”) Given the length of probate, survivorship requirements prevent assets from being potentially tied up in two people’s estates before transfer can be complete. Likewise, many couples have provisions that take effect only in the event of simultaneous death.

V. Changing and Revoking a Will

Like revocable trusts, an individual is free to change his or her will up until the time he or she dies. Because of life changes that often result in changes in estate plans, it is important to understand how a will can be changed or revoked.

A. REVOCATION

A will can be revoked in a number of ways, including the following:

- By a subsequent instrument that is inconsistent with the prior will; or
- By a physical act done with intent to revoke (burning, tearing, etc…).

1. Subsequent Instrument

If making a new will, a testator might expressly provide that all prior wills are revoked. In such a case, the latest valid will controls disposition of the testator’s property. In the absence of a clear enunciation of the prior will, changes to the testator’s intent may be clear from inconsistent provisions.

> **Example.**
>
> *Walt has but one house and in an early will leaves it to his friend, Jack, and in a later will leaves it to his son. A court will assume that Walt intended to disinherit his friend in lieu of his son. This is referred to as revocation by a subsequent inconsistent act. Remember, however, that if Walt merely intended to change the provision but never in fact executed a new will, the provisions in the valid will are going to be enforced by a court.*

Changing your mind is not sufficient to revoke a will; an overt act is required by the testator to give effect to his or her changed wishes. The second will must be inconsistent or contain an express statement of revocation. Revocation by inconsistency will revoke the entire prior will. Where the will is only partially inconsistent with the prior will, only that part of the will is revoked and the remaining provisions are read in conjunction with the prior will.

2. Physical Act

Any physical act that manifests the testator's intent to revoke a will can be given effect. Examples include tearing or burning a will, or crossing out its provisions and writing "I hereby revoke this will."

3. Presumption of Revocation

If a testator's will cannot be found at his or her death (assuming he or she executed a will at sometime in his or her life), courts will generally presume that the testator destroyed it with the intent of revoking it. If no new will can be found, the decedent's property will be transferred according to the state's laws of intestate succession.

4. Partial Revocation

Many states allow partial revocation of a will. In other words, if part of the will was revoked by drawing a line through one of the gifts, the question becomes whether the testator intended to revoke the entire will or only the portion that he or she crossed out.

If a testator's intent in striking through the part of the will was to revoke only that part of the will, the court will give effect to that intent. On the other hand, if it can be shown that the line through was intended to revoke the entire will, the court will likely find that the entire will was revoked.

5. Revocation by Operation of Law

Under certain circumstances, certain actions of the testator will result in a revocation of a prior will by operation of law. In some states, for example, when an individual gets married, any wills that were drafted prior to marriage are revoked through operation of law. California law, for example, provides that the omitted spouse receives the decedent's half of any community property as well as the decedent's quasi community property.

6. Reviving a Revoked Will

A testator cannot generally revive a will that has been formerly revoked without a executing a new document. If the testator wants to enforce the provisions of a former will, he or she will have to re-execute the revoked will in compliance with his or her state's requirements for a valid will. Another option is to execute a codicil stating expressly that the terms of a specified prior will are to be revived. In order to avoid potential problems at death, however, it is best to simply draft a new will that expressly revokes all prior wills and clearly spells out the wishes of the testator.

7. Dependent Relative Revocation

Courts have developed the doctrine of dependent relative revocation as a salvage tool. This doctrine allows a court to revive a revoked will if the revocation was dependent on an instrument that has since been revoked or was never in fact made. The doctrine is not accepted in all states.

Example.

Douglas executed a valid will in 2000 in which he left his guitar collection to his nephew, John. In 2011, Douglas decided he would leave the collection to his son, William, instead. He crossed out the portion of the 2000 will in which John was given the collection. Before he had time to draft a codicil giving the collection to his son, Douglas died. Under the doctrine of dependent relative revocation, a court would find that the attempted revocation was conditioned on making a new bequeath of the collection. Since that attempt failed, the court will enforce the prior gift.

The theory behind the doctrine is that the testator would have wanted his original wishes enforced if he knew his attempt to change the provision would not be effective. As with many other issues in probate, the focus of the rule is to try to enforce the intentions of the testator. In the absence of the rule, property in many cases would be subject to distribution through the laws of intestate succession.

B. CODICILS

1. Use of Codicils

A codicil is an amendment to a will. To be valid, a codicil must be executed with the same formalities as a formal will.

2. Revocation of a Codicil

The revocation of a codicil does not revive the original matter to which that codicil relates. This doctrine is not embodied in any of the statutory codes. It is a common law, judge made law. The question here is whether the testator would rather die intestate or under the earlier will. *Intent is key*. Sometimes this doctrine is seen as a conditional revocation. Often courts will engage in the fiction that there is a conditional intention to revoke a former will based on the validity of the new will.

CHAPTER 2 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Court-supervised distribution of assets is called probate.

   a) true
   b) false

2. Which of the following statements about probate is <u>not</u> correct:

   a) probate is something that should be avoided at any cost
   b) the probate process is overseen by a court
   c) there are fees associated with the probate process
   d) debts must be paid before assets can be distributed to heirs

3. In order to make a valid gift before death, it must be given more than three years prior to the individual's death.

   a) true
   b) false

4. Which of the following is the best definition of a "Pay-on-Death" account:

   a) it allows an owner to have the proceeds disbursed to a beneficiary at death without any current right to withdraw funds
   b) income from such accounts is not subject to tax
   c) it allows the government to seize assets once the owner of the account dies
   d) it protects the owner's assets from claims made by a former spouse

5. States that have adopted the Uniform Probate Code are permitted to follow an informal probate process.

   a) true
   b) false

6. Which of the following is an advantage of disposing of assets through a will:

   a) avoidance of estate taxes
   b) the ease of disinheriting disliked relatives
   c) avoidance of probate
   d) all of the above

7. Which of the following is the best definition of a "power of appointment":

   a) the authority given to a person designated in a will or trust to distribute certain assets at his or her discretion
   b) the authority to manage the assets of a minor beneficiary
   c) the authority to represent the decedent before the probate court
   d) the authority to settle tax claims against the decedent's estate

8. To make a valid will, a testator must be of sound mind at the time the will is executed.

   a) true
   b) false

9. An individual can completely disinherit his or her spouse.

   a) true
   b) false

10. What term is used to describe an amendment to a will:

   a) letter of designation
   b) codicil
   c) clause extraordinaire
   d) trust

CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** Probate is the process under which property would pass under a will, if any, and in the absence of a will, property that would pass under the intestacy laws of succession.

   B: False is incorrect. The court-supervised distribution of assets can be made pursuant to a valid will, or in the case where a decedent does not have a valid will, according to the applicable state's law of intestate succession.

   (See page 2-1 of the course material.)

2. **A: Correct.** Probate is not always something to dread. An advantage of probate is the shortened statute of limitations for creditors who have claims against the decedent's estate.

   B: Incorrect. The appropriate court in each state is responsible for overseeing the probate process.

   C: Incorrect. The fees and costs associated with probate vary with each state and the size of the estate.

   D: Incorrect. The probate process requires debts and taxes to be paid from the deceased's estate before assets can be distributed to the heirs.

   (See page 2-2 of the course material.)

3. A: True is incorrect. The elements that must be present in order to make a gift valid are the intent on the part of the donor to make a present transfer, delivery of the gift (either actual or constructive), and acceptance of the gift by the recipient.

   B: False is correct. In order to make a valid gift before death, the following elements must be present: 1) the intent on the part of the donor to make a present transfer, 2) delivery of the gift, either actual or constructive, and 3) acceptance of the gift by the recipient.

   (See page 2-3 of the course material.)

4. **A: Correct.** They are also known as informal bank accounts, Totten trusts, and bank trust accounts. They allow the owner of the account to pass proceeds from an account to an heir without going through probate.

   B: Incorrect. The funds in such an account are not exempt from taxation.

   C: Incorrect. There is no such mechanism in this type of account.

   D: Incorrect. The only thing this type of account does is avoid probate.

   (See page 2-5 of the course material.)

5. **A: True is correct.** An informal probate process that permits a probate administration to proceed unsupervised by any court is available to states that have adopted the Uniform Probate Code.

   B: False is incorrect. An informal and independent probate administration is available in states that have adopted the Uniform Probate Code.

   (See page 2-7 of the course material.)

6. A: Incorrect. There is no tax savings associated with dispersing assets through a will rather than intestate succession.

   B: Correct. Individuals can choose their beneficiaries when they dispose of their assets through a will. When assets pass through intestate succession, certain relatives may be entitled to assets even if they were disfavored.

   C: Incorrect. A will must generally be probated unless there is an applicable small estate exception.

   D: Incorrect. Only one of the responses is correct.

   (See page 2-9 of the course material.)

7. **A: Correct.** Under a general power of appointment, the person appointed has total discretion as to who should receive a gift. Under a special power of appointment, the testator or trustor establishes guidelines that the person appointed must follow in choosing a beneficiary.

   B: Incorrect. This is typically the function of a trustee.

   C: Incorrect. This is typically the function of an attorney or the executor of the estate.

   D: Incorrect. This is typically the function of an attorney or the executor of the estate.

   (See page 2-13 of the course material.)

8. **A: True is correct.** If the testator later becomes incompetent, the validity of the will is not affected.

   B: False is incorrect. Competency normally requires that the testator know that he or she is executing a will, the nature and extent of his or her property, and who his or her family members are.

   (See page 2-16 of the course material.)

9. A: True is incorrect. State law generally precludes an individual from completely disinheriting his or her spouse.

   B: False is correct. In community property states, each spouse automatically has a one-half interest in the estate of the community. Other states provide that a spouse is entitled to between one-quarter and one-half of his or her mate's estate, regardless of what is contained in a will.

   (See page 2-18 of the course material.)

10. A: Incorrect. There is no such legal instrument.

    B: Correct. An amendment, known as a codicil, must be executed with the same formalities as a formal will.

    C: Incorrect. There is no such legal instrument.

    D: Incorrect. This type of instrument is separate from a will.

    (See page 2-22 of the course material.)

Chapter 3: Estate and Gift Taxes

I. Introduction

One of the primary reasons people choose to establish a trust is to minimize their tax liability, or that of their heirs. Trusts can, in some circumstances, either limit or defer the payment of estate or gift taxes. However, a trust is not a panacea against these taxes. Given the importance of taxes in the creation of trusts, it is important to have a good understanding of estate and gift taxes before considering any specific type of trust. We will therefore review these issues before turning to the next chapter to the issue of trust creation.

If an individual gives someone money or property during his or her lifetime, the donor may be subject to federal gift tax. The money and property an individual owns when he or she dies (the estate) may be subject to federal estate tax. The purpose of this chapter is to provide a general understanding of when these taxes apply and when they do not. It explains how much money or property an individual can give away during his or her lifetime or leave to his or her heirs at death before any tax will be owed.

A. RECENT MAJOR CHANGES TO ESTATE AND GIFT TAXES

On December 17, 2010, Congress enacted and on December 18, 2010 the President signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Relief Act"), legislation that extends the 2001 tax cuts for two more years, temporarily increases estate, gift, and generation skipping tax exemption amounts, and temporarily reduces the estate tax rate. The 2010 Tax Relief Act came just thirteen days prior to the scheduled expiration of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which, but for the 2010 Tax Relief Act, would have resulted in increased taxes for many Americans.

Highlights of the 2010 Tax Relief Act include:

- The federal estate tax exemption amount was raised to $5 million for all deaths occurring in 2010-2012.

- The federal estate tax rate was set at 35% for 2010-2012.

- The estates of decedents dying in 2010 can choose between: (1) estate tax (based on a $5 million exemption and 35% top rate) and a step-up in basis, or (2) no estate tax and modified carryover basis. In technical terms, the Act achieves this choice by making the estate tax and basis changes effective retroactively for estates of decedents dying after 2009 but allowing the opt-out choice for estates of decedents dying in 2010.

- The federal estate and gift tax was unified again at $5,000,000 for 2011-2012.

- The generation skipping transfer ("GST") tax exemption amount is set at $5,000,000 and a 35% rate for 2011 and 2012.

- Stepped up basis reinstituted. For deaths occurring in 2011 and 2012, stepped up income tax basis of assets received from a decedent is now reinstituted.

- These changes are also temporary and will once again change if no action is taken by Congress prior to December 31, 2012.

B. RELATIONSHIP BETWEEN ESTATE AND GIFT TAXES

Unlike most tax structures, the estate tax and gift tax are unified – integrated – into one tax system again effective with the start of year 2011. The federal estate and gift tax imposes a tax on transferring assets: one tax catches transfers made during your life – the gift tax; the other catches transfers at death – the estate tax. Transfers while an individual was alive and at his or her death are combined and subject to one progressive tax. The rates are the same for both taxes.

The reunification of the gift and estate tax exemptions (made effective again by the passage of the 2010 Tax Relief Act) provides planning opportunities for clients who may have used all of their $1,000,000 gift tax exemption who now desire to make additional large lifetime gifts, but who don't want to pay gift tax.

C. NORMALLY NO TAX OWED

Most gifts are not subject to the gift tax and most estates are not subject to the estate tax. (Only about 2% of all estates are subject to the estate tax.) For example, there is usually no tax if an individual makes a gift to his or her spouse or a qualified charity or if the individual's estate goes to his or her spouse or qualified charity upon death. If an individual makes a gift to someone else, the gift tax does not apply until the value of the gifts given to that person is more than the annual exclusion for the year. Even if tax applies to a gift or estate, it may be eliminated by the Unified Credit, discussed later.

D. NO RETURN NEEDED

Generally, an individual does not need to file a gift tax return unless he or she gives someone, other than his or her spouse, money or property worth more than the annual exclusion for that year. Although a return may be required, no actual gift tax will become payable until the cumulative lifetime taxable gifts exceed the applicable exclusion amount.

The donor is primarily responsible for the payment of the Gift Tax. An estate tax return generally will not be needed unless the estate is worth more than the applicable exclusion amount for the year of death. This amount is shown in the section under Unified Credit, below.

E. NO TAX ON PERSON RECEIVING GIFT OR ESTATE

The person who receives a gift or estate generally will not have to pay any gift tax or estate tax because of it. In addition, that person will not have to pay income tax on the value of the gift or inheritance received. Note, however, that there are some technical applications for "Income in Respect of Decedent" under Internal Revenue Code §691 that will have to be considered for income earned but not otherwise taxed prior to the date of death.

F. NO INCOME TAX DEDUCTION

Making a gift or leaving an estate to a decedent's heirs does not ordinarily affect federal income tax. An individual cannot deduct the value of gifts made (other than gifts that are deductible charitable contributions).

> **Example.**
>
> *Chuck has a valuable stamp collection that has been appraised at $10,000. He would like to give the collection to his grandson, Harold, before his death. If he chooses to make the gift, it will not be subject to gift tax because it is below the taxable threshold. However, Chuck is not entitled to take a deduction from his income tax for the value of the collection. The gift has no impact on Chuck's current tax liability whatsoever.*

G. UNIFIED CREDIT

1. Application to Estate and Gift Taxes

A credit is an amount that eliminates or reduces tax. The unified credit applies to both the gift tax and the estate tax. An individual must subtract the unified credit from any gift taxes that he or she owes. Any unified credit that is used against an individual's gift tax in one year reduces the amount of credit that he or she can use against his or her gift tax in a later year. The total amount used against an individual's gift tax reduces the credit available to use against his or her estate tax.

2. Amount of Credit

In 2010, the gift tax remains in place with a lifetime exclusion amount of $1,000,000. Also for 2010, the estate exclusion was set to $5,000,000 by the recently passed 2010 Tax Relief Act.

Lastly, the 2010 Tax Relief Act provides for the reunification of the gift and estate tax exemptions for 2011 and 2012. The legislation provides for a $5,000,000 unified exemption and a 35% tax rate for estates and gifts exceeding the $5,000,000 exemption level.

II. Estate Taxes: An Overview

A. FORM 706

The executor of a decedent's estate uses Form 706 to figure the estate tax imposed by Chapter 11 of the Internal Revenue Code. This tax is levied on the entire taxable estate, not just on the share received by a particular beneficiary. Form 706 is also used to compute the generation-skipping transfer (GST) tax imposed by Chapter 13 on direct skips (transfers to skip persons of interests in property included in the decedent's gross estate).

B. WHICH ESTATES MUST FILE

Federal law provides an exemption from estate tax in an amount that varies from year to year. For example, for decedents who died in 2010, for example, Form 706 must have been filed by the executor for the estate of every U.S. citizen or resident whose gross estate, plus adjusted taxable gifts and specific exemption, was more than $5,000,000. If the value of the estate is less than the applicable exemption in the decedent's year of death, no return is required.

To determine whether an executor must file a return for the estate, add:

- The adjusted taxable gifts (under § 2001(b)) made by the decedent after December 31, 1976;
- The total specific exemption allowed under § 2521 (as in effect before its repeal by the Tax Reform Act of 1976) for gifts made by the decedent after September 8, 1976; and
- The decedent's gross estate valued at the date of death.

C. GROSS ESTATE AND TAXABLE ESTATE

The gross estate includes all property in which the decedent had an interest (including real property outside the United States). It also includes:

- Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth;
- Annuities;
- The includible portion of joint estates with right of survivorship (see the instructions on the back of Schedule E);
- The includible portion of tenancies by the entirety (see the instructions on the back of Schedule E);
- Certain life insurance proceeds (even though payable to beneficiaries other than the estate) (see the instructions on the back of Schedule D);
- Property over which the decedent possessed a general power of appointment;
- Dower or curtesy (or statutory estate) of the surviving spouse; and
- Community property to the extent of the decedent's interest as defined by applicable law.

After determining the gross value of a decedent's estate, the personal representative should take all possible deductions to reduce the taxable estate. These deductions include:

- Funeral expenses paid out of the decedent's estate;
- Debts the decedent owed at the time of death; and
- The marital deduction (generally, the value of the property that passes from the decedent's estate to his or her surviving spouse).

D. ADMINISTRATIVE EXPENSES

Expenses of administering an estate can be deducted either from the gross estate in figuring the federal estate tax, or from the estate's gross income in figuring the estate's income tax.

1. Typical Expenses

In general, administration expenses deductible in figuring the estate tax include:

- Fees paid to the fiduciary for administering the estate;
- Attorney, accountant, and return preparer fees;
- Expenses incurred for the management, conservation, or maintenance of property; and
- Expenses in connection with the determination, collection, or refund of the estate's tax liability.

2. No Double Dipping

Administrative expenses cannot be claimed for both estate tax and income tax purposes. The expenses incurred in the sale of property are deductible from the gross estate only if the sale was necessary to pay decedent debts, or to preserve or distribute the property of the estate.

E. MARITAL DEDUCTION

One of the primary deductions for married decedents is the Marital Deduction. All property that is included in the gross estate and passes to the surviving spouse is eligible for the marital deduction. The property must pass "outright." In some cases, certain life estates also qualify for the marital deduction.

F. CHARITABLE DEDUCTION

If the decedent leaves property to a qualifying charity either during his or her life or at death, it is deductible from the gross estate. Potential donors must be sure the "charity" they are considering qualifies for tax purposes. Generally, only the following types of organizations can be qualified organizations:

- A community chest, corporation, trust, fund, or foundation organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). It must be organized and operated only for one or more of the following purposes:

    - Religious;
    - Charitable;
    - Educational;
    - Scientific;
    - Literary; and
    - The prevention of cruelty to children or animals.

    Certain organizations that foster national or international amateur sports competition;

- War veterans' organizations, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions;

- Domestic fraternal societies, orders, and associations operating under the lodge system (note that contribution to this type of organization is deductible only if it is to be used solely for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals);

- Certain nonprofit cemetery companies or corporations (note that a contribution to this type of organization is not deductible if it can be used for the care of a specific lot or mausoleum crypt);

- The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions (note that to be deductible, a contribution to this type of organization must be made solely for public purposes).

Example 1.

Ozzie contributes cash to his city's police department to be used as a reward for information about a crime. The city police department is a qualified organization, and his contribution is for a public purpose. He can deduct his contribution.

Example 2.

Sharon makes a voluntary contribution to the social security trust fund, not earmarked for a specific account. Because the trust fund is part of the U.S. Government, she contributed to a qualified organization. She can deduct her contribution.

The following list gives some examples of qualified organizations:

- Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations;
- Most nonprofit charitable organizations such as the Red Cross and the United Way;
- Most nonprofit educational organizations, including the Boy (and Girl) Scouts of America, colleges, museums, and day-care centers if substantially all the child care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution;
- Nonprofit hospitals and medical research organizations;
- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs;
- Nonprofit volunteer fire companies;
- Public parks and recreation facilities; and
- Civil defense organizations.

1. <u>Giving Property That Has Decreased in Value</u>

One of the more technical areas of charitable giving involves gifts of property that have decreased in value. If an individual contributes property with a fair market value that is less than his or her basis in it, the deduction is limited to its fair market value. An individual cannot claim a deduction for the difference between the property's basis and its fair market value. Common examples of property that decreases in value include clothing, furniture, appliances, and cars.

2. <u>Giving Property That Has Increased in Value</u>

Another common estate planning tool involves the gift of property that has appreciated in value. If an individual contributes property with a fair market value that is more than his or her basis in it, he or she may have to reduce the fair market value by the amount of appreciation (increase in value) when calculating his or her deduction. Different rules apply to figuring the deduction, depending on whether the property is ordinary income property or capital gain property.

Property is ordinary income property if its sale at fair market value on the date it was contributed would have resulted in ordinary income or in short-term capital gain. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held 1 year or less.

Property used in a trade or business is considered ordinary income property to the extent of any gain that would have been treated as ordinary income because of depreciation had the property been sold at its fair market value at the time of contribution.

The amount an individual can deduct for a contribution of ordinary income property is its fair market value less the amount that would be ordinary income or short-term capital gain if the owner sold the property for its fair market value. Generally, this rule limits the deduction to the owner's basis in the property.

Example.

Lonnie, who knows he has only six months to live, donates stock that he has held for 5 months to his church. The fair market value of the stock on the day he donates it is $1,000, but he paid only $800 (his basis). Because the $200 of appreciation would be short-term capital gain if Lonnie sold the stock, his deduction is limited to $800 (fair market value less the appreciation).

Property is capital gain property if its sale at fair market value on the date of the contribution would have resulted in long-term capital gain. Capital gain property includes capital assets held more than one year.

Capital assets include most items of property that an individual owns and uses for personal purposes or investment. Examples of capital assets are stocks, bonds, jewelry, coin or stamp collections, and cars or furniture used for personal purposes. For purposes of figuring a charitable contribution, capital assets also include certain real property and depreciable property used in your trade or business and, generally, held more than one year. (Individuals may have to treat this property as partly ordinary income property and partly capital gain property.)

When figuring the deduction for a gift of capital gain property, an individual can usually use the fair market value of the gift. However, in certain situations, they must reduce the fair market value by any amount that would have been long-term capital gain if the individual had sold the property for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis. This must be done if:

- The property (other than qualified appreciated stock) is contributed to certain private nonoperating foundations;
- The contributed property is tangible personal property that is put to an unrelated use by the charity; or
- The individual chooses the 50% limit instead of the 30% limit, discussed later.

The reduced deduction applies to contributions to all private nonoperating foundations other than those qualifying for the 50% limit, discussed later.

However, the reduced deduction does not apply to contributions of qualified appreciated stock. Qualified appreciated stock is any stock in a corporation that is capital gain property and for which market quotations are readily available on an established securities market on the day of the contribution. But stock in a corporation does not count as qualified appreciated stock to the extent you and your family contributed more than 10% of the value of all the outstanding stock in the corporation.

The term tangible personal property means any property, other than land or buildings, that can be seen or touched. It includes furniture, books, jewelry, paintings, and cars. The term unrelated use means a use that is unrelated to the exempt purpose or function of the charitable organization. For a governmental unit, it means the use of the contributed property for other than exclusively public purposes.

Example.

If a painting contributed to an educational institution is used by that organization for educational purposes by being placed in its library for display and study by art students, the use is not an unrelated use. But if the painting is sold and the proceeds are used by the organization for educational purposes, the use is an unrelated use.

Ordinary or capital gain income is included in gross income. An individual should not reduce his charitable contribution if he includes the ordinary or capital gain income in his gross income in the same year as the contribution. This may happen when an individual transfers installment or discount obligations or when he or she assigns income to a charitable organization.

Example.

Ray donates an installment note to a qualified organization. The note has a fair market value of $10,000 and a basis to Ray of $7,000. As a result of the donation, Ray has a short-term capital gain of $3,000 ($10,000 - $7,000), which he includes in his income for the year. Ray's charitable contribution is $10,000.

3. <u>Bargain Sales</u>

A bargain sale of property to a qualified organization (a sale or exchange for less than the property's fair market value) is partly a charitable contribution and partly a sale or exchange. The part of the bargain sale that is a sale or exchange may result in a taxable gain.

The part that is a charitable contribution is calculated in three steps:

Step 1. Subtract the amount the individual received for the property from the property's fair market value at the time of sale. This gives the fair market value of the contributed part.

Step 2. Find the adjusted basis of the contributed part. It equals: Adjusted basis of entire property x fair market value of contributed part ÷ fair market value of entire property.

Step 3. Determine whether the amount of the charitable contribution is the fair market value of the contributed part (which was found in *Step 1*) or the adjusted basis of the contributed part (which was found in *Step 2*). Generally, if the property sold was capital gain property, the charitable contribution is the fair market value of the contributed part. If it was ordinary income property, the charitable contribution is the adjusted basis of the contributed part.

Example.

Bernard sells ordinary income property with a fair market value of $10,000 to a church for $2,000. Bernard's basis is $4,000 and his adjusted gross income is $20,000. Bernard makes no other contributions during the year. The fair market value of the contributed part of the property is $8,000 ($10,000 - $2,000). The adjusted basis of the contributed part is $3,200 ($4,000 × ($8,000 ÷ $10,000)). Because the property is ordinary income property, Bernard's charitable contribution deduction is limited to the adjusted basis of the contributed part. He can deduct $3,200.

4. Limits on Deductions

If an individual's total contributions for the year are 20% or less of his or her adjusted gross income, this section does not apply. However, for someone considering making large contributions to reduce the size of his or her taxable estate, the following rules are very important.

The amount of an individual's deduction is limited to 50% of his or her adjusted gross income, and may be limited to 30% or 20% of his or her adjusted gross income, depending on the type of property donated and the type of organization to which it is given.

a. 50% Limit

The 50% limit applies to the total of all charitable contributions made during the year. This means that an individual's deduction for charitable contributions cannot be more than 50% of the individual's adjusted gross income for the year. The 50% limit is the only limit that applies to gifts to organizations listed below under *50%* Limit Organizations. But there is one exception. A 30% limit also applies to these gifts if they are gifts of capital gain property for which an individual figures his or her deduction using fair market value without reduction for appreciation.

b. 50% Limit Organizations

Only the following types of organizations are 50% limit organizations:

- Churches, and conventions or associations of churches;

- Educational organizations with a regular faculty and curriculum that normally have a regularly enrolled student body attending classes on site;

- Hospitals and certain medical research organizations associated with these hospitals;

- Organizations that are operated only to receive, hold, invest, and administer property and to make expenditures to or for the benefit of state and municipal colleges and universities and that normally receive substantial support from the United States or any state or their political subdivisions, or from the general public;

- The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions;

- Corporations, trusts, or community chests, funds, or foundations organized and operated only for charitable, religious, educational, scientific, or literary purposes, or to prevent cruelty to children or animals, or to foster certain national or international amateur sports competition. These organizations must be “publicly supported,” which means they normally must receive a substantial part of their support, other than income from their exempt activities, from direct or indirect contributions from the general public or from governmental units;

- Organizations that may not qualify as “publicly supported” but that meet other tests showing they respond to the needs of the general public, not a limited number of donors or other persons. They must normally receive more than one-third of their support either from organizations described in above or from persons other than “disqualified persons”;

- Most organizations operated or controlled by and operated for the benefit of those organizations described above;

- Private operating foundations;

- Private nonoperating foundations that make qualifying distributions of 100% of contributions within 2½ months following the year they receive the contribution. A deduction for charitable contributions to any of these private nonoperating foundations must be supported by evidence from the foundation confirming that it made the qualifying distributions timely. Attach a copy of this supporting data to the tax return; and

- A private foundation whose contributions are pooled into a common fund, if the foundation would be described above but for the right of substantial contributors to name the public charities that receive contributions from the fund. The foundation must distribute the common fund's income within 2½ months following the tax year in which it was realized and must distribute the corpus not later than 1 year after the donor's death (or after the death of the donor's surviving spouse if the spouse can name the recipients of the corpus).

c. 30% Limit

A 30% limit applies to the following gifts:

- Gifts to all qualified organizations other than 50% limit organizations. This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations; and
- Gifts for the use of any organization.

However, if these gifts are of capital gain property, they are subject to the 20% limit, described later, rather than the 30% limit.

d. Special 30% Limit for Capital Gain Property

A special 30% limit applies to gifts of capital gain property to 50% limit organizations. However, the special 30% limit does not apply when an individual chooses to reduce the fair market value of the property by the amount that would have been long-term capital gain if he or she had sold the property. Instead, only the 50% limit applies.

This special 30% limit for capital gain property is separate from the other 30% limit. Therefore, the deduction of a contribution subject to one 30% limit does not reduce the amount an individual can deduct for contributions subject to the other 30% limit. However, the total an individual can deduct cannot be more than 50% of his or her adjusted gross income.

Example.

Paul's adjusted gross income is $50,000. During the year, he gave capital gain property with a fair market value of $15,000 to a 50% limit organization. Paul does not choose to reduce the property's fair market value by its appreciation in value. He also gave $10,000 cash to a qualified organization that is not a 50% limit organization. The $15,000 gift of property is subject to the special 30% limit. The $10,000 cash gift is subject to the other 30% limit. Both gifts are fully deductible because neither is more than the 30% limit that applies ($15,000 in each case) and together they are not more than the 50% limit ($25,000).

e. 20% Limit

The 20% limit applies to all gifts of capital gain property to or for the use of qualified organizations (other than gifts of capital gain property to 50% limit organizations).

f. Calculating a Deduction When Limits Apply

If an individual's contributions are subject to more than one of the limits just discussed, he or she can deduct them as follows:

1. Contributions subject only to the 50% limit, up to 50% of the individual's adjusted gross income.

2. Contributions subject to the 30% limit, up to the lesser of:

    - 30% of adjusted gross income; or
    - 50% of adjusted gross income minus the individual's contributions to 50% limit organizations, including contributions of capital gain property subject to the special 30% limit.

3. Contributions of capital gain property subject to the special 30% limit, up to the lesser of:

    - 30% of adjusted gross income; or
    - 50% of adjusted gross income minus the individual's other contributions to 50% limit organizations.

4. Contributions subject to the 20% limit, up to the lesser of:

    - 20% of adjusted gross income;
    - 30% of adjusted gross income minus the individual's contributions subject to the 30% limit;
    - 30% of adjusted gross income minus the individual's contributions of capital gain property subject to the special 30% limit; or
    - 50% of adjusted gross income minus the total of the individual's contributions to 50% limit organizations and the individual's contributions subject to the 30% limit.

Example.

Martha's adjusted gross income is $50,000. During the year, she gave her church $2,000 cash and land with a fair market value of $28,000 and a basis of $22,000. Martha held the land for investment purposes. She does not choose to reduce the fair market value of the land by the appreciation in value. Martha also gave $5,000 cash to a private foundation to which the 30% limit applies.

The $2,000 cash donated to the church is considered first and is fully deductible. Her contribution to the private foundation is considered next. Because her contributions to 50% limit organizations ($2,000 + $28,000) are more than $25,000 (50% of $50,000), her contribution to the private foundation is not deductible for the year. It can be carried over to later years. The gift of land is considered next. Martha's deduction for the land is limited to $15,000 (30% × $50,000). The unused part of the gift of land ($13,000) can be carried over. For this year, Martha's deduction is limited to $17,000 ($2,000 + $15,000).

g. Capital Gain Property Election

An individual may choose the 50% limit for gifts of capital gain property to 50% limit organizations instead of the 30% limit that would otherwise apply. If an individual makes this choice, the individual must reduce the fair market value of the property contributed by the appreciation in value that would have been long-term capital gain if the property had been sold.

This choice applies to all capital gain property contributed to 50% limit organizations during a tax year. It also applies to carryovers of this kind of contribution from an earlier tax year.

An individual must make the choice on his or her original return or on an amended return filed by the due date for filing the original return.

Example.

In the previous example, if Martha chose to have the 50% limit apply to the land (the 30% capital gain property) given to her church, she must reduce the fair market value of the property by the appreciation in value. Therefore, the amount of her charitable contribution for the land would be its basis to her of $22,000. Martha adds this amount to the $2,000 cash contributed to the church.

She can now deduct $1,000 of the amount donated to the private foundation because her contributions to 50% limit organizations ($2,000 + $22,000) are $1,000 less than the 50%-of-adjusted-gross-income limit. Her total deduction for the year is $25,000 ($2,000 cash to her church, $22,000 for property donated to her church, and $1,000 cash to the private foundation). Martha can carry over to later years the part of her contribution to the private foundation that she could not deduct ($4,000).

h. Carryovers

An individual can carry over his or her contributions that he or she is not able to deduct in the current year because the individual exceeds his or her adjusted-gross-income limits. The individual can deduct the excess in each of the next 5 years until it is used up, but not beyond that time. The individual's total contributions deduction for the year to which he or she carries his or her contributions cannot exceed 50% of the individual's adjusted gross income for that year.

Contributions an individual carries over are subject to the same percentage limits in the year to which they are carried. For example, contributions subject to the 20% limit in the year in which they are made are 20% limit contributions in the year to which they are carried.

For each category of contributions, an individual can deduct carryover contributions only after deducting all allowable contributions in that category for the current year. If an individual has carryovers from two or more prior years, he or she must use the carryover from the earlier year first.

Also note that a carryover of a contribution to a 50% limit organization must be used before contributions in the current year to organizations other than 50% limit organizations.

G. VALUING AN ESTATE

As a general rule, every asset included in a decedent's gross estate is valued at its fair market value. The personal representative can choose from the following valuation dates:

- The decedent's date of death; or
- The value six months later (known as the alternate valuation date).

The alternative valuation date election is allowed only if it lowers the individual's tax liability. Whatever date is selected, it is irrevocable and will apply to all assets in the estate. If the 6-months-after-death date applies, all of the decedent's assets must be valued on that date. Furthermore, if property is sold, distributed, exchanged, or disposed of during the 6-month period, it is valued on the date of the distribution, sale, etc., rather than the alternative valuation date. Family farmland and closely-held family business interests can be valued at less than their highest-and-best use. It is important that the decedent's personal representative accurately value the estate. Otherwise, underpayment penalties described below apply.

H. U.S. CITIZENS OR RESIDENTS; NONRESIDENT NONCITIZENS

An executor must file Form 706 for the estates of decedents who were either U.S. citizens or U.S. residents at the time of death. For estate tax purposes, a resident is someone who had a domicile in the United States at the time of death. A person acquires a domicile by living in a place for even a brief period of time, as long as the person had no intention of moving from that place.

An executor must file Form 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return, Estate of nonresident not a citizen of the United States, for the estates of nonresident alien decedents (decedents who were neither U.S. citizens nor residents at the time of death).

III. Gift Tax

The gift tax applies to the transfer by gift of any property. An individual makes a gift if he or she gives property (including money), or the use of or income from property, without expecting to receive something of at least equal value in return. If an individual sells something at less than its full value or if he or she makes an interest-free or reduced interest loan, the individual may be making a gift.

Example 1.

Lisa's granddaughter, Katie, is going away to college and needs a car to come home on the weekends. Lisa buys Katie a Volkswagen bug. This is clearly a gift.

Example 2.

Rob's cousin, Mark, is trying to open a new business detailing cars. Rob has always felt that Mark did not get as much financial support from their grandparents as he did so he wants to help his cousin out. He tells Mark that he will "loan" him $50,000 to open his business, but that the money does not need to be paid back until the business becomes successful. Although Rob is calling this payment a "loan," it appears more like a gift since there is no apparent expectation of repayment.

Even if tax applies to a gift or estate, it may be eliminated by the Unified Credit, discussed below.

A. GENERAL RULE

The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule. Generally, the following gifts are not taxable gifts:

- Gifts that are not more than the annual exclusion for the calendar year;
- Tuition or medical expenses a taxpayer pays for someone (the educational and medical exclusions);
- Gifts to an individual's spouse;
- Gifts to a political organization for its use; and
- Gifts to qualified charities (a deduction is available for these amounts).

B. ANNUAL EXCLUSION

A separate annual exclusion applies to each person to whom an individual makes a gift. For 2011, the annual exclusion is $13,000. Therefore, during 2011 an individual generally could give up to $13,000 each to any number of people, and none of the gifts would be taxable.

1. Married Couples

If an individual is married, both the individual and his or her spouse can separately give up to $13,000 to the same person in the same year without making a taxable gift. If one of the two gives more than $13,000 to a person, the gift splitting rules discussed below apply. Gifts to individuals are not deductible on the donor's income tax returns.

2. Inflation Adjustment

In the future, the annual exclusion may be increased due to a cost-of-living adjustment. See the instructions for Form 709 for the amount of the annual exclusion for the year the gift is made.

> **Example 1.**
>
> *In 2011, Wanda gives her niece a cash gift of $8,000. It is her only gift to her this year. The gift is not a taxable gift because it is not more than the $13,000 annual exclusion.*
>
> **Example 2.**
>
> *Martin pays the $15,000 college tuition of his friend. Because the payment qualifies for the educational exclusion, the gift is not a taxable gift.*
>
> **Example 3.**
>
> *In 2011, Ken gives $25,000 to his 25-year-old daughter. The first $13,000 of his gift is not subject to the gift tax because of the annual exclusion. The remaining $12,000 is a taxable gift. As explained later under Applying the Unified Credit to Gift Tax, Ken may not have to pay the gift tax on the remaining $12,000. However, he does have to file a gift tax return.*

3. Gift Splitting

If an individual and his spouse make a gift to a third party, the gift can be considered as made one-half by the individual and one-half by his spouse. This is known as gift splitting. Both spouses must consent (agree) to split the gift. If such consent is given, each spouse can take the annual exclusion for their part of the gift. In 2011, for example, gift splitting allowed married couples to give up to $26,000 to a person without making a taxable gift.

If a couple does decide to split a gift, they must file a gift tax return showing that there was an agreement to split the gift.

> **Example.**
>
> *John and his wife, Marsha, agree to split the gifts that they made during 2011. John gives his son, George, $21,000, and Marsha gives her daughter, Gina, $18,000. Although each gift is more than the annual exclusion ($13,000), by gift splitting they can make these gifts without making a taxable gift.*

John's gift to George is treated as one-half ($10,500) from John and one-half ($10,500) from Marsha. Marsha's gift to Gina is also treated as one-half ($9,000) from Marsha and one-half ($9,000) from John. In each case, because one-half of the split gift is not more than the annual exclusion, it is not a taxable gift. However, each of them must file a gift tax return.

4. <u>No Limit on Number of Gift Recipients</u>

An individual is free to give away as many gifts as he or she wants. In theory, a rich man could dispose of his entire estate by giving thousands of people a gift that falls under the annual exclusion level.

Example.

Walt, who knows that he is dying, decides to dispose of his entire $910,000 cash estate by making gifts to his many family members and friends. Assuming the applicable annual exclusion in the year he wishes to make the gifts is $13,000, Walt can make a gift of $13,000 to 70 people and avoid any gift tax liability. In so doing, he will be disposing of his entire $910,000 in a single year.

C. APPLICATION OF THE UNIFIED CREDIT

A credit is an amount that eliminates or reduces tax. The unified credit applies to both the gift tax and the estate tax. You must subtract the unified credit from any gift tax that you owe. Any unified credit you use against your gift tax in one year reduces the amount of credit that you can use against your gift tax in a later year. The total amount used against your gift tax reduces the credit available to use against your estate tax.

Example.

In 2011, Lori gave her niece, Mary, a cash gift of $8,000. It is her only gift to her this year. Lori pays the $15,000 college tuition of her friend, David. Lori gave her 25-year-old daughter, Lisa, $25,000. She also gave her 27-year-old son, Ken, $25,000. Before 2011, Lori had never given a taxable gift. She applies the exclusions to the gift tax and the unified credit as follows:

Apply the educational exclusion. Payment of tuition expenses is not subject to the gift tax. Therefore, the gift to David is not a taxable gift.

Apply the annual exclusion. The first $13,000 she gave someone during 2011 is not a taxable gift. Therefore, her $8,000 gift to Mary, the first $13,000 of her gift to Lisa, and the first $13,000 of her gift to Ken are not taxable gifts.

Apply the unified credit. The gift tax on $24,000 ($12,000 remaining from her gift to Lisa plus $12,000 remaining from her gift to Ken) is $4,680. Lori subtracts the $4,680 from her unified credit for 2011.

Lori does not have to pay any gift tax for 2011. However, she does have to file Form 709.

D. GIFTS EXEMPT FROM TAX

Regardless of the identity of the recipient or the purpose of the gift (i.e. to help pay for a car or to take a Caribbean cruise), any gift which falls under the annual exclusion limit is exempt from tax. There are other categories that provide a larger exemption.

1. Educational and Medical Expenses

In addition to the $13,000 annual gift tax exclusion, there is a 100% exclusion when an individual makes direct payments for someone's medical bills or tuition expenses. Both the medical and educational exclusions are allowed without regard to the relationship, so the recipient need not be a close relative or dependent. The payments must be made directly to the medical care provider or the educational institution. Payments to the recipient cancels the tax benefit. Room and board, supplies, books and other fees do not qualify.

A qualifying educational organization is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students. Medical care includes expenses for diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, or for transportation. It also includes medical insurance.

2. Gifts to a Spouse

Transfers between spouses are 100% deductible for gift tax purposes. This is known as the "unlimited gift tax marital deduction." However, the value of the gift, whether it was for a future or present interest, must be included in the giver's gross estate on death in order for the deduction to apply. If the gross estate does not include the transfers to the spouse, no marital deduction applies. This gift exclusion only applies to gifts to a U.S. citizen spouse.

3. Charitable Contributions

Individuals can give any amount – no matter how large – to a qualified charity completely tax-free. For example, if Martin owns real estate that he gifts outright to a charity, no gift tax is due. The value of what Martin transferred is included in the gross estate after his death, but it is 100% subtracted before the tax rates are applied. This issue is discussed in more detail above in the section on estate taxes. A common way of making charitable donations is through a trust. The topic of charitable trusts is discussed in detail in Chapter 11.

E. VALUING GIFTS

An important component in determining the applicability of a gift tax is the value of the gift. If someone makes a gift of $15,000 in cash, valuation is obviously not an issue. Valuation questions arise with other types of property, such as real property, stocks and collectibles.

Example.

Michael makes a gift to his nephew of 1,000 shares of stock in XYZ Corporation. Michael purchased the shares two years ago at $5 per share. On the day he makes the gift, the stock is trading at $15 per share. Is the value of the gift $5,000 (the amount Michael paid for the stock) or $15,000 (the current value of the stock at the time the gift is executed)? The IRS considers the value of the gift to be its fair market value at the time the gift is made. This means that the value of this gift is $15,000, above the applicable annual exclusion of $13,000. The gift will still, however, come under Michael's lifetime umbrella exclusion and he will therefore not currently have to pay tax on the gift. Upon Michael's death, the total amount of his lifetime gifts will be calculated and subtracted from his unified credit applicable in the year of his death.

Table 3.1 Determining Whether Gift Is Subject to Gift Tax

The following table is intended to help the reader determine whether a gift is subject to gift tax or not.

Type of Gift	Whether It Is Subject to Gift Tax
Father gives 10 gifts of $2,000 each to his son during calendar year.	Yes. Total of gifts during year exceed annual exclusion level.
Mother gifts her remainder interest in her mother's life estate to her daughter.	Yes. Future interests are always subject to gift tax, regardless of value.
Husband gives his wife a $25,000 diamond ring to celebrate their silver wedding anniversary.	No. Gift to spouse is exempt regardless of value.
Uncle pays the $15,000 annual tuition for his nephew to attend a private university.	No. Educational expenses are normally exempt.
Grandmother pays $20,000 for surgery for grandson who does not have medical insurance.	No. Medical expenses are normally exempt.
Husband and wife jointly donate $1,000,000 to cancer research at the UCLA medical center.	No. Gift is made to a charitable organization.

F. FILING A GIFT TAX RETURN

As with the income tax return, Gift Tax returns (Form 709) are due on April 15 of the year following the year in which the taxpayer made the gift. The Gift Tax (if any) is due at the time of filing the return.

1. Return Required

An individual must file a gift tax return on Form 709 (a copy of which is provided at the end of Chapter 9 for reference) if any of the following apply:

- The individual gave gifts that are more than the annual exclusion for the year to someone (other than his or her spouse);
- An individual and his or her spouse are splitting a gift (discussed above);
- An individual gave someone (other than his or her spouse) a gift that he or she cannot actually possess, enjoy, or receive income from until some time in the future; or
- An individual gave his or her spouse an interest in property that will be ended by some future event.

2. Return Not Required

An individual is not required to file a gift tax return to report gifts to (or for the use of) political organizations and gifts made by paying someone's tuition or medical expenses. An individual also does not need to report the following deductible gifts made to charities:

- The individual's entire interest in property, if no other interest has been transferred for less than adequate consideration or for other than a charitable use; or
- A qualified conservation contribution that is a restriction (granted forever) on the use of real property.

IV. Generation Skipping Tax

A. APPLICATION AND RATIONALE

The generation skipping tax sounds complicated but in reality it is a simple concept intended to prevent families from avoiding estate taxes. A detailed discussion is provided in Chapter 9. This section will provide a brief overview.

Example.

Roger is an 85-year-old widower with one son and five grandchildren. Roger's son, Jason, is 62-years-old and is suffering from advanced prostate cancer. He is also financially secure. If Roger leaves his property to his son, it will likely soon pass to his grandchildren. If this happens, it

may be subject to estate taxes when it passes to Jason and then again when Jason dies and leaves the estate to his own children. In order to avoid the potential of double taxation, Roger elects to "skip" his son's generation and leave his estate directly to his grandchildren. While the idea may seem sound, the generation skipping tax could kick in and eliminate his planned tax savings.

The generation skipping tax (hereinafter referred to as "GST") can apply outside of familial situations as well. It may be due if a beneficiary of a gift or estate is 37.5 years younger than the donor or deceased.

B. EXEMPTIONS

1. Life Time Exemption

Individuals may avoid the impact of the GST through their applicable lifetime exemption. The exemption is $5,000,000 for the year 2011. Application of the exemption can have a profound tax savings effect on an estate.

Example.

Lorraine plans to gift $1.12 million to a trust to provide income to her son and grandchildren. She allocates all of her GST exemption to the transfer. Because all of Lorraine's property placed in the trust is permanently exempt from GST tax, neither the principal in the trust nor proceeds paid to her son or grandchildren will be subject to tax. If, on the other hand, Lorraine had not used her GST exemption and her son were to die, the $1.12 million that would pass to her grandchildren would be subject to the GST. Assuming a tax rate of 35%, that would reduce the value of the estate to $728,000.

2. Gifts

Gifts given outright that qualify for the applicable Gift Tax exclusion are shielded from the GST tax as are education and medical expenses.

3. Allocation of Exemption

The exemption may be allocated to the transferred property at any time before an estate tax return becomes due. Once the allocation election is made, the decision is irrevocable.

4. Unused Exemption

Unused GST credit is automatically allocated to direct skip transfers made during the life of a decedent unless the person elects otherwise on a gift tax return. In addition, the exemption will be deemed allocated to any trust that involves an "indirect skip" during the decedent's lifetime.

Any portion of the exemption that remains unallocated upon the death of the decedent is first allocated to any direct skips that occur at his or her death (e.g. a bequest to a grandchild), and then to trusts from which a taxable distribution or taxable termination may occur by virtue of the individual's death. A generation-skipping trust may undergo a "qualified severance" under which it would be split into exempt and non-exempt trusts.

C. TAX RATE

Due to the 2010 Tax Relief Act signed into law by the President on December 18, 2010, the GST exemption amount is set at $5,000,000 (and a 35% tax rate) for 2011 and 2012. For deaths occurring in 2010, the GST exemption is also $5,000,000, but the tax rate is zero percent. Prior to 2010, the exemption amount was the same as the estate tax exemption amount.

D. PAYMENT OF TAX

The party responsible for payment of the GST tax depends upon the type of generation skipping transfer.

V. State Death Taxes

A. STATE DEATH TAXES: INHERITANCE, ESTATE AND GIFT TAXES

For some people, state taxes are also an issue in estate planning. States levy one of two types of death taxes: inheritance and estate (states also levy gift taxes). Inheritance taxes are imposed on the person receiving the devise, while estate taxes are levied on the estate of the deceased person before assets are distributed to heirs.

Currently, only a handful of states impose some sort of “death tax” on estates. These include: Indiana (Indiana has a layered inheritance tax system), Iowa (Iowa has an estate tax that is intended to absorb the maximum credit against the federal estate tax and also has a layered inheritance tax system), Kentucky (Kentucky has two types of death taxes: an inheritance tax and an estate tax. The Kentucky inheritance tax is imposed on a beneficiary’s right to receive property from a deceased person. The amount of tax imposed depends on who receives what assets), Maryland (Maryland imposes both an inheritance tax and an estate tax), Ohio (the basic Ohio estate tax is imposed on the value of a resident decedent’s gross estate, minus deductions and any exemptions), and Pennsylvania (Pennsylvania has an inheritance tax and an estate tax that is intended to absorb the difference between the inheritance tax and the maximum credit against the federal estate tax (i.e., a “pick up tax”). New Jersey, Tennessee and Washington also have forms of death taxes. The amount of inheritance tax imposed depends on who inherits which assets after the decedent’s death).

1. Inheritance Tax

Inheritance taxes are normally imposed at graduated rates based upon the amount of the devise and upon the relationship between the deceased and the beneficiary. Several types of exemptions are typically allowed under the inheritance tax:

- Personal exemptions based on the relationship of the giver and receiver (the most common one is for a surviving spouse);
- Exemptions of a specified amount allowed the entire estate;
- Exemptions for property on which a tax already has been paid;
- Exemptions for bequests to charitable, religious or educational institutions; and
- Exemptions for particular types of property.

The personal exemption is usually the most important for state estate tax purposes. There is normally a greater exemption for gifts given to close relatives than to more distant relatives or non-relatives.

In South Dakota, for example, the inheritance of children is taxed at rates varying from nothing on the first $30,000 to 7.5 percent for amounts over $100,000. Surviving children also receive a $3,000 exemption. On the other hand, non-relatives are subject to rates ranging from 6 percent to 30 percent and receive only a $100 exemption.

Rates also vary significantly between states. In Indiana, for example, lineal descendants are taxed at rates varying from 1 percent on inheritances of up to $25,000 to 10 percent on amounts of $1.5 million or more. In Pennsylvania, they are taxed at a 6 percent rate and non-relatives are taxed at a 15 percent rate, regardless of the amount of inheritance.

2. <u>Estate Taxes</u>

Estate taxes are also imposed at graduated rates based upon the value of the estate. Unlike the inheritance tax, the rates generally are imposed on the estate as a whole and do not vary based upon the relationship of the beneficiary to the donor. Estate tax rates also vary a great deal from state to state. For example, in Ohio, the rates range from 2 percent for taxable estates not exceeding $40,000 to 7 percent for taxable estates exceeding $500,000.

3. <u>Gift Tax</u>

The rates imposed and the exemptions allowed under state gift tax laws are similar to rates and exemptions under the inheritance tax. In the case of a gift tax, however, it is the donor rather than the beneficiary who is liable for payment of the tax.

B. STATE DEATH TAX CREDIT

When the federal estate tax was enacted, so too was a provision that provided a state death tax credit. Individuals have historically been entitled to a credit against the federal tax for death taxes paid to a state. Under the Federal Estate Tax Act of 1926, the maximum credit is 80 percent. This credit is commonly referred to as a "pick-up" tax. The total tax liability for the beneficiaries does not increase and all states currently impose this tax up to the allowable federal credit.

One of the many components of The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased out the state death tax credit allowed against the federal estate tax in 25% increments between 2002 and 2005. The repeal of the credit was intended to increase revenues to the federal government.

Prior to the enactment of EGTRRA in 2001, 38 states and the District of Columbia used a pick-up tax in which the state death tax was an amount equal to the maximum amount of state death tax credit allowed under federal law.

In several states, the state pick-up tax was tied to the federal estate tax as of a particular date prior to the enactment of EGTRRA. In the remaining cases, the state pick-up tax was tied to the federal code on an automatic or rolling basis, meaning that the pick-up tax would phase-out in these states unless the state enacted legislation to the contrary.

Form **706**

(Rev. September 2009)

Department of the Treasury
Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

Estate of a citizen or resident of the United States (see separate instructions).
To be filed for decedents dying after December 31, 2008, and before January 1, 2010.

OMB No. 1545-0015

Part 1—Decedent and Executor

1a Decedent's first name and middle initial (and maiden name, if any)	**1b** Decedent's last name		**2 Decedent's Social Security No.**
3a County, state, and ZIP code, or foreign country, of legal residence (domicile) at time of death	**3b** Year domicile established	**4** Date of birth	**5** Date of death
6a Name of executor (see page 5 of the instructions)	**6b** Executor's address (number and street including apartment or suite no.; city, town, or post office; state; and ZIP code) and phone no.		
6c Executor's social security number (see page 5 of the instructions)	Phone no. ( )		
7a Name and location of court where will was probated or estate administered			**7b** Case number

8 If decedent died testate, check here ▶ ☐ and attach a certified copy of the will. **9** If you extended the time to file this Form 706, check here ▶ ☐

10 If Schedule R-1 is attached, check here ▶ ☐

Part 2—Tax Computation

Line	Description			Line	Amount
1	Total gross estate less exclusion (from Part 5—Recapitulation, page 3, item 12)			1	
2	Tentative total allowable deductions (from Part 5—Recapitulation, page 3, item 22)			2	
3a	Tentative taxable estate (before state death tax deduction) (subtract line 2 from line 1)			3a	
b	State death tax deduction			3b	
c	Taxable estate (subtract line 3b from line 3a)			3c	
4	Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includible in decedent's gross estate (section 2001(b)))			4	
5	Add lines 3c and 4			5	
6	Tentative tax on the amount on line 5 from Table A on page 4 of the instructions			6	
7	Total gift tax paid or payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includible in the decedent's gross estate (see instructions)			7	
8	Gross estate tax (subtract line 7 from line 6)			8	
9	Maximum unified credit (applicable credit amount) against estate tax	9			
10	Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed $6,000. See page 6 of the instructions.)	10			
11	Allowable unified credit (applicable credit amount) (subtract line 10 from line 9)			11	
12	Subtract line 11 from line 8 (but do not enter less than zero)			12	
13	Credit for foreign death taxes (from Schedule(s) P). (Attach Form(s) 706-CE.)	13			
14	Credit for tax on prior transfers (from Schedule Q)	14			
15	Total credits (add lines 13 and 14)			15	
16	Net estate tax (subtract line 15 from line 12)			16	
17	Generation-skipping transfer (GST) taxes payable (from Schedule R, Part 2, line 10)			17	
18	Total transfer taxes (add lines 16 and 17)			18	
19	Prior payments. Explain in an attached statement			19	
20	Balance due (or overpayment) (subtract line 19 from line 18)			20	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Sign Here

▶ Signature of executor ▶ Date

▶ Signature of executor ▶ Date

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ▶ ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN ▶	
		Phone no. ( )	

For Privacy Act and Paperwork Reduction Act Notice, see page 30 of the separate instructions for this form. Cat. No. 20548R Form **706** (Rev. 9-2009)

Estate of: | **Decedent's Social Security Number**

Part 3—Elections by the Executor

Please check the "Yes" or "No" box for each question (see instructions beginning on page 7).

Note. Some of these elections may require the posting of bonds or liens.

			Yes	No
1	Do you elect alternate valuation?	**1**		
2	Do you elect special-use valuation? If "Yes," you must complete and attach Schedule A-1.	**2**		
3	Do you elect to pay the taxes in installments as described in section 6166? If "Yes," you must attach the additional information described on pages 10 through 12 of the instructions. **Note. By electing section 6166, you may be required to provide security for estate tax deferred under section 6166 and interest in the form of a surety bond or a section 6324A lien.**	**3**		
4	Do you elect to postpone the part of the taxes attributable to a reversionary or remainder interest as described in section 6163?	**4**		

Part 4—General Information

(Note. Please attach the necessary supplemental documents. **You must attach the death certificate.)** (see instructions on page 12)

Authorization to receive confidential tax information under Regs. sec. 601.504(b)(2)(i); to act as the estate's representative before the IRS; and to make written or oral presentations on behalf of the estate if return prepared by an attorney, accountant, or enrolled agent for the executor:

Name of representative (print or type)	State	Address (number, street, and room or suite no., city, state, and ZIP code)

I declare that I am the ☐ attorney/ ☐ certified public accountant/ ☐ enrolled agent (you must check the applicable box) for the executor and prepared this return for the executor. I am not under suspension or disbarment from practice before the Internal Revenue Service and am qualified to practice in the state shown above.

Signature	CAF number	Date	Telephone number

1 Death certificate number and issuing authority (attach a copy of the death certificate to this return).

2 Decedent's business or occupation. If retired, check here ▶ ☐ and state decedent's former business or occupation.

3 Marital status of the decedent at time of death:

☐ Married

☐ Widow or widower—Name, SSN, and date of death of deceased spouse ▶

☐ Single

☐ Legally separated

☐ Divorced—Date divorce decree became final ▶

4a Surviving spouse's name	**4b** Social security number	**4c** Amount received (see page 12 of the instructions)

5 Individuals (other than the surviving spouse), trusts, or other estates who receive benefits from the estate (do not include charitable beneficiaries shown in Schedule O) (see instructions).

Name of individual, trust, or estate receiving $5,000 or more	Identifying number	Relationship to decedent	Amount (see instructions)
All unascertainable beneficiaries and those who receive less than $5,000 ▶			
Total			

Please check the "Yes" or "No" box for each question.

		Yes	No
6	Does the gross estate contain any section 2044 property (qualified terminable interest property (QTIP) from a prior gift or estate) (see page 12 of the instructions)?		
7a	Have federal gift tax returns ever been filed? If "Yes," please attach copies of the returns, if available, and furnish the following information:		
7b	Period(s) covered / **7c** Internal Revenue office(s) where filed		
8a	Was there any insurance on the decedent's life that is not included on the return as part of the gross estate?		
b	Did the decedent own any insurance on the life of another that is not included in the gross estate?		

(continued on next page)

Part 4—General Information *(continued)*

	If you answer "Yes" to any of questions 9–16, you must attach additional information as described in the instructions.	Yes	No
9	Did the decedent at the time of death own any property as a joint tenant with right of survivorship in which **(a)** one or more of the other joint tenants was someone other than the decedent's spouse, and **(b)** less than the full value of the property is included on the return as part of the gross estate? If "Yes," you must complete and attach Schedule E		
10a	Did the decedent, at the time of death, own any interest in a partnership (for example, a family limited partnership), an unincorporated business, or a limited liability company; or own any stock in an inactive or closely held corporation?		
b	If "Yes," was the value of **any** interest owned (from above) discounted on this estate tax return? If "Yes," see the instructions for Schedule F on page 20 for reporting the total accumulated or effective discounts taken on Schedule F or G		
11	Did the decedent make any transfer described in section 2035, 2036, 2037, or 2038 (see the instructions for Schedule G beginning on page 15 of the separate instructions)? If "Yes," you must complete and attach Schedule G		
12a	Were there in existence at the time of the decedent's death any trusts created by the decedent during his or her lifetime?		
b	Were there in existence at the time of the decedent's death any trusts not created by the decedent under which the decedent possessed any power, beneficial interest, or trusteeship?		
c	Was the decedent receiving income from a trust created after October 22, 1986, by a parent or grandparent?		
	If "Yes," was there a GST taxable termination (under section 2612) upon the death of the decedent?		
d	If there was a GST taxable termination (under section 2612), attach a statement to explain. Provide a copy of the trust or will creating the trust, and give the name, address, and phone number of the current trustee(s).		
e	Did the decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 12a or 12b?		
	If "Yes," provide the EIN number to this transferred/sold item. ▶		
13	Did the decedent ever possess, exercise, or release any general power of appointment? If "Yes," you must complete and attach Schedule H		
14	Did the decedent have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?		
15	Was the decedent, immediately before death, receiving an annuity described in the "General" paragraph of the instructions for Schedule I or a private annuity? If "Yes," you must complete and attach Schedule I		
16	Was the decedent ever the beneficiary of a trust for which a deduction was claimed by the estate of a pre-deceased spouse under section 2056(b)(7) and which is not reported on this return? If "Yes," attach an explanation		

Part 5—Recapitulation

Item number	Gross estate		Alternate value	Value at date of death
1	Schedule A—Real Estate	1		
2	Schedule B—Stocks and Bonds	2		
3	Schedule C—Mortgages, Notes, and Cash	3		
4	Schedule D—Insurance on the Decedent's Life (attach Form(s) 712)	4		
5	Schedule E—Jointly Owned Property (attach Form(s) 712 for life insurance)	5		
6	Schedule F—Other Miscellaneous Property (attach Form(s) 712 for life insurance)	6		
7	Schedule G—Transfers During Decedent's Life (att. Form(s) 712 for life insurance)	7		
8	Schedule H—Powers of Appointment	8		
9	Schedule I—Annuities	9		
10	Total gross estate (add items 1 through 9)	10		
11	Schedule U—Qualified Conservation Easement Exclusion	11		
12	Total gross estate less exclusion (subtract item 11 from item 10). Enter here and on line 1 of Part 2—Tax Computation	12		

Item number	Deductions		Amount
13	Schedule J—Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims	13	
14	Schedule K—Debts of the Decedent	14	
15	Schedule K—Mortgages and Liens	15	
16	Total of items 13 through 15	16	
17	Allowable amount of deductions from item 16 (see the instructions for item 17 of the Recapitulation)	17	
18	Schedule L—Net Losses During Administration	18	
19	Schedule L—Expenses Incurred in Administering Property Not Subject to Claims	19	
20	Schedule M—Bequests, etc., to Surviving Spouse	20	
21	Schedule O—Charitable, Public, and Similar Gifts and Bequests	21	
22	Tentative total allowable deductions (add items 17 through 21). Enter here and on line 2 of the Tax Computation	22	

Estate of:	Decedent's Social Security Number

SCHEDULE A—Real Estate

- For jointly owned property that must be disclosed on Schedule E, see the instructions on the reverse side of Schedule E.
- Real estate that is part of a sole proprietorship should be shown on Schedule F.
- Real estate that is included in the gross estate under section 2035, 2036, 2037, or 2038 should be shown on Schedule G.
- Real estate that is included in the gross estate under section 2041 should be shown on Schedule H.
- If you elect section 2032A valuation, you must complete Schedule A and Schedule A-1.

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
Total from continuation schedules or additional sheets attached to this schedule . . .				
TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 1.)				

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)

(See the instructions on the reverse side.)

CHAPTER 3 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The Estate Tax and Gift Tax are unified into one tax system.

   a) true
   b) false

2. Which of the following best describes the impact of a decedent leaving money to an heir on federal income taxes:

   a) a decedent may deduct the value of a gift made through a will from his or her estate's income tax liability
   b) the value of a planned gift can be deducted when an individual executes his or her will
   c) a decedent's estate generally cannot deduct the value of gifts made to an heir unless they are made to qualifying charitable organizations
   d) a decedent is entitled to a credit equal to the value of all the property he or she disposed of through a will

3. Administrative expenses that can be deducted from a decedent's estate include which of the following:

   a) attorney's fees
   b) accountant's fees
   c) expenses associated with managing property of the estate
   d) all of the above

4. If an individual contributes property with a fair market value that is less than his or her basis in it, the deduction is limited to its fair market value.

   a) true
   b) false

5. An individual's deduction for charitable contributions cannot be more than what percentage of the individual's adjusted gross income for the year:

   a) 20 percent
   b) 30 percent
   c) 50 percent
   d) there is no such limit

6. A personal representative can choose from two valuation dates: the decedent's date of death, or the value six months later (the alternate valuation date).

   a) true
   b) false

7. Any gift is a taxable gift.

   a) true
   b) false

8. Under what circumstances is gift splitting allowed:

   a) only where both spouses agree
   b) if at least one spouse agrees
   c) if the total value of the gift does not exceed $10,000
   d) gift splitting is not allowed under federal law

9. A gift tax return is required if an individual and his or her spouse are splitting a gift.

   a) true
   b) false

10. What role do states play in the world of death and taxes:

    a) none; federal law forbids states from levying death or inheritance taxes
    b) some states impose death taxes on estates
    c) all states impose a significant death tax on estates
    d) federal law allows states to impose inheritance taxes but not death taxes

CHAPTER 3 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** The federal Estate and Gift Tax imposes a tax on transferring assets: one tax catches transfers made during an individual's life, and the other catches transfers at death.

   B: False is incorrect. Transfers while an individual is alive and at the individual's death are combined and subject to one progressive tax. The rates are the same for both taxes.

   (See page 3-2 of the course material.)

2. A: Incorrect. An individual cannot deduct the value of gifts made, unless they are to qualifying charitable organizations.

   B: Incorrect. There is no such deduction allowed.

   C: Correct. An individual cannot deduct the value of gifts made, unless they are to qualifying charitable organizations.

   D: Incorrect. There is no such deduction allowed.

   (See page 3-3 of the course material.)

3. A: Incorrect. Legal expenses associated with probating an estate are deductible as administrative expenses. However, this is not the best answer.

   B: Incorrect. Accounting fees, such as preparation of the decedent's tax return, are deductible as administrative expenses. However, this is not the best answer.

   C: Incorrect. Fees for managing property, such as hiring a property manager for real property, are deductible as administrative expenses. However, this is not the best answer.

   D: Correct. Because A, B and C are all examples of deductible administrative expenses, D is the best answer.

   (See page 3-5 of the course material.)

4. **A: True is correct.** An individual cannot claim a deduction for the difference between the property's basis and its fair market value.

   B: False is incorrect. Contributed property that has decreased in value, such as clothing, furniture, appliances, and cars, is limited to a deduction equal to the fair market value of the contribution.

   (See page 3-7 of the course material.)

5. A: Incorrect. The limit for an individual's deduction for charitable contributions cannot be more than 50 percent, not 30 percent, of the individual's adjusted gross income for the year.

   B: Incorrect. The limit for an individual's deduction for charitable contributions cannot be more than 50 percent of the individual's adjusted gross income for the year.

   C: Correct. The 50 percent limit applies to the total of all charitable contributions made by the taxpayer during the calendar year.

   D: Incorrect. There is in fact a limit to the amount of deductions an individual can take for charitable contributions that is based on the donor's adjusted gross income for the year the contribution is made.

   (See page 3-10 of the course material.)

6. **A: True is correct.** The alternative valuation date election is allowed only if it lowers the individual's tax liability.

   B: False is incorrect. Whatever date is selected, it is irrevocable and will apply to all assets in the estate.

   (See page 3-15 of the course material.)

7. A: True is incorrect. There are many exceptions, allowing some gifts to not be taxable.

   B: False is correct. Examples of nontaxable gifts include gifts that are not more than the annual exclusion for the calendar year, tuition or medical expenses a taxpayer pays for someone, gifts to an individual's spouse, gifts to a political organization for its use, and gifts to qualified charities.

   (See page 3-16 of the course material.)

8. **A: Correct.** If an individual and his/her spouse make a gift to a third party, the gift can be considered as made one-half by the individual and one-half by his/her spouse, as long as they both consent.

   B: Incorrect. Gift splitting requires that consent be given by both spouses.

   C: Incorrect. The value of the gift has nothing to do with whether or not it can be split.

   D: Incorrect. Gift splitting is allowed under federal law where both spouses agree.

   (See page 3-17 of the course material.)

9. **A: True is correct.** The gift tax return (Form 709) is due on April 15 of the year following the year in which the taxpayer made the gift. The gift tax due (if any) is due at the time of filing the return.

   B: False is incorrect. Other situations in which a gift tax return is required include if gifts are given greater than the annual exclusion, if an individual gave someone (other than his/her spouse) a gift that he or she cannot actually possess, enjoy, or receive income from until some time in the future, or an individual gave his or her spouse an interest in property that will be ended by some future event.

   (See page 3-21 of the course material.)

10. A: Incorrect. There is no such federal prohibition, although many states choose not to impose such taxes.

    B: Correct. A handful of states levy such a tax. Such taxes are levied on the estate prior to the distribution of assets to heirs.

    C: Incorrect. Only a handful of states impose death taxes.

    D: Incorrect. Federal law does not preclude either type of tax, and there are states that impose one or the other or both.

    (See page 3-23 of the course material.)

Chapter 4: Creation, Modification and Construction of Trusts

I. Overview of Trust Creation

A. PROPER SUBJECTS OF A TRUST

Virtually anything can be the subject of a trust – real property, personal property such as a coin collection or furniture as well as stocks, bonds, and other investment vehicles. The only significant limitation is that a trust cannot be used for an illegal purpose or to support an illegal activity, i.e. a trust to support domestic terrorism would be invalid. Also, as a general rule a trust cannot be used to operate a business. The IRS will generally classify such an entity as either a corporation or a partnership for purposes of federal taxation.

B. PARTIES TO A TRUST

1. Trustee

The trustee is the individual who is in charge of managing the trust. Every trust must have a trustee. If for whatever reason the trustee cannot serve, however, the trust will not fail. Rather, an alternative trustee will be named either by a court or by the trust document itself if it contains the name of an alternate or successor trustee. In a living trust, the trustor may be the trustee and the beneficiary.

The trustee owes a fiduciary duty to the trustor and the beneficiaries. The trustee's concern must be for the benefit of the beneficiary. This means that he or she must act in the best interests of the trustor. The specific powers of the trustee are either set forth in the trust document or provided for in accordance with applicable state law. This topic is discussed in greater detail in Chapter 6.

2. Beneficiary

The beneficiary or beneficiaries are the person or persons for whose benefit the trust has been created. There must be a designated beneficiary in order to have a valid trust. Without a beneficiary, a court cannot ascertain who should benefit from the trust. Nor is there a person who can enforce the obligations of the trustee. The beneficiary can be a specifically named individual or individuals or a class of persons.

> **Example 1.**
>
> *In his will, John creates a testamentary trust for the benefit of his sons, Roger, Egbert and Michael. The proceeds are to be held in trust for the sons until they have all reached the age of 21. This is a trust in which the beneficiaries are specifically named.*

Example 2.

In his will, John, who is childless, creates a testamentary trust for the benefit of "my nieces and nephews." Each niece and nephew is a beneficiary under the trust even though the names of each individual are not specifically used. This is referred to as a "class" gift.

3. Trust Property

To be valid, a trust must also have some identifiable trust property. Whether or not a formal transfer of the property is required depends on the law of each state and the nature of the property that is the subject of the trust. For example, real property must typically be formally transferred in order to be placed in a trust. In some cases, however, a mere declaration of trust by the trustor or grantor will be sufficient to change the nature of the property and place it in a trust.

C. TITLE TO TRUST PROPERTY

The creation of a trust vests equitable title of the property in a trust with the beneficiary or beneficiaries, while legal title is transferred to the trustee. The exception is testamentary trusts, which do not come into being until the death of the trustor. Title to property that is the subject of a testamentary trust remains with the trustor until his or her death. In the case of a revocable trust, title can be reclaimed by the trustor according to the terms of the trust instrument. The language of the trust document establishes the terms and conditions for the usage of the assets of the trust.

Example 1.

Jack creates a trust for the benefit of his son, Roger, the proceeds of which are to pay for Roger's education. Any funds leftover at the end of his education are to be distributed to charity. Roger may not use the proceeds of the trust to buy a car, to take a vacation or to pay for a wedding. The limits are dictated by the language of the trust instrument.

Example 2.

Richard establishes a trust for the benefit of his wife, Lois, so long as his wife remains alive. After Lois' death, the proceeds are to be distributed to his children and grandchildren in equal amounts. Under the terms of this type of life interest, Lois is free to remain on and use the property, but is not free to dispose of or otherwise encumber it.

D. STATE LAW

State law plays an important role in governing the use of trusts. The formalities of trust creation differ from state to state and, to some extent, based upon the type of property that is the subject of the trust. In the case of real property, it is governed by the laws of the state in which the property is located. In the case of all other property, the law of the state of the trustor's domicile generally governs the trust. An individual's domicile is the state in which he or she makes his or her permanent home. Each person may have only one domicile. As always, refer to the laws of each state for more specific guidance.

II. Elements of a Valid Trust

As we said above, trusts are governed by state law. That means that anyone considering creating a trust should be familiar with the laws of his or her state of domicile. However, as an illustration, most states require each of the elements described below.

A. PRECATORY LANGUAGE

Precatory language is an expression of the trustor's wishes. There must be a declaration – either orally or in writing – to create a valid trust. As a practical matter, oral trusts are never a good idea. Even if they are technically enforceable, any problems that might arise during their administration would be difficult to resolve absent a written document to provide guidance to a court. As with a will, the trustor must have the requisite intent to create a trust in order for the document to be effective. This intent is set forth in the precatory language.

> **Example.**
>
> *Roger, as part of his estate plan, drafts a living trust in which he is the primary beneficiary and his children, Bob and Brenda, are the contingent beneficiaries. The precatory language provides as follows: "I Roger Applebe, do hereby place all of my property, real and personal, in trust for my benefit during my lifetime and, at the end of my lifetime, for the benefit of my children Bob and Brenda." This language is a clear indication of Roger's intentions.*

B. WRITTEN INSTRUMENT

A trust that involves real property must generally be in writing. As we said above, however, it is a good idea to reduce any declaratory trust to writing in order to better protect the trustor's wishes.

The statute of frauds, a common law doctrine that has been codified in every state, generally requires that a trust be in writing if the subject matter of the trust is an interest in land. Courts have also commonly held that the statute of frauds likewise governs a trust where the subject matter of the trust is both land and the proceeds from the sale of the land. Some states view such a situation as two separate and severable trusts. Maryland, for example, follows the rule that an express oral trust involving land is void and the alleged trust or promise involving the proceeds of the sale of the land is also void.

C. DELIVERY

In most cases, no formal hand over of property is required to execute a valid trust. A mere declaration of trust normally, however, requires delivery of the trust property in order to be effective. In addition, the title to certain property often must be placed in the name of the trust, i.e. real property or motor vehicles in certain circumstances. The law of Iowa, set forth below, is fairly representative of the above general requirements for the creation of a valid trust.

Iowa Code § 633.2102. Requirements for validity

1. A trust is created only if all of the following elements are satisfied:

a. The settlor was competent and indicated an intention to create a trust.

b. The same person is not the sole trustee and sole beneficiary.

c. The trust has a definite beneficiary or a beneficiary who will be definitely ascertained within the period of the applicable rule against perpetuities, unless the trust is a charitable trust, an honorary trust, or a trust for pets.

d. The trustee has duties to perform.

2. A power in a trustee to select a beneficiary from an indefinite class is valid. If the power is not exercised within a reasonable time, the power fails and the property passes to the person or persons who would have taken the property had the power not been conferred.

3. A trust is not merged or invalid because a person, including but not limited to the settlor of the trust, is or may become the sole trustee and the sole holder of the present beneficial interest in the trust, provided that one or more other persons hold a beneficial interest in the trust, whether such interest be vested or contingent, present or future, and whether created by express provision of the instrument or as a result of reversion to the settlor's estate.

D. KNOWLEDGE OF BENEFICIARY

It is not necessary for the validity of a voluntary trust that the beneficiary have knowledge of the existence of the trust or its provisions. In many cases, a trustor may wish to keep his estate plan confidential, at least until his or her death. In particular, a trustor may not want the beneficiaries of a testamentary trust to rely on its proceeds.

E. TERMINATION PROVISIONS

Every trust should contain the conditions under which it is to be terminated. This is necessary to help a trustee carry out the trustor’s wishes and for a court to enforce the provisions of a trust in the event of conflict. As we have said, most express terms of a trust, including termination provisions, are enforced so long as they are not illegal or do not violate public policy.

In some cases, a trust will be self-terminating, such as when all of its assets have been paid to its beneficiaries. In other cases, the trustor may want to impose more artificial conditions that act to terminate the trust, such as when the beneficiaries have finished college.

Example.

Estelle creates a living trust for her benefit during her lifetime and, after her death, for the benefit of her son until his 40th birthday. By its terms, the trust will terminate when her son reaches the age of 40.

The subject of termination of trusts is discussed in more detail in Chapter 5.

III. Duration of Trusts: The Rule Against Perpetuities

A. TRUSTORS GENERALLY FREE TO SET TERMS OF TRUST

A trustor is generally free to establish the terms, including duration, of a trust. One significant limitation in the creation of a trust, however, is the duration for which the trust is to last. With the exception of charitable trusts, most states do not allow trusts that last in perpetuity, i.e. forever. This limit arose at common law and is referred to as the Rule Against Perpetuities. The essence of the rule is that no interest in real or personal property is good unless it must vest, if at all, no later than twenty-one years after a life in being.

Example 1.

William, a 75-year-old widower, leaves his property in trust for his grandchildren, under the terms of which the grandchildren receive income from the trust until their 35th birthday, at which time they are entitled to the body of the trust. William is free to impose the 35-year-old requirement, as he would be to pick a different age, such as 25 or 40-years-old. This does not violate the Rule Against Perpetuities.

Problems with the Rule Against Perpetuities arise when a trustor attempts to control the assets of the trust for a long period of time following his or her death.

Example 2.

William, a 75-year-old widower, leaves his property in trust for his grandchildren. His grandchildren are to receive income from the trust for their life. When they die, the profits from the trust are to be paid to his future great-grandchildren. At their death, the profits are to be paid to his future great-great-grandchildren. This disposition violates the Rule Against Perpetuities.

B. POLICY OF RULE

The policy behind this rule has historically been to keep individuals from controlling their property for too long after their death. At some point in time, the policy goes, a dead person should no longer be able to exert control. As formulated in North Carolina law, for example, the Rule Against Perpetuities provides as follows:

N.C.G.S.A. § 41-15. Statutory rule against perpetuities

(a) A nonvested property interest is invalid unless:
(1) When the interest is created, it is certain to vest or terminate no later than 21 years after the death of an individual then alive; or
(2) The interest either vests or terminates within 90 years after its creation.

Example 1.

Ivan creates a testamentary trust in which he leaves all of his property in trust for the benefit of his wife, Lisa, during her lifetime, and after her lifetime for the benefit of their son, Augustus, until he reaches his 40th birthday, at which time he shall be entitled to the assets of the trust. By its terms the trust will not last longer than 21 years after the death of an individual then alive, because Augustus will receive the assets of the trust during his lifetime.

Example 2.

Ivan creates a testamentary trust in which he leaves all of his property in trust for the benefit of his wife, Lisa, during her lifetime, and after her lifetime, for the benefit of any grandchildren that might be born to his minor son Augustus until they reach the age of 40. Because by its terms the trust would not end within 21 years after the death of an individual alive at the time, it violates the Rule Against Perpetuities.

C. SAVINGS CLAUSES

Because running afoul of the rule is fatal – that is, it makes the trust unenforceable – it is common practice to put "savings clauses" in trust instruments. These clauses basically state that if the interest created should be deemed to violate the rule against perpetuities it shall terminate one day before twenty-one years after the last life in being has passed.

D. TREND TOWARD MODIFICATION OR REPEAL

Recently, there has been movement to simplify the rule against perpetuities or, in some states, to repeal it. In 1998, for example, Maryland adopted an important exception to the rule against perpetuities. Under Estates and Trusts Article 11-102(e) the rule against perpetuities does not apply to "[a] trust in which the governing instrument states that the rule against perpetuities does not apply to the trust and under which the trustee, or other person to whom the power is properly granted, has the power under the governing instrument, applicable statute, or common law to sell, lease, or mortgage property for any period of time beyond the period that is required for an interest created under the governing instrument to vest, so as to be good under the rule against perpetuities." In other words, if the trustee were given the power to sell or otherwise dispose of property which is the subject of the trust after the rule against perpetuities would have required that the trust be terminated, such a trust will be upheld.

IV. <u>Construction of Trust Gifts</u>

Although most trustors attempt to clearly set forth their wishes in the instrument creating the trust, controversy does arise in interpreting a trust. State law has generally adopted various rules used to construe gifts made through a trust, particularly in the case of class gifts, i.e., those given to a group of people identified by a title rather than by name (e.g., a trust for the benefit "of all my grandchildren").

A. CONSTRUCTION OF CLASS GIFTS

1. Increase in Class Membership

When a trustor makes a gift to a class of people, i.e. "to all my nieces and nephews", membership in the class may continue to increase until at least one member of the class becomes entitled to possession of the property that is the subject of the class gift.

> **Example 1.**
>
> *William, a 65-year-old man, creates a trust in which be placed certain securities for the support and benefit of his grandchildren. At the time the trust is created, William has three grandchildren. During the next 10 years, five additional grandchildren are born. All eight grandchildren are entitled to the benefit of the proceeds of the trust, according to its language.*

The exception to this rule occurs if, at the time an interest is intended to become possessory, no member of the class has yet been born. In such a case, the trust will generally close to potential new members.

> **Example 2.**
>
> *Same as the facts above except that the trust provides that the proceeds of the trust are to be given outright to his grandchildren at the time of his death. When William dies, he has four grandchildren, all of whom will share in the proceeds of the trust. Grandchildren born after his death will not, by the terms of the trust, be entitled to its proceeds.*

2. Decrease in Class Membership

A different scenario occurs when a class decreases in size to the surprise of the trustor. For example, what happens if the trustor established a trust for the benefit of his children, and one of them unexpectedly dies? There are three possible scenarios:

- No survivorship requirement is imposed. Thus, a predeceased child would still take her share and it would be distributed to that child's heirs.
- A survivorship requirement is imposed. The predeceased child's share is divided among the surviving members of the class.

- If the predeceased child has children of his own, the court may allow the grandchildren to "step into the shoes of the child" and become the heir.

The rule here is that the language of a will creating a trust should be so construed as to give effect to the *intention of the testator,* if that intention is able to be ascertained from the language of the will itself, considered in the light of the surrounding circumstances. Implied conditions of survival tell us that courts treat the problem in three varied ways:

- Treat the shares as vested (no condition of survival) (children means children);

- Treat the shares as subject to a condition of survival (children means children); or

- Treat the shares as a gift to the class members and their issue (children means issue).

Given the potential for judicial interpretation, individuals should make their wishes as clear as possible when executing a trust or provisions of a will that establish a trust.

3. <u>Adoptive Members of a Class</u>

The modern trend is to include adopted members in a class described generically as "my child, my children, my grandchildren, etc…" An adoptive child is deemed an heir of his or her adoptive parents but not necessarily a child of his or her natural parents. In many states, there are express probate codes dealing with adoptive children.

4. <u>Class Gift of Income</u>

Some testators direct that income should be divided among her children until the death of the last surviving child. If one child dies, what happens to that child's share of the income? The majority rule provides that the surviving child shall take the predeceased child's share (the doctrine of cross remainders). Most commentators argue that the income should go to the issue of the deceased child. Well drafted trusts provide the latter answer.

V. <u>Powers of Appointment</u>

A. INTRODUCTION

A power of appointment allows either a beneficiary or another designated person to designate how certain assets in a trust are to be disposed.

Example.

Luther, an elderly man, establishes a trust to pay for the education of his grandson, Tad. After Tad completes his education, the trust provides that Tad has the authority to determine how to dispose of any remaining assets. This power is referred to as a power of appointment.

The trust may or may not limit the scope of authority available to the individual with the power of appointment.

B. TYPES OF POWERS OF APPOINTMENT

In general, there are two main types of powers of appointment.

1. General Power of Appointment

A general power of appointment is one that results in the property of the trust becoming the property of the beneficiary who retains the power of appointment. A general power of appointment is exercisable in favor of the beneficiary, his or her estate, or creditors.

2. Special Power of Appointment

A special power of appointment is a power that is not exercisable in favor of the donee, his estate, his creditors, or the creditors of his estate.

C. IMPORTANCE OF DISTINCTION

The distinction for federal tax purposes between a special and a general power of appointment is extremely important.

1. Tax Implications

A general power of appointment brings the property into the beneficiary's estate for estate tax purposes. One area where this distinction is important is in marital deduction trusts. Although a QTIP trust is currently the most common, the other way property can be left in trust for a surviving spouse yet still qualify for the marital deduction is to give the spouse a general power of appointment. Another area under federal tax laws where a general power of appointment becomes an important planning tool involves non-exempt GST trusts. Granting a general power of appointment in such circumstances will sidestep the generation-skipping transfer tax rates.

26 U.S.C. § 2041. Powers of appointment

(a) In general.--The value of the gross estate shall include the value of all property.

(1) Powers of appointment created on or before October 21, 1942.*--To the extent of any property with respect to which a general power of appointment created on or before October 21, 1942, is exercised by the decedent--*

> ***(A)*** *by will, or*
>
> ***(B)*** *by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive; but the failure to exercise such a power or the complete release of such a power shall not be deemed an exercise thereof. If a general power of appointment created on or before October 21, 1942, has been partially released so that it is no longer a general power of appointment, the exercise of such power shall not be deemed to be the exercise of a general power of appointment if--*

__(i)__ such partial release occurred before November 1, 1951, or

__(ii)__ the donee of such power was under a legal disability to release such power on October 21, 1942, and such partial release occurred not later than 6 months after the termination of such legal disability.

***(2) Powers created after October 21, 1942.**--To the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive. For purposes of this paragraph (2), the power of appointment shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised.*

***(3) Creation of another power in certain cases.**--To the extent of any property with respect to which the decedent--*

__(A)__ by will, or

__(B)__ by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent's gross estate under section 2035, 2036, or 2037, exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

***(b) Definitions.**--For purposes of subsection (a)--*

***(1) General power of appointment.**--The term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that--*

__(A)__ A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.

__(B)__ A power of appointment created on or before October 21, 1942, which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment.

__(C)__ In the case of a power of appointment created after October 21, 1942, which is exercisable by the decedent only in conjunction with another person--

__(i)__ If the power is not exercisable by the decedent except in conjunction with the creator of the power--such power shall not be deemed a general power of appointment.

__(ii)__ If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent--such power shall not be deemed a general power of appointment. For the purposes of this clause a person who, after the death of the decedent, may be possessed of a power of appointment (with respect to the property subject to the decedent's power) which he may exercise in his own favor shall be deemed as having an interest in the

property and such interest shall be deemed adverse to such exercise of the decedent's power.

(iii) *If (after the application of clauses (i) and (ii)) the power is a general power of appointment and is exercisable in favor of such other person--such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the decedent) in favor of whom such power is exercisable.*

For purposes of clauses (ii) and (iii), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate.

(2) Lapse of power.*--The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:*

(A) *$5,000, or*

(B) *5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.*

(3) Date of creation of power.*--For purposes of this section, a power of appointment created by a will executed on or before October 21, 1942, shall be considered a power created on or before such date if the person executing such will dies before July 1, 1949, without having republished such will, by codicil or otherwise, after October 21, 1942.*

26 U.S.C. § 2514. Powers of appointment

(a) Powers created on or before October 21, 1942.*--An exercise of a general power of appointment created on or before October 21, 1942, shall be deemed a transfer of property by the individual possessing such power; but the failure to exercise such a power or the complete release of such a power shall not be deemed an exercise thereof. If a general power of appointment created on or before October 21, 1942, has been partially released so that it is no longer a general power of appointment, the subsequent exercise of such power shall not be deemed to be the exercise of a general power of appointment if--*

(1) *such partial release occurred before November 1, 1951, or*

(2) *the donee of such power was under a legal disability to release such power on October 21, 1942, and such partial release occurred not later than six months after the termination of such legal disability.*

(b) Powers created after October 21, 1942.*--The exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power.*

(c) Definition of general power of appointment.*--For purposes of this section, the term "general power of appointment" means a power which is exercisable in favor of the individual possessing the power (hereafter in this subsection referred to as the "possessor"), his estate, his creditors, or the creditors of his estate; except that--*

(1) *A power to consume, invade, or appropriate property for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor shall not be deemed a general power of appointment.*
(2) *A power of appointment created on or before October 21, 1942, which is exercisable by the possessor only in conjunction with another person shall not be deemed a general power of appointment.*
(3) *In the case of a power of appointment created after October 21, 1942, which is exercisable by the possessor only in conjunction with another person--*

(A) *if the power is not exercisable by the possessor except in conjunction with the creator of the power--such power shall not be deemed a general power of appointment;*
(B) *if the power is not exercisable by the possessor except in conjunction with a person having a substantial interest, in the property subject to the power, which is adverse to exercise of the power in favor of the possessor--such power shall not be deemed a general power of appointment. For the purposes of this subparagraph a person who, after the death of the possessor, may be possessed of a power of appointment (with respect to the property subject to the possessor's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the possessor's power;*
(C) *if (after the application of subparagraphs (A) and (B)) the power is a general power of appointment and is exercisable in favor of such other person-- such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the possessor) in favor of whom such power is exercisable.*

For purposes of subparagraphs (B) and (C), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate.

(d) Creation of another power in certain cases.*--If a power of appointment created after October 21, 1942, is exercised by creating another power of appointment which, under the applicable local law, can be validly exercised so as to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power, such exercise of the first power shall, to the extent of the property subject to the second power, be deemed a transfer of property by the individual possessing such power.*

(e) Lapse of power.*--The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts:*

(1) *$5,000, or*
(2) *5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied.*

(f) Date of creation of power.*--For purposes of this section a power of appointment created by a will executed on or before October 21, 1942, shall be considered a power created on or before such date if the person executing such will dies before July 1, 1949, without having republished such will, by codicil or otherwise, after October 21, 1942.*

2. Reach of Creditors

It is not only for federal tax purposes that a general power of appointment will make the property subject to the power deemed to be in the estate of the holder of the power. A general power of appointment also has consequences for the creditors of the beneficiary of the power. For example, courts have commonly ruled that creditors of a trust beneficiary could reach the assets of the trust in cases where the beneficiary had been granted a general power of appointment.

> **Example.**
>
> *In* ***Brent v. State Central Collection Unit****, 311 Md. 626 (1988) the Court of Appeals held that the creditors of a trust beneficiary could reach the assets of the trust after the beneficiary gained the power to appoint such assets to herself. The trust had spendthrift provisions that governed the trust. The terms of the trust, however, stated that when the beneficiary reached the age of 40 years she could direct that the trustees pay her all of the trust assets.*
>
> *The trust beneficiary had reached the age of 40 but at that time was legally incompetent and was an in-patient at a state mental hospital. The state sought to reach the trust assets to pay for her care. The Court of Appeals held that there was a general power of appointment in this trust and that not only the beneficiary of a general power of appointment could reach those assets but his or her creditors as well. The Court followed the rule that whenever property is subject to alienation by the owner it then also becomes subject to his debts.*
>
> *Additionally, the Court held: "The key is the right of the beneficiary to the corpus as distinguished from his actual possession of it. So the rights of the beneficiary's creditors depend upon the beneficiary's interest in the property, not on the actual distribution of the funds to him." The Court of Appeals also held that the fact the beneficiary was incompetent to actually exercise her power to withdraw trust assets was immaterial: "It was her right to demand distribution of the corpus that governed, not her ability to demand."*

VI. <u>Modification of Trusts</u>

The laws of most states assume a trust to be revocable unless it specifically states that it is irrevocable. For example, California Probate Code § 15400 provides that "[u]nless a trust is expressly made irrevocable by the trust instrument, the trust is revocable by the settlor."

A. REVOCABLE TRUSTS

To the extent that a trust is revocable, a trustor can modify or terminate the trust at virtually any time.

> **Example.**
>
> *Tommy creates a living trust for his benefit during his lifetime with the remainder to be used for the support of his grandchildren following his death. Tommy appoints himself trustee during his lifetime and names his CPA, Dennis, to be the successor trustee following his death. The trust is revocable during Tommy's lifetime and becomes irrevocable upon his death, at which time Dennis will become the trustee. A year after creating the trust, Tommy meets and marries Doris. Tommy is free to change the trust to make Doris a beneficiary either in addition to or in lieu of his grandchildren. The trust does not become irrevocable until his death. It can therefore be modified or terminated according to Tommy's wishes at any time.*

California Probate Code § 15401, for example, provides as follows:

(a) A trust that is revocable by the settlor may be revoked in whole or in part by any of the following methods:
(1) By compliance with any method of revocation provided in the trust instrument.
(2) By a writing (other than a will) signed by the settlor and delivered to the trustee during the lifetime of the settlor. If the trust instrument explicitly makes the method of revocation provided in the trust instrument the exclusive method of revocation, the trust may not be revoked pursuant to this paragraph.
(b) Unless otherwise provided in the instrument, if a trust is created by more than one settlor, each settlor may revoke the trust as to the portion of the trust contributed by that settlor, except as provided in Section 761 of the Family Code.
(c) A trust may not be modified or revoked by an attorney in fact under a power of attorney unless it is expressly permitted by the trust instrument.
(d) Nothing in this section limits the authority to modify or terminate a trust pursuant to Section 15403 or 15404 in an appropriate case.
(e) The manner of revocation of a trust revocable by the settlor that was created by an instrument executed before July 1, 1987, is governed by prior law and not by this section.

B. AMENDING TESTAMENTARY TRUSTS

A will does not have legal effect until the death of the testator. Many wills contain provisions creating testamentary trusts. Because a testamentary trust cannot take effect until the death of the trustor, its provisions within a will can be altered at anytime prior to the trustor's death. The only limitation is that the new trust provisions must comply fully with the requirements for the creation of a valid will or codicil. Each state has its own laws governing the execution of a valid will or codicil.

> **Example.**
>
> *Linda drafted a valid will 10 years ago, the provisions of which included the creation of a testamentary trust for the benefit of her children. Lately, however, Linda has been very disappointed with the choices that some of her children have been making and wants to leave the proceeds that would have funded the trust to charity instead. Linda can accomplish this by drafting a new valid will that will supercede the prior will. She also has the option of amending the trust in a new valid will eliminating some but not all of her children as beneficiaries of the trust rather than eliminating it altogether.*

C. AMENDING IRREVOCABLE TRUSTS

There are many circumstances that can arise and lead to a desire to amend an irrevocable trust. The circumstances are as varied as the reasons for creating a trust in the first place. Examples may include the following:

- The desire to achieve certain tax goals;
- The desire to remove a restriction prohibiting the sale of certain trust assets in the face of changed financial conditions;
- The existence of an unanticipated beneficiary; or
- The death or incapacitation of a beneficiary.

The laws of each state govern the ability to amend an irrevocable trust (remember that the subject of termination is discussed separately in Chapter 5, next). Whether the IRS recognizes the change for tax purposes is a separate question. Changes must be authorized by the Internal Revenue Code to have an effect on federal tax obligations.

California, for example, allows for the amendment, modification or termination of an otherwise irrevocable trust under certain circumstances. California Probate Code § 15403 provides that, if all beneficiaries of an irrevocable trust consent, they may compel modification or termination of the trust upon petition to the court.

California law also sets forth detailed procedures involved in seeking a modification or termination of an irrevocable trust, including the filing of a petition setting forth the grounds for the requested modification or termination and the provision of notice to all beneficiaries.

California Probate Code § 15402 provides that where all of the beneficiaries of an irrevocable trust consent, a court can either modify or terminate the trust if either it is no longer necessary to carry out the essential purpose of the trust or if the benefit in changing or terminating it outweighs the benefits of not doing so. If any beneficiary does not consent to the modification or termination of the trust, Probate Code § 15404 provides that upon petition to the court, the other beneficiaries, with the consent of the trustor, may compel modification or a partial termination of the trust if the interests of the beneficiaries who do not consent are not substantially impaired.

In entertaining any modification to an irrevocable trust, the courts are careful to ensure that any change helps to effectuate the wishes of the trustor.

CHAPTER 4 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Every trust must have a trustee.

   a) true
   b) false

2. Which of the following is not a requirement for establishing a valid trust:

   a) the trustor must have at least $100,000 in assets
   b) the beneficiary must be made aware of the existence of the trust
   c) there must be property that is the subject of the trust
   d) both a and b above

3. A trustor is generally free to establish the terms, including the duration, of a trust.

   a) true
   b) false

4. A power of appointment allows either a beneficiary or other designated person to designate how certain assets in a trust are to be disposed.

   a) true
   b) false

5. When can the provisions of a testamentary trust be revised:

   a) never; once a testamentary trust is included in the provisions of a will, it cannot be amended
   b) so long as the testator is alive and has the capacity to revise his or her will, the provisions of a testamentary trust can be revised, amended, or revoked
   c) within five years of its creation
   d) anytime following the death of the trustor

CHAPTER 4 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** Although every trust must have a trustee, if for whatever reason the trustee cannot serve, the trust will not fail.

   B: False is incorrect. In a living trust, the trustor may be the trustee and the beneficiary.

   (See page 4-1 of the course material.)

2. A: Incorrect. A trust can contain any property. There is no income or asset requirement. However, this is not the best answer.

   B: Incorrect. There is no requirement that the beneficiary be made aware of the existence of a trust. However, this is not the best answer.

   C: Incorrect. A trust cannot exist in a vacuum. It must contain some property or asset.

   D: Correct. Because both A and B are not true, this is the best answer.

   (See pages 4-2 to 4-3 of the course material.)

3. **A: True is correct.** With the exception of charitable trusts, most states do not allow trusts that last in perpetuity.

   B: False is incorrect. Although a trustor is generally free to establish the duration of the trust, most states do not allow trusts that last in perpetuity other than charitable trusts.

   (See page 4-5 of the course material.)

4. **A: True is correct.** There are two main types of powers of appointment: general and special. The distinction for federal tax purposes between these two types is important.

   B: False is incorrect. The trust may or may not limit the scope of authority available to the individual with the power of appointment.

   (See page 4-9 of the course material.)

5. A: Incorrect. Because the trust does not take affect until after the death of the trustor, it can be revised at any time (prior to his or her death or loss of testamentary capacity).

   B: Correct. Such trusts can be revised any time by the trustor, so long as he or she is alive and has the requisite capacity.

   C: Incorrect. There is no such time limitation.

   D: Incorrect. To the contrary, changes can only be made so long as the trustor is alive to make them.

   (See page 4-15 of the course material.)

Chapter 5: Termination of Trusts and the Rights of Beneficiaries

I. Introduction

Once a trust is created, can it be terminated? Can a beneficiary demand that a trust be terminated or is that decision solely in the hands of the trustor? Under what circumstances does a court have the authority to end a trust and order the assets to be distributed? These are common questions that can result in a variety of answers depending on how the trust was created. The first thing to note is that all trusts fall into one of two general categories: (1) revocable trusts; and (2) irrevocable trusts. The law generally assumes a trust to be revocable unless it specifically states that it is irrevocable.

To the extent that a trust is revocable, the trustor can modify or terminate the trust at virtually any time. If a trust is irrevocable, there are still circumstances under which the trust can be terminated. Those circumstances are governed by two things: (1) the intent of the trustor as expressed in the language of the trust itself; and (2) state law, which governs the creation, operation and termination of trusts.

Ideally, every trust should contain the conditions under which it is to be terminated. This is helpful for the trustee whose job it is to carry out the wishes of the trustor. It is also helpful when a court is asked to enforce the provisions of a trust in the event of a conflict.

In some circumstances, a trust will be self-terminating, such as when all of the assets have been distributed to its beneficiaries. In other cases, the trustor may want to impose more artificial conditions that act to terminate the trust, such as when the beneficiaries have finished college.

Example 1.

Rita established a testamentary trust in which she placed $100,000 for the care and support of her nephew, Lincoln. Five years after the trust was funded following Rita's death, the proceeds have been exhausted. In the absence of any remaining assets, the trustee will have to terminate the trust.

Example 2.

Estelle creates a living trust for her benefit during her lifetime and, after her death, for the benefit of her son until his 40th birthday. By its terms, the trust will terminate when her son reaches the age of 40.

II. <u>Common Methods of Revocation</u>

There are a number of ways that a valid trust can be terminated. Remember that termination is governed by the terms of the trust instrument and the law of the state in which the trust was created. In general, they can be grouped into four categories:

- Termination by operation of the express terms of the trust;
- Termination by revocation of the trust by the trustor (in the case of a revocable trust);
- Termination by order of a court; or
- Termination by agreement of the beneficiaries.

California law, for example provides as follows:

Probate Code § 15407. Termination of Trusts

(a) A trust terminates when any of the following occurs:
(1) The term of the trust expires.
(2) The trust purpose is fulfilled.
(3) The trust purpose becomes unlawful.
(4) The trust purpose becomes impossible to fulfill.
(5) The trust is revoked.
(b) On termination of the trust, the trustee continues to have the powers reasonably necessary under the circumstances to wind up the affairs of the trust.

A. TERMINATION BASED ON OPERATION OF TRUST INSTRUMENT

Trusts often terminate based on the language of the trust document itself. Texas law, for example, provides as follows:

§ 112.052. TERMINATION.

A trust terminates if by its terms the trust is to continue only until the expiration of a certain period or until the happening of a certain event and the period of time has elapsed or the event has occurred. If an event of termination occurs, the trustee may continue to exercise the powers of the trustee for the reasonable period of time required to wind up the affairs of the trust and to make distribution of its assets to the appropriate beneficiaries. The continued exercise of the trustee's powers after an event of termination does not affect the vested rights of beneficiaries of the trust.

1. <u>Purpose Has Been Achieved</u>

If a trustor creates a trust for a particular purpose, rather than to provide a general means of support, the trust will generally end when that purpose has been achieved. For example, a trustor may provide money in trust to pay for the education of his grandchildren. Such trusts commonly provide for the distribution of the assets at the time the purpose of the trust no longer exists – namely the beneficiary has finished his education.

A trust may also be terminated on the grounds that it is no longer necessary. However, a trust will not be terminated if its purpose has not been completed. The termination of a trust on accomplishment of its purpose, however, does not affect the validity of acts of the trustee before the date of termination.

However, even when the purposes of the trust have clearly been met, termination generally cannot take place when it is contrary to the clearly expressed intention of the trustor.

Example.

Paul created a testamentary trust that provided, in part: I hereby place in trust the sum of $100,000, the proceeds of which are to be used to pay the educational expenses of my nephew, Vladamir. In no event, however, shall the trust be terminated prior to his 30th birthday. Based on the language of the trust, it cannot be terminated even if, at age 25, Vladamir has finished both law school and medical school.

2. Time Provisions

A trust may also terminate if, by its terms, the trust is to continue only until the expiration of a certain period or until the happening of a certain event and the period of time has elapsed or the event has occurred. In some cases, a trust will also terminate by operation of law where the terms of the trust violate the Rule Against Perpetuities. This rule, which is discussed in detail in Chapter 4, limits the number of years that a trust can operate in many states.

3. Purpose Has Become Impossible

What if the trustor established a trust for a particular purpose and such purpose is no longer possible? A trustee would probably have discretion under those circumstances to either terminate the trust or modify its provisions to carry out the intentions of the trustor.

Example.

William creates a testamentary trust to provide support for the education of his niece, Mary. Mary is a 21-year-old college student at the time of William's death. Shortly thereafter, she is involved in a serious accident that renders her a quadriplegic. Unable to continue school, the trustee wishes to use the funds intended to pay for her education to help defray her medical expenses. Since William's intention was to provide support for Mary, it is probably fair for the trustee to infer that he would want to help Mary with her medical expenses under these extreme and unforeseen circumstances.

B. TERMINATION BY CONSENT

Under some circumstances, and in compliance with state law, the beneficiaries of a trust can elect to terminate. The laws of each state vary. In some cases, a trust can be terminated at the election of all of the beneficiaries unless continuance of the trust is necessary to carry out a material purpose of the trust. The trend in these cases is in favor of allowing early termination so long as there is no material purpose remaining for the trust. Given the potential for judicial interpretation, individuals should make their wishes as clear as possible when executing a trust or provisions of a will that establish a trust.

Case-in-Point

In ***Carnahan v. Johnson***, 127 Ohio App.3d 195, 711 N.E.2d 1093 (1998), the Ohio Court of Appeals addressed the request of a trust's primary and contingent beneficiaries to allow the trustee to sell certain trust property. The trustee of testamentary trust filed petition to sell real estate held by the trust. The trust's primary and contingent beneficiaries filed response and requested that petition be granted. The Probate Court denied petition and the trustee and the beneficiaries appealed.

The decedent, Edward T. Leach, died on March 10, 1984. The terms of Leach's will pertinent herein are the following:

"I give and devise my 142 acre tract at 801 Alton Road in Prairie Township, Franklin County, Ohio, to Robert Richards, as Trustee and to his Successor Trustees hereinafter named, for the equal benefit of my two grand-daughters, Melanie [sic] R. Young and Sandra E. Patton, or to their children, per stirpes, in the event of their death; or to the survivor of my grand-daughters if either should die without children prior to the termination of this Trust. Said Trust shall continue for a period of thirty (30) years upon the following terms and conditions:

"The Trustee shall encourage and may assist the beneficiaries of this Trust to develop said land into cemetery lots as an extension of the adjoining Sunset Cemetery. If and when any cemetery lots in said 142 acre tract are sold the net proceeds shall be paid by the Trustee at least quarterly to the said beneficiaries."

"While said tract remains as farm land the Trustee shall rent or crop-share the same and the net proceeds divided at least annually to said beneficiaries. At the end of said thirty years this Trust shall terminate and the said land and/or the remaining unsold cemetery lots and undistributed net funds shall be conveyed and delivered to said beneficiaries."

Named as defendants in the petition were Melonie R. Johnson (f.n.a. Young) and Sandra E. Patton, granddaughters of the decedent and primary beneficiaries of the trust. Additional defendant-contingent beneficiaries are the children of Melonie and Sandra, Jennifer T. Young, a minor, David T. Young, a minor, Robert A. Patton, John P. Patton, William M. Patton, and Katherine E. Patton. A guardian *ad litem* was appointed for the two minor contingent beneficiaries, who filed an answer opposing approval of the sale. The adult primary and contingent beneficiaries filed a joint response to the petition, requesting the probate court to grant the petition to sell the real estate.

The real estate involved in the trust is a one-hundred-forty-two-acre tract of land adjacent to the Sunset Cemetery in Franklin County, Ohio. In 1983, the one hundred forty-two acres were owned by Edward Leach, who also owned an approximate one-third interest in Sunset Cemetery. The other two-thirds interest in Sunset Cemetery were owned by Leach's son-in-law, John Erwin, who had inherited his interest in the cemetery from his wife, Elizabeth Erwin, who died in 1982.

The Erwins had two daughters, Melonie Johnson and Sandra Patton. Pursuant to Leach's last will and testament, his granddaughters, Melonie and Sandra, were to inherit all of his one-third interest in Sunset Cemetery. Also included in the will was the trust consisting of the one hundred forty-two acres.

After Leach died in 1984, his will was duly admitted to probate, and Leach's interest in Sunset Cemetery was transferred to Melonie and Sandra, who sold this interest to their father, John. The one hundred forty-two acres in the trust were transferred to the trustee, Robert R. Richards, who administered the trust until his death, when John A. Carnahan became the successor trustee pursuant to the will.

Subsequently, John Erwin died, leaving all his interest in Sunset Cemetery to his daughters, Melonie and Sandra. However, it was necessary for the estate to sell the shares of Sunset Cemetery to pay federal and state estate taxes. The shares of Sunset Cemetery were sold to SCI Ohio Funeral Services, Inc. SCI was also interested in purchasing the one hundred forty-two acres held in trust and entered into a contract, subject to probate court approval, to purchase the one hundred forty-two acres for $900,000. It is this contract for sale that is at issue in the case.

It is well settled that a fundamental tenet for the construction of a trust is to ascertain, within the bounds of the law, the intent of the settlor, the court said. The trustee and beneficiaries argued that the sale of the one hundred forty-two acres is permitted by state law, which provides in part:

*"[I]n an action by the trustee or beneficiaries, if the estate is held in trust, courts of common pleas may * * * authorize the sale of any estate, whether it was created by will * * * when satisfied that such sale would be for the benefit of the person holding the first and present estate, interest or use, and do no substantial injury to the heirs in tail, or others in expectancy."*

A trust may be ordered terminated if all beneficiaries consent to its termination, and if the trust instrument does not by express terms or by implication prohibit its termination, the court said. Furthermore, a trust should be terminated if all beneficiaries consent to its termination *unless* such termination would defeat a material purpose of the trust.

In this case, the court said that a careful reading of the trust instrument shows that Edward Leach's intent was to provide for the primary beneficiaries, Melonie and Sandra. While Leach may have preferred that the one hundred forty-two acres be developed as cemetery lots as an extension of Sunset Cemetery, the language of the trust does not mandate that cemetery lots be the only possible use of the one hundred forty-two acres, the court said. Leach left one hundred forty-two acres in trust and directed the trustee to "encourage" and "assist" the primary beneficiaries to develop the land into cemetery lots as an extension of the adjacent family-owned cemetery. When "words of recommendation must be followed to carry out the clear intention of the settlor, such

words are regarded as words of command or direction." On the other hand, the words, "encourage" and "assist" mean to help or aid. Accordingly, the court said it did not find that the words "encourage" and "assist" are words of recommendation which must be followed as if they are a command or direction.

Furthermore, it is clear from the words of the trust that Leach intended that the primary beneficiaries benefit from the sale of the property. "If and when any cemetery lots in said 142 acre tract are sold the net proceeds shall be paid by the Trustee at least quarterly to the said beneficiaries." Accordingly, the court said that the material purpose of the trust was to provide for the primary beneficiaries.

Appellants further argue that the doctrine of deviation applies because due to changed circumstances they no longer own Sunset Cemetery and therefore the trust purpose is impossible to accomplish. Under the doctrine of deviation, a court can "direct or permit a deviation from the terms of the trust where compliance is impossible or illegal, or where owing to circumstances not known to the settlor and not anticipated by him compliance would defeat or substantially impair the accomplishment of the purposes of the trust."

The court also addressed the issue of whether compliance with the trust purpose was impossible and, therefore, the trust should be terminated. The probate court disagreed as to whether the purpose of the trust was impossible, finding that "there is no evidence that the primary beneficiaries have attempted to use the land as security for obtaining the necessary endowment fund, nor evidence of any other attempt to determine the feasibility of fulfilling decedent's wishes. Without such evidence the court cannot find that all possible avenues have been explored, and therefore that sale as cemetery lots is, in fact, impossible."

However, on appeal the court said the material purpose of the trust is to provide for the primary beneficiaries, even if a purpose of the trust was to develop the land into cemetery lots as an extension of Sunset Cemetery, this purpose is now impossible. Sunset Cemetery has been sold to SCI. The primary beneficiaries no longer have any control over the expansion of Sunset Cemetery. As a result, the court said that it is impossible for the primary beneficiaries to "develop said land into cemetery lots as an extension of the adjoining Sunset Cemetery."

Accordingly, the court concluded that the probate court erred in not granting the petition to sell real estate, as the material purpose of the trust was to provide for the primary beneficiaries and the suggested purpose to develop the real estate into cemetery lots had become impossible. However, where "real property, which is held in trust, is sold under court order pursuant to a petition for sale in accordance with state law, the sale results in a mere substitution of assets; hence, the proceeds of the sale must be held by the trustee, just as the land was originally held, with the income payable to the beneficiaries in the same manner or order as the income from the land, in accordance with the distribution set forth in the trust instrument."

The court ruled that while the petition to sell real estate is granted, the proceeds from the sale of the land must be held in trust and distributed according to the terms of the trust.

When a trust contains a spendthrift provision, one of the material purposes of the trust is the protection afforded a beneficiary by that clause. Consequently, courts are reluctant to modify or terminate a trust with a spendthrift provision. It does happen in some cases, however. Texas law, § 112.054, expressly provides that "[t]he court shall consider spendthrift provisions as a factor in making its decision whether to modify or terminate, but the court is not precluded from exercising its discretion to modify or terminate solely because the trust is a spendthrift trust."

Case-in-Point

In ***In re Estate of Somers***, 277 Kan. 761, 89 P.3d 898 (2004), the life beneficiaries and remainder beneficiary of a charitable spendthrift trust brought a joint petition to terminate the trust. Eula M. Somers died in 1956. She left a testamentary trust for her grandchildren, Susan Somers (now Smiley), then age 7, and Kent Somers, then age 5. The trust was funded from the residuary estate of Eula Somers in an amount of approximately $120,000. By January 2001, the value of the Trust had increased to approximately $3,500,000. The payout provision of the Trust instrument states in Article X(b): *"I authorize and direct my Trustee to pay, from the Trust Estate, beginning August 25, 1966, or one year after my death, whichever is the later date, the sum of $100.00 per month each to my said granddaughter, SUSAN ANN SOMERS, and to my grandson, KENT CLIFFORD SOMERS, so long as she or he shall live or until my Trust Estate is exhausted. If either of my such grandchildren should die before or after such monthly payments begin and before the Trust Estate is exhausted, then such deceased grandchild shall have no further interest in or right to receive monthly payments accruing after the date of her or his death, from the Trust Estate. If both of such grandchildren should die before or after such monthly payments begin and before the Trust Estate is exhausted, then there shall be no monthly payments accruing after the date of the death of the survivor of my such grandchildren made from the Trust Estate, and the remainder of the Trust Estate, after payment of the expenses of the trust, shall be distributed and paid over to the SHRINERS HOSPITALS FOR CRIPPLED CHILDREN, a Colorado Corporation, free of any trust and this trust shall terminate."*

The Trust was originally placed with the Johnson County National Bank and Trust Company. Firstar Bank, N.A. (Firstar) is the successor to the original trustee. The Shriners Hospitals for Children (Shriners) and the grandchildren reached an agreement to terminate the trust. They agreed that the Grandchildren would each receive a distribution of $150,000 from the trust and that the remainder of the trust assets would immediately be distributed to Shriners. Shriners agreed to continue the $100 monthly payments to the grandchildren.

Firstar opposed the termination of the trust. Shriners and the grandchildren then filed a joint petition in district court asking that the trust be terminated immediately. The district court denied the petition to terminate the trust and the grandchildren's request for individual distributions of $150,000. However, the district court ordered an immediate, partial distribution of the corpus of the Trust to Shriners, but required that $500,000 remain in the trust to fund the annuity payments to the grandchildren. The court further ordered that the attorney fees and expenses of the grandchildren's attorneys be paid from the Shriners' distribution. Firstar, the trustee appealed.

The grandchildren argued that the district court should have terminated the trust because all of the beneficiaries agreed to the termination and the termination would not frustrate a material purpose of the trust. On appeal, Shriners appeared to adopt a different view than the grandchildren, arguing that the district court properly resolved the issue by distributing a portion of the trust to them. In contrast, Firstar, the trustee, argued that the district court properly concluded that it could not terminate the trust.

All of the parties agreed that the trust is a spendthrift trust. Thus, the court said, the question is whether a court can terminate a spendthrift trust at the request of the beneficiaries, who are all in agreement and competent to consent, if the trustor is not available to consent to the termination. The grandchildren claimed that the district court had the power to terminate the trust with all of the beneficiaries' consent because the spendthrift provision is not a material purpose of the trust.

State law gives the court authority to evaluate the circumstances of the trust and determine whether the trustor anticipated such circumstances, the court said. If the trustor did not anticipate the circumstances, the court can modify the trust in furtherance of the trust's purpose. The district court found that the dramatic growth in the trust's corpus presented a "unique and unusual set of facts" justifying modification of the trust. The court on appeal agreed.

The district court concluded that Eula Somers intended to provide for Shriners, that a partial distribution from the trust assets furthered her goal of providing for Shriners, and that the partial distribution was not detrimental to the payment of the grandchildren's annuity. On appeal, the court agreed with the district court's finding that the growth of the trust and its present worth constituted a circumstance that was not anticipated by the trustor and that modification or a partial distribution of the trust assets furthers the purposes of the trust, to benefit Shriners. "We are, therefore, in agreement with the finding and order of the trial court that the corpus of the trust be distributed to Shriners, with the exception of $500,000 to be kept in the trust to provide for the payments to the grandchildren under the provision of the spendthrift clause," the court wrote.

The grandchildren further argued that if the district court had authority to modify the trust to distribute funds to Shriners, it should have modified the trust to grant the $300,000 in distributions in accordance with their agreement with Shriners. The grandchildren claimed that the $300,000 distribution would not have affected the spendthrift portion of the trust because it was intended to come from Shriners' remainder interest. However, the court noted that Eula Somers' will and the Trust do not provide for any cash distributions to the grandchildren aside from the $100 monthly payments. Other than the distribution of Eula Somers' jewelry and some miscellaneous household items that were devised to Susan, there are no other provisions in the will authorizing distributions to the grandchildren. Consequently, the court said, the district court had no power to authorize a distribution from the trust that was not authorized by Eula Somers' will even though the beneficiaries consented to the distribution.

C. JUDICIAL MODIFICATION OR TERMINATION

States generally give courts authority to modify or even terminate a trust under appropriate circumstances. Typically, this can only occur if the court determines that termination would achieve the wishes of the trustor. California law, for example, provides as follows:

Probate Code §15409.

(a) On petition by a trustee or beneficiary, the court may modify the administrative or dispositive provisions of the trust or terminate the trust if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust. In this case, if necessary to carry out the purposes of the trust, the court may order the trustee to do acts that are not authorized or are forbidden by the trust instrument.
(b) The court shall consider a trust provision restraining transfer of the beneficiary's interest as a factor in making its decision whether to modify or terminate the trust, but the court is not precluded from exercising its discretion to modify or terminate the trust solely because of a restraint on transfer.

Case-in-Point

Frost National Bank of San Antonio v. Newton, 554 S.W.2d 149 (1977), is a Texas Supreme Court decision that addresses many of the important issues involving termination of a trust. The trustee in the case, the Frost National Bank of San Antonio, instituted a suit to obtain a declaration as to whether a testamentary trust created by the decedent, Louise Cozby, should be terminated. The district court entered judgment terminating the trust and the trustee appealed.

The terms of Cozby's will included the creation of a testamentary trust, the pertinent terms of which provided:

"I hereby give, devise and bequeath unto the FROST NATIONAL BANK OF SAN ANTONIO, AS TRUSTEE, in trust for the following beneficiaries and for the uses and purposes hereinafter set forth, all of my right, title and ownership in and to all of the residue and remainder of my property and estate, not otherwise hereinabove disposed of, . . . all of which property will be hereinafter referred to as the "TRUST ESTATE", and is to be held, managed, controlled and disposed of by said Bank as Trustee, as hereinafter provided.

"The said Trust shall become effective as soon as my Independent Executor shall have completed the administration, or sooner if the said Bank as Executor or Trustee shall so elect, and shall continue in force and effect during the remainder of the lifetime of the last survivor of the following named three beneficiaries, viz: Rexford S. Cozby, Karolen Newton and Louise Purvis, and shall terminate upon the date of death of the last survivor of said three last named beneficiaries. Provided, however, that said Trustee shall have the right, at its option, to sooner terminate said Trust in the event the income from the trust property shall hereafter cease to be sufficient in amount to justify the further continuance of such Trust, in the opinion of the Trustee."

The decedent's will further set forth how the proceeds of the trust were to be distributed:

"During the entire existence of the term of said Trust, the said Trustee is directed to pay, out of said Trust funds, to or for the use and benefit of the following named respective beneficiaries the following periodical payments:

One-third (1/3) of the net income from said Trust Estate shall be by said Trustee paid to my husband, Rexford S. Cozby, during the remainder of his lifetime; and the remaining two-thirds (2/3) of said net income from said Trust Estate (plus such portions of the principal thereof as the Trustee may deem necessary) shall be applied to the payment of the expenses incident to: (a) The support and education through high school and college of my great-nephew, Warren S. Wilkinson, Jr., so long as he may attend and continue in school or college during the term of said Trust; and (b) The support and education through college of my great-niece, Susan Arnette, so long as she may attend and continue in college during the term of said Trust; and (c) The support and education through college of my great-niece, Karolen (Lyn) Wilkinson, so long as she may attend and continue in college during the term of said Trust; and (d) If, as and when any one or more of said three student beneficiaries shall, during the term of said Trust, obtain a college degree, he or she shall be paid by said Trustee the sum of $1,000.00 in cash out of the interest or principal of said two-thirds (2/3) of said total Trust Estate, as a graduation present.

In addition to other provisions directing the trustee in how to distribute the assets of the trust, the will provided as follows:

"Upon the final termination of said Trust Estate all of the property then comprising said Trust Estate, and all of the remainder and residue of my property and estate, if any, not hereinabove otherwise disposed of, I hereby give, devise and bequeath to the following named ultimate beneficiaries, in equal shares, an undivided one-half (1/2) to each, viz: Karolen Newton and Louise Purvis. If either one of said last named beneficiaries be not living at the time of the final termination of the Trust Estate above provided for, then the share of my estate which such deceased beneficiary would be otherwise entitled to receive if living, shall go to and vest in her then living children, in equal shares."

The will was executed on August 25, 1965. Mrs. Cozby died in December 1967, her husband having predeceased her. All other beneficiaries of the will survived Mrs. Cozby. The Bank administered the trust as provided in the will, making the specified payments to the student beneficiaries and disbursing the excess income to Louise Purvis and Karolen Newton, the nieces of the decedent. Warren Wilkinson, Jr., the last of the beneficiaries to be entitled to the educational benefits provided for in the trust, graduated from college in 1971 and received the stipulated one thousand dollars as a graduation present.

In 1974 the Bank brought this declaratory judgment suit to determine whether the trust had terminated upon the completion of the payments to the student beneficiaries or whether the trust remained in effect until the death of the last to survive of Karolen Newton and Louise Purvis. Named as defendants in the suit were Karolen Newton, Louise Purvis, Warren S. Wilkinson, Jr., Susan Arnette, Karolen (Lyn) Wilkinson Dittmar, Doreen N. Levine, Howard P. Newton, L. Inez Newton, and Alibel M. Pardue. Warren Wilkinson, Jr., Susan Arnette, and Karolen Dittmar, the student beneficiaries of the trust, are the only three children of Louise Purvis. Doreen Levine, Howard P. Newton, and L.

Inez Newton are the children of Karolen Newton. Alibel M. Pardue is the testatrix's surviving sister.

Karolen Newton, Louise Purvis, and their children entered into an agreement urging the court to terminate the trust and releasing the Bank from all responsibilities in connection with such termination. After a hearing at which all parties were represented, including the unborn and unadopted children of Karolen Newton and Louise Purvis, the trial court rendered a judgment terminating the trust on the ground that, while the trust estate was sufficient in amount to justify its continuance, its primary purposes had been accomplished and fulfilled and all the beneficiaries except the unborn and unadopted children of Karolen Newton and Louise Purvis had agreed to the termination of the trust. The court ordered the Bank to deliver the funds comprising the trust estate to the ultimate beneficiaries, Karolen Newton and Louise Purvis. The Court of Civil Appeals affirmed the trial court judgment, agreeing that the primary purposes of the trust had been accomplished and that its termination would not subvert the wishes of the testatrix.

The Bank and the guardian ad litem for the unborn and unadopted children of Karolen Newton and Louise Purvis here contend the lower courts erred in decreeing termination of the trust. They argue the language of the will is unambiguous and clearly states that, unless the Bank voluntarily terminates the trust due to insufficient income, the trust is to terminate only upon the death of the last to survive of Karolen Newton and Louise Purvis.

Newton and Purvis asserted that they were "ultimate beneficiaries" only in the sense that they would be entitled to the corpus of the trust in the event the Bank terminated it because of insufficient income. Furthermore, according to the Bank and the guardian ad litem, the primary purposes of the trust have not been fulfilled because the provision for the payment of excess income to Karolen Newton and Louise Purvis is not incidental and is a continuing obligation of the Bank as trustee. The beneficiaries argued the two primary purposes of the trust have been accomplished and that therefore termination of the trust as decreed by the lower courts is proper and does not defeat the intent of the decedent.

The Texas Supreme Court disagreed. Louise Cozby could not have stated more clearly her intention regarding the termination of the Trust, the court concluded. The language provides that the trust is to remain in effect until the death of the last surviving named beneficiaries. The will then provides that the Frost National Bank, as trustee, could terminate the trust if in its opinion the income from the trust property was insufficient to justify the continuation of the trust.

The Supreme Court noted that the trial court found the income of the trust was sufficient to justify the continued existence of the trust. “That being the case,” the court wrote, “it is clear the trust established under the will of Louise Cozby will terminate upon the death of the last to survive of Karolen Newton and Louise Purvis unless circumstances dictate an earlier termination due to insufficient income.”

The beneficiaries also argued that the payment of "excess income" to Karolen Newton and Louise Purvis was merely an incidental purpose of the trust and that the primary purposes of the trust – the support for education – had been accomplished and therefore the trust could be terminated.

"To accept such a contention would require a determination of what the [decedent] considered to be the principal purposes of the trust and what she considered only incidental," the court said. "Such a determination would take the court beyond the express language of the will into the realm of conjecture and speculation, for it is by no means clear that the provision for excess income distribution was merely an incidental purpose of the [decedent]. It is consistent with the estate plan of Louise Cozby to infer that after the death of her husband and the education of the student beneficiaries, the trust was to continue in effect, with periodical payments of excess income to Karolen Newton and Louise Purvis, until the death of the last to survive of Purvis and Newton. In construing an unambiguous will, the cardinal rule is to give effect to the intentions of the testator or testatrix as they are expressed within the four corners of the instrument."

Absent an express declaration of purpose in the instrument, the court said it lacked authority to go beyond the face of the will to make an ad hoc and speculative assessment of which purposes the trustor or testator considered "primary" and which he considered merely "incidental." Thus, the court said, "the trust established by Louise Cozby in her will cannot be judicially terminated on the ground that its primary purposes have been accomplished where, as in the instant case, the trust expressly provides for its termination upon the happening of specified events."

D. LACK OF FUNDS

In some cases, a trust may fail for lack of assets. For example, a trustor may have the intention in creating a trust to support the education of his children or grandchildren. But what happens if the first two children go to college and medical school and there are no funds remaining for the other children? Under such circumstances, the trustee will generally have authority to terminate the trust.

Texas law, for example, provides as follows:

§ 72-33-412. Trust with uneconomically low principal.

(1) On petition by a trustee or beneficiary, if the court determines that the fair market value of the principal of a trust has become so low in relation to the cost of administration that continuation of the trust under its existing terms will defeat or substantially impair the accomplishment of its purposes, the court may, in its discretion and in a manner that conforms as nearly as possible to the intention of the trustor, order any of the following:
(a) termination of the trust;
(b) modification of the trust; or
(c) appointment of a new trustee.
(2) Notwithstanding subsection (1), if the trust principal does not exceed $20,000 in value, the trustee has the power to terminate the trust.
(3) The existence of a trust provision restraining transfer of the beneficiary's interest does not prevent application of this section.

E. COMBINATION OR DIVISION OF SIMILAR TRUSTS

Under some circumstances, a trustee may have authority – with or without the consent of a court – combine two or more trusts into one or to dissolve one trust into several smaller trusts when it is necessary to carry out the wishes of the trustor.

1. Combination of Similar Trusts

If the terms of two or more trusts are substantially similar, on petition by a trustee or beneficiary, a court may combine the trusts if the court determines that administration as a single trust would not impair the goals of the trust or infringe on the interests of the beneficiaries.

2. Division of Trusts

On petition by a trustee or beneficiary, a court in some circumstances may divide a trust into two or more separate trusts if the court finds that it is in the best interests of the beneficiaries and will not defeat the purpose of the trust.

F. AUTHORITY OF TRUSTEE UPON TERMINATION

When a trust is terminated, the trustee has responsibility for winding up of the trust and producing a final accounting to be provided to the beneficiaries. Depending on how and why the trust is being terminated, the trustee's obligations can vary. For example, if a trust is terminated because there are no remaining assets, there is little work involved. If, on the other hand, there are remaining assets, the trustee will be responsible for selling those assets, if appropriate, and distributing them to the beneficiaries. A trustor may provide in the trust instrument how property may or may not be disposed of in the event of failure, termination, or revocation of the trust. In other cases, the trustee will have discretion to distribute the assets and wind up the trust.

Texas law, for example, provides as follows:

§ 72-33-414. Disposition of property upon termination.

At the termination of a trust, the trust property shall be disposed of as follows:
(1) In the case of a trust that is revoked by the trustor, as directed by the trustor.
(2) In the case of a trust that is terminated by the consent of the trustor and all beneficiaries, as agreed by the trustor and all beneficiaries.
(3) In any other case, as provided in the trust instrument or in a manner directed by the court that conforms as nearly as possible to the intention of the trustor as expressed in the trust instrument. If a trust is terminated by the trustee pursuant to 72-33-412(2), the trust property shall be distributed as determined by the trustee pursuant to this subsection.

California law, Probate Code § 15410, provides as follows:

At the termination of a trust, the trust property shall be disposed of as follows:
(a) In the case of a trust that is revoked by the settlor, as directed by the settlor.
(b) In the case of a trust that is terminated by the consent of the settlor and all beneficiaries, as agreed by the settlor and all beneficiaries.
(c) In any other case, as provided in the trust instrument or in a manner directed by the court that conforms as nearly as possible to the intention of the settlor as expressed in the trust instrument.
(d) If a trust is terminated by the trustee pursuant to subdivision (b) of Section 15408, the trust property may be distributed as determined by the trustee pursuant to the standard provided in subdivision (c) without the need for a court order.
Where the trust instrument does not provide a manner of distribution at termination and the settlor's intent is not adequately expressed in the trust instrument, the trustee may distribute the trust property to the living beneficiaries on an actuarial basis.

III. Types and Rights of Beneficiaries

A. TYPES OF BENEFICIARIES

1. Primary and Contingent

Simply put, a beneficiary is an individual (or institution, group, charity, etc.) who is designated to receive a gift through a trust. In many if not most cases, there is little need to discuss “types” of beneficiaries.

Example.

In his will, Larry creates a testamentary trust to provide financial support to his nephew, Chris. Chris is the primary beneficiary of the trust.

But what if Larry is concerned that Chris, who has cancer, might not recover. In such a case, Larry could revise his will to provide that in the event Chris does not survive him, his nephew Michael will become the beneficiary of the trust. Michael is therefore the “contingent” beneficiary. That means he is only entitled to receive the gift if a contingency occurs, in this case, the death of Chris. Chris would be referred to as either the “primary beneficiary” or simply as the “beneficiary.”

2. Income Beneficiary

In some cases, a trustor may wish to make a gift that includes income from certain property but not the underlying property itself.

Example 1.

Roger drafts a will in which he creates a testamentary trust that includes an apartment complex. The trust provides that his nephews Richard and Rob are entitled to the income from the complex during their lifetimes. Richard and Rob are "income beneficiaries," as they are entitled to the income only from the asset.

Example 2.

Stanley establishes a trust for the benefit of his children, Susan, Emily and Alex. The three are entitled to income from the property during their lives, with the remainder of the assets being distributed to their children upon their death. Susan, Emily and Alex do not have any rights to distribute the property within the trust. They are only entitled to income during their lifetimes. They are therefore income beneficiaries.

3. Life Estates

In most cases, people own property in a form that is referred to using the archaic British terminology as "fee simple." This means that the owner has total ownership of the property in question. The owner may hold it, dispose of it during life or death in any manner he or she so chooses.

Example.

Brian dies with a will that leaves his one-half interest in his home to his wife, Linda. Linda is said to have a fee simple in the home. It is hers to live in or sell or otherwise dispose of as she wishes.

One of the reasons that an individual establishes a trust rather than making an outright gift or testamentary disposition is that he or she does not want the beneficiary to have complete control over the asset. The individual may also want to ensure that assets are available for successive generations. One way this can be achieved is through the use of so-called "life estates".

Example.

Brian's will creates a testamentary trust that a will that allows his wife, Linda, to receive the income from their properties during her lifetime. However, she is not free to dispose of them. Upon her death, the properties are to go to his son Collin. Linda does not receive a fee simple to the farm; she receives a life estate only. When she dies, the farm passes to Collin, who will become the owner in fee simple. Collin is referred to in this scenario as a "remainderman," namely the individual who is to receive the remainder of the estate following the end of the life estate.

B. RIGHTS OF BENEFICIARIES

Simply put, the beneficiary of a trust has only those rights that are established by the trustor in the trust instrument. For example, if a trust gives Ed the right to receive $1,000 per month for the rest of his life, that is all Ed is entitled to. He does not generally have any other rights or obligations under the trust.

1. Right to Compel Distribution

Whether the beneficiary of either a living or testamentary trust has the right to *compel* the trustee to make a distribution of principal and/or income to him or any other beneficiary depends on the circumstances of each case. The answer depends on a number of factors, most importantly the provisions of the trust itself and, secondly, the finding by a court that the failure to make such a distribution would be a violation of the trustee's fiduciary responsibility.

For example, it is common for family trusts to provide for the mandatory payment of *income only* to a surviving spouse and such amounts of principal as the trustee determines are appropriate and reasonable. For example, a surviving spouse who did not receive the mandatory payments of income would have a right to seek a court order compelling those income payments. However, whether or not the trustee's refusal to pay principal to the spouse amounted to a violation of fiduciary duty would be for the Court to determine after hearing all of the relevant facts of the case.

Case-in-Point

In ***Hertel v. Nationalsbank***, 37 S.W.3d 408 (2001), the court ruled that a trustee had no duty to ignore the beneficiary's other assets in deciding whether to provide additional support from a trust, despite the objections of the beneficiary. The beneficiary, Susan Hertel, asserted that the trustees should not be allowed to consider the financial resources available to her in determining what amount, if any, should be paid to her from the principal of a trust created by her father, Robert Tuhro ("Trustor").

Since the early 1980's, Hertel has suffered from multiple sclerosis. Trustor, aware of his daughter's illness, established a trust over his assets in December 1991 and executed a trust detailing the administration of the trust. In essence, the trust provided that when Trustor died, his assets were to be divided into two equal trusts, one for Hertel and the other for her children from a previous marriage. Hertel's provided that all income is to be paid to her and at her death, the principal is to be distributed to her children's trust. The trustor died in December 1994.

Since being diagnosed with multiple sclerosis, Hertel's health has steadily declined. She has been unable to drive, work, or walk since the late 1980's. As her condition has worsened, she has had multi-day hospital stays, including a 10-week hospital stay in 1995 after suffering an aneurysm. Hertel was placed in a skilled-care nursing facility in July 1998, where she continues to reside.

As her medical and nursing facility bills accumulated, income from the trust was not adequate to pay the bills, including $21,000 due the nursing home. Although Hertel received an inheritance from her grandmother of almost $156,000, she requested that Trustees encroach upon the trust principal, which was valued at over $400,000, to pay her medical expenses. Trustees requested Hertel to provide details of her financial resources before determining whether to encroach upon the principal. When the information was not forthcoming, Trustees denied her request.

Hertel then filed suit against Trustees for breach of trust and breach of fiduciary duties, claiming Trustees were obligated, under the terms of the trust to encroach on the principal to pay her medical bills without considering her other financial resources. Trustees counterclaimed for a declaratory judgment that would authorize them to consider the financial resources available to Hertel under the terms of the trust.

The issue in this case, the court said, is whether a trustee has the right to consider the other resources of a beneficiary when there is a request to invade the principal of a trust. To resolve this issue, the limited case law in this area has developed the following test: does the trust constitute an absolute gift of support and maintenance, or is the gift of income coupled with a provision that the principal may be invaded in case of need? If the trust is an absolute gift, then the private income of the beneficiary cannot be considered, the court said. If, however, the income gift includes principal encroachment based on need, then a beneficiary's private income must be considered in determining whether such need exists.

In order to make this determination the court examined the language of the trust and the circumstances surrounding its creation. In reviewing the trust instrument, its various provisions support a finding that Trustor did not intend an absolute gift, the court said, but rather conditioned encroachment of the principal upon a showing of need.

The trust agreement addresses encroachment of the principal in Article IV, section 4.00 as follows:

[T]he Trustees shall have power in their discretion to encroach upon the principal of this share of the trust estate during the life of Grantor's daughter for her health, education, maintenance and support and such encroachments may be made from time to time and in such amounts as the Trustees may consider necessary or advisable under the circumstances.

The court interpreted this provision to grant Trustees the power to encroach upon the principal in their discretion. Use of the word "may" grants Trustees discretion to encroach upon the principal when and in the amount they consider necessary or advisable.

Further, the court found that the "necessary or advisable" language applies to the amount of the encroachment as well as to its timing. Thus, Trustor intended Trustees to exercise their judgment and discretion in determining whether an encroachment for the health, education, maintenance, and support of Beneficiary is necessary or advisable, and whether the amount requested is necessary or advisable.

Trustor also included administrative provisions that further delineate the broad discretion he gave Trustees in the trust agreement.

Article V, in pertinent part, provides:

1.00 The Trustees of the trusts shall have full power and authority to do any and all things necessary or proper to manage and control the property of the trust estate and every part thereof ... all of which may be exercised by the Trustees at any time or from time to time upon such terms and conditions as the Trustees may deem best.... ....
1.10 Should any doubt or uncertainty arise as to the meaning or interpretation of any word, phrase, clause or part of this trust instrument, due to any claimed ambiguity or choice of words, or any controversy of fact, the Trustees are authorized to determine the proper construction or interpretation and what are the true facts, and any such determination made by the Trustees in good faith shall be binding upon all beneficiaries and other persons concerned.

1.11 The Trustees are further authorized to do all other similar or dissimilar acts and things which the Trustees deem to be for the benefit of the trust estate and the beneficiaries thereof, whether or not such acts and things are hereinabove specifically set forth. In the exercise of any or all of the foregoing powers, all decisions of the Trustees made in good faith shall be conclusive and binding upon all parties in interest.

Sections 1.00 and 1.11 lend support to Trustees' argument that they have the power to request financial information prior to performing their discretionary power of encroachment. Section 1.10 gives Trustees the power to interpret provisions of the trust, and this interpretation is binding upon the beneficiaries, the court said. Moreover, the Trustor included a spendthrift provision in Article VIII, Section 1.00. This provision provides that beneficiaries under the trust do not have the power to transfer, assign, encumber, or anticipate their interest in the trust property, nor is their interest subject to garnishment or attachment. Essentially, these provisions are meant to prolong the life of the trust principal, by preventing other persons from attaching a beneficiary's interest in the trust before it has been disbursed.

In total, the court said, these provisions evidence Trustor's intent to give Trustees the power and authority to preserve and maintain the trust corpus while also allowing Trustees to accommodate for unforeseen events. The trust provisions grant Trustees the broad discretion to do any act that effectuates management of the trust, including inquiring as to whether encroachment is necessary or advisable. Trustees, however, must be mindful of their duty to act in the best interests of the beneficiary.

The court said its conclusion that it was Trustor's intent to give a gift of income to the beneficiary coupled with a provision that the principal may be invaded only in cases of need, is also supported by the circumstances surrounding creation of the trust. First, upon the beneficiary's death, the trust corpus is to be paid over into the trust established for Hertel's children from a previous marriage. Given that the trust principal is to be paid over to successor beneficiaries, it is unlikely that Trustor intended an absolute gift.

2. Periodic Accounting and Right to Information

The trustee of either a testamentary or living trust should communicate periodically and regularly with the trust beneficiaries as the trust or circumstances dictate. Beneficiaries should normally be kept abreast of major decisions affecting the trust. For example:

- The sale or exchange of a major asset of the trust;
- A major expense;
- The fees, if any, of the trustee and any other professional hired by the trustee;
- Amounts distributed to beneficiaries; and
- Other matters of direct concern.

If the trustee *does not* so communicate, or if any beneficiary believes he or she is being kept "in the dark" by the trustee, the beneficiary has the right to petition the appropriate probate court for relief.

For example, § 45a-175(c) of the Connecticut General Statutes permits the probate court to order an accounting from the trustee *of a living trust*, if the Court finds:

- The beneficiary has a sufficient interest in the trust;
- Cause has been shown that an accounting is necessary; and
- The request for an accounting is not for the purpose of harassment.

Under Connecticut law, a beneficiary of a *testamentary trust* may ask a court for an accounting at any time upon a proper showing of cause. In addition, the trustee of such a trust *must* render a written accounting to the court at least every three years, unless the filing is excused by the will itself and the court.

A periodic accounting may also be mandated by the trust instrument itself. In most such cases, a beneficiary will receive an accounting on an annual basis and at such time as the trust is terminated.

Typically only an "interested person" has the right to demand an accounting. Courts have generally found the following persons to be "interested":

- Every trust beneficiary, including those who hold only a present interest in the trust; and
- The remainderman or remaindermen of a testamentary trust.

On the other hand, the courts have typically held that mere contingent beneficiaries do not have a present right to demand an accounting. It would be up to current beneficiaries to make such a request.

3. Modification or Termination

As we saw above, beneficiaries also have the right to demand modification or termination of a trust either according to the terms of the trust instrument or based on state law.

4. Right to a Copy of the Trust Instrument

If the beneficiary or other interested party of a living trust requested the trustee to supply a copy of the trust but was refused, that person may apply to either the probate court or the appropriate superior court for an order compelling that disclosure as part of an action for an accounting. It is within the discretion of either court to grant the request or not. Normally, the Court would be inclined to do so if the party could prove sufficient economic interest in the trust, which might be jeopardized without direct knowledge of the terms of the trust.

CHAPTER 5 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Under what circumstances can a revocable trust be amended or terminated:

    a) never; trusts, once created, cannot be amended
    b) virtually anytime
    c) only where there is approval by the beneficiaries
    d) only upon approval by a court of law

2. Under any circumstance, a trust can be terminated if all of the beneficiaries of the trust agree.

    a) true
    b) false

3. The trustee generally has authority to terminate a trust due to lack of funds.

    a) true
    b) false

4. Who is responsible for winding up a trust when it is terminated:

    a) only the trustor has such responsibility
    b) the trustee
    c) the beneficiaries
    d) an executor appointed by a court of law

5. Why might a trustor establish a trust in which the beneficiary receives a life estate:

    a) to keep the beneficiary from having complete control over the property of the trust
    b) for tax savings purposes
    c) to maximize the income of the beneficiary
    d) all of the above

CHAPTER 5 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. By definition, a revocable – as opposed to an irrevocable – trust can generally be amended or revoked by the trustor at any time.

   B: Correct. The lynchpin of a revocable trust is that the trustor can generally either revoke or amend the trust at any time during his or her lifetime.

   C: Incorrect. There is no such requirement for a revocable trust.

   D: Incorrect. There is no such requirement for a revocable trust.

   (See page 5-1 of the course material.)

2. A: True is incorrect. Termination by consent is only permitted in some circumstances, and must be in compliance with state law. The laws of each state vary.

   B: False is correct. If continuance of the trust is required to carry out a material purpose of the trust, it generally cannot be terminated.

   (See page 5-4 of the course material.)

3. **A: True is correct.** A trust may fail due to lack of assets.

   B: False is incorrect. If a trustor intended to be able to support the education of his children with the trust funds, but the first child uses all of the funds for his/her education, the trustee generally can terminate the trust prior to the other children completing their education.

   (See page 5-12 of the course material.)

4. A: Incorrect. The trustor established the trust but, unless he or she also acts as trustee, does not have responsibility for winding up a trust upon termination.

   B: Correct. The trustee, not the beneficiary or trustor, is responsible for winding up the trust.

   C: Incorrect. The beneficiaries are not responsible for the winding up of the trust.

   D: Incorrect. It is the trustee who has such responsibility.

   (See page 5-13 of the course material.)

5. **A: Correct.** In a life estate, the beneficiary can use and enjoy the assets of the trust while alive but cannot dispose of them.

   B: Incorrect. There is no tax savings.

   C: Incorrect. To the contrary, a life estate generally limits income potential.

   D: Incorrect. Only one of the responses is correct.

   (See page 5-15 of the course material.)

Chapter 6: The Role and Responsibility of Trustees

I. Overview

A. NAMING A TRUSTEE

A trust cannot exist in the absence of a trustee – an individual or institution whose duty it is to carry out the wishes of the trustor. In the case of a living trust, the trustor may act as trustee during his or her lifetime. Following the death of the trustor, however, a successor trustee must assume the duties of managing the trust if the trust is going to continue.

Example 1.

Roger creates a testamentary trust to provide support for his wife during her lifetime, with the remainder of the estate to be used for the support of his mentally retarded grandchild. The trust must have a trustee to manage the assets of the trust. If Roger's will fails to name a trustee, one will have to be appointed by the probate court. It is, however, in Roger's best interest to name a trustee to ensure that the trust is managed in the way he would like.

Example 2.

Roger creates a revocable living trust in which he and his wife are the beneficiaries. Upon his death, the trust will become irrevocable and be used for the support of his wife and his grandchildren. While he is alive, Roger may act as trustee. However, upon his death the trust should contain a provision to name a trustee.

B. SUCCESSOR TRUSTEES

Given the amount of responsibility involved, a court will virtually *never* require any individual to act as a trustee. It is therefore a good idea for anyone creating a trust – particularly a testamentary trust that does not become effective until after the trustor's death – to ask the individual he or she wants to serve whether the individual is willing to act as trustee. Even if the individual agrees, circumstances can change. A trustee may die or become incapacitated, for example, or may move away from the area. It is therefore common for a trust to name a successor trustee, someone to serve in case the original trustee is unable or unwilling to serve.

C. USE OF CO-TRUSTEES

In some rare cases, a trustor will appoint co-trustees to manage a trust. In such circumstances it is important that the trust delineate the authority of each trustee so as to avoid conflicting decision-making.

D. CHARACTERISTICS OF TRUSTEE

Trustors should never underestimate the importance of selecting a qualified trustee. A large trust can turn small very quickly in the hands of an inexperienced or unsophisticated trustee. The qualification of a trustee will of course vary with the purpose and type of trust involved. Key characteristics of any trustee are integrity and financial responsibility. The following questions are important and should be posed when selecting a trustee:

- Is the trustee likely to carry out my wishes?

  Example.

  Kim and her sister Mary have never seen eye-to-eye on anything. Kim has always believed in making her children work for everything. She never gave them an allowance and made them pay for part of their college educations. Mary, on the other hand, has always doted on her children, bought them new cars when they turned 16 and paid for their college educations in full. Kim, a widow, is diagnosed with an inoperable brain tumor and wants to create a discretionary testamentary trust for the care and support for her children. Given their vastly different viewpoints about money, it is probably unwise for Kim to name Mary as the trustee.

- Is the trustee financially responsible?

  Example.

  Paul is looking for someone to act as trustee for a trust to benefit his mentally retarded son after his death. Paul's only other child, Richard, has always managed his money poorly. He has filed for bankruptcy protection and had two homes repossessed. Paul should consider someone other than Richard to act as trustee.

- Is the trustee knowledgeable in the area of investing and taxes?

  Example.

  Glenn would like to have his daughter, Glenda, act as trustee of a trust to benefit his grandchildren following his death. Glenda, however, is a nurse with no financial background. He therefore decides to ask his friend and CPA, Ned, to act as trustee. Ned's superior knowledge about investing and taxes makes him a better choice of trustee.

- In the case of a spendthrift trust, is the trustee able to say “no” to demands from the beneficiary?

  Example.

  Mary and Dan have been married for 45 years and raised three children, Ryan, Lisa and Dave. All of the children have developed lavish tastes during their lives. Mary has always acquiesced to their requests while Dan has always felt the children should make their own way in the world. Dan wishes to create a spendthrift trust for the support of his children following his death, but knows that Mary will be unable to reject a request for money once he is dead. He therefore selects Steve, his longtime and incredibly thrifty CPA to act as trustee.

E. DUTIES OF TRUSTEE

A trustee has both powers and responsibilities in the administration of the trust. As a general rule, both of these are governed by the trust itself. However, state law typically imposes minimum responsibilities on a trustee, particularly as they relate to the exercise of a fiduciary duty. Duties of a trustee generally include all of the following:

- A duty to be loyal to the beneficiaries;
- A duty to be impartial in dealing with multiple beneficiaries;
- A duty to avoid conflicts of interest;
- A duty to control and preserve the assets of the trust; and
- A duty to make a periodic accounting to the beneficiaries.

A trustee has a legal duty to manage the trust's assets in the best interests of the beneficiary or beneficiaries. This might include managing rental properties, investing funds or paying income to the beneficiary. How much a trustee is required to do and how much access he or she has to the funds should be specified in the trust. A simple or mandatory trust requires the trustee to distribute income to the beneficiary. A complex or discretionary trust may afford the trustee discretion over the principal and income to be distributed.

F. USE OF BANKS OR OTHER FINANCIAL INSTITUTIONS

Persons with particularly large estates often choose a bank to act as trustee. This can be advantageous because the entire institution, not a single person, is responsible for the assets. On the other hand, the service might be less personal than from someone with an emotional interest in the trustor or beneficiary. Banks and other financial institutions normally only handle trusts with a minimum worth, i.e. $1 million. In addition, their fees may be higher than those charged by an individual.

G. TRUSTEE FEES

Trustees are often paid for their services because of the amount of work involved in managing a trust and the threat of potential liability if assets are mismanaged. This is more likely to be the case when the trustee is not a family member or is a professional such as a CPA or attorney. How much a trustee is to be paid should be agreed upon in advance. The terms of a trust will normally set forth the fee, if any, the trustee is to receive for his or her services. Banks and other financial institutions generally set their own fees.

II. The Duties of a Trustee

First and foremost, a trustor can set forth the duties of the trustee in the trust instrument. The more detailed the trust document is, the fewer issues there will be regarding the rights and responsibilities of the trustee. In addition to the express responsibilities of the trustee provided for in the trust document, courts have implied certain common law obligations on trustees, notably a fiduciary duty to act in the best interests of the beneficiaries of the trust. This section will focus on those legal duties and obligations, as well as the ramifications of failing to meet those rules.

A. THE RULE OF UNDIVIDED LOYALTY

The "Rule of Undivided Loyalty" requires that the primary duty which a trustee owes to its beneficiary is undivided loyalty. This rule requires that a trustee act with undivided loyalty for the beneficiary and prohibits, for example, a trustee from owning its own stock.

B. MANAGING THE TRUST: THE PRUDENT INVESTOR RULE

Most courts have taken the position that a trustee has a duty to diversify the investments of a trust. This is commonly referred to as the "prudent investor rule." The rule requires more than merely investing the proceeds in multiple places; it requires the exercise of due care in selecting each individual investment vehicle.

Many states, including Pennsylvania, have codified the Prudent Investor Rule:

20 Pa.C.S.A. § 7204. Diversification

(a) Requirement.--*Except as provided in section 7205 (relating to retention of inception assets), a fiduciary shall reasonably diversify investments, unless the fiduciary reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes, terms and other circumstances of the trust and the requirements of this chapter.*

(b) Applicability.--*Subsection (a) does not apply to any of the following:*

(1) A trust which became irrevocable prior to December 25, 1999. This paragraph applies even if the action of the trustee occurs after December 25, 1999.

(2) A trust created by a revocable instrument executed prior to December 25, 1999, if such instrument is not amended after December 24, 1999. This paragraph applies even if the action of the trustee occurs after December 25, 1999.

20 Pa.C.S.A. § 7205. Retention of inception assets

A fiduciary, in the exercise of reasonable care, skill and caution, may retain any asset received in kind, even though the asset constitutes a disproportionally large share of the portfolio.

Some courts have held that there is no mandatory duty to diversify, absent some specific provision in the trust instrument itself. This is clearly the minority view. Even in such circumstances, however, the trustee is required to comply with any provisions of the trust to expressly mandate diversification.

1. <u>Factors to Consider in Making Investment Decisions</u>

In diversifying the assets of a trust, a trustee should consider a number of factors, including the following:

- The purpose of the trust;
- The amount of the trust estate;
- Financial and industrial conditions;
- The condition and needs of the beneficiaries;
- The type of investment, whether mortgages, bonds, or shares of stock;
- Distribution as to geographical location;
- Distribution as to industries;
- Prospects of inflation or deflation;
- The marketability or liquidity of various investment options; and
- Tax consequences of certain investment strategies.

2. <u>Duty to Diversify</u>

The duty to diversify generally includes the duty to diversify those assets that are part of a trust at its inception. If, for example, a trustor created a testamentary trust in which he placed 5,000 shares of stock in IBM, the proceeds of which were to be used for the education of his grandchildren, the trustee would generally be obligated to sell some of those shares and reinvest the proceeds in another investment or investments. Thus, the duty to diversify trust assets attaches to all investments, even those already held in trust, absent special circumstances or explicit authorization not to diversify in the trust instrument.

Diversification is imposed on trust assets in the expectation that it will minimize the possibility of large losses of capital through the failure of only one of the investments in the entire portfolio. Courts have commonly said that the basic rule of diversification applies both to the making of investments and the retention of those investments made by the trustor. A trustee should generally not invest the entire or a large percentage of a trust into a single security.

Example.

William, a CPA, is the trustee for a trust held for the benefit of two minor children. The corpus of the trust, which is intended to fund college educations in the future, is $100,000. William invests 50 percent of the proceeds, or $50,000, into a single technology stock. Such action likely is a breach of his duties to prudently invest the assets of the trust.

Likewise, even if a trustee invests in multiple companies, a prudent trustee will diversify among different industries so as to limit the vulnerability of the trust to an economic downturn in any one industry.

Example.

Assume the same facts as in the above example. Rather than investing 50 percent of the proceeds in a single technology stock, William invests $10,000 in 10 different technology stocks. This still lacks the diversification required of a prudent investor and makes the trust vulnerable to a downturn in the technology marketplace.

Remember, however, that the express terms of a trust may direct a trustee to invest a specified amount, or even the whole amount of a trust into a particular security or type of security.

Example.

In his will, Andrew placed $100,000 and 1,000 shares of company X in a testamentary trust and makes Bob the trustee. By the terms of the testamentary trust, Bob is authorized to invest the money in the purchase of additional shares of company X. Bob thereafter invests $50,000 in the purchase of such shares. In the absence of any further circumstances (i.e., if he had knowledge that the company was about to fail and made the investment anyway), Bob is liable for breach of his fiduciary duties to the trust in making the investment.

Note that the mere fact that a trustee is authorized to use discretion in making investment decisions does not mean he is absolved of his or her obligation to act prudently in diversifying the assets of the trust.

Case-in-Point

*In **Wood v. U.S. Bank**, 160 Ohio App.3d 831 (2005), the court addressed the question of whether a trustee has a duty to diversify the assets of a trust when the language of the trust authorizes retention of a specific asset, namely stock in the corporate trustee. The court held that even if the trust document allows the trustee to "retain" assets that would not normally be suitable, the trustee's duty to diversify remains unless there are special circumstances. Of course, a trustee's duty to diversify may be expanded, restricted, eliminated, or otherwise altered by the terms of the trust. But this statement is true only if the instrument creating the trust clearly indicates an intention to abrogate the trustee's duty to diversify.*

Wood's husband, John Wood II (he will be referred to as "John" since there are other Woods involved in the case) was a prominent Cincinnati attorney with estate-planning experience. John created a trust worth over $8 million. Wood was a beneficiary of the trust. John served as trustee during his lifetime and named Star Bank the successor trustee. Star Bank, formerly First National Bank of Cincinnati, later became Firstar Bank. U.S. Bank is the successor-in-interest to First National, Star, and Firstar. Nearly 80 percent of the trust assets were in Firstar stock. The rest was mostly Cincinnati Financial Corporation stock.

John modified his estate plan several times; the last modification took place in September 1998, shortly before his death. He modified it with the advice of an estate-planning attorney. Firstar trustees were permitted to retain, manage, and invest the stock that was in the trust "as they deem advisable or proper." The trust included a retention clause that allowed Firstar to retain Firstar stock -- otherwise, it would have had to sell off the Firstar stock upon becoming trustee.

The trust specifically gave Firstar the power "[t]o retain any securities in the same form as when received, including shares of a corporate Trustee . . . , even though all of such securities are not of the class of investments a trustee may be permitted by law to make and to hold cash uninvested as they deem advisable or proper."

The trust did not last long--John had directed the trustee to distribute almost all the trust assets to the beneficiaries after paying the debts and expenses of the estate. Beginning in early 1998, Firstar had custody of the trust assets.

At the meeting, Firstar recommended selling some stock to pay the debts and expenses of the estate and retaining the remainder pending the eventual distribution to the beneficiaries free of trust. The debts and expenses were nearly $4 million; the trust itself contained approximately $8 million, of which roughly $6 million was in Firstar stock. This plan did not call for selling any Firstar stock other than what was necessary to cover the taxes and other debts. Firstar trust officers premised the plan on Firstar stock's strong earnings momentum at the time, so it called for a sale of two-thirds of Cincinnati Financial stock and only about ten percent of the Firstar stock.

Since the original composition of the trust was 82 percent Firstar stock and 18 percent Cincinnati Financial stock, selling more of the Cincinnati Financial stock meant that the final trust was approximately 86 percent Firstar stock and only 14 percent Cincinnati Financial stock. The trust officers and Sean Wood (one of the other beneficiaries) testified that the parties agreed to the distribution plan. Firstar estimated that it would

take 18 to 20 months to finalize the estate. At trial, Wood agreed that she had seen the distribution plan and did not object to it at the meeting. But she emphasized that she had asked Firstar to diversify once the stock started increasing in value.

Firstar held the assets during this time and did not diversify. Firstar focused primarily on liquidating non-Firstar stock to raise estate-tax funds. Though approximately half of the Cincinnati Financial stock was sold (for around $1 million), only about ten percent of the Firstar stock was sold. Thus, Firstar stock made up an even higher percentage of the trust assets after the liquidation because there was so much of it to begin with.

Because of a Firstar merger, Firstar's stock increased from about $21 per share in October 1998 to almost $35 per share in early 1999. In April 1999, Wood asked Firstar to sell some of the stock. Harvey Knowles, Wood's advisor, also requested diversification. Neither Wood nor her attorneys and financial advisors made any written request that Firstar diversify the trust assets. Firstar did not sell any stock as a result of these requests.

Firstar's stock price plunged beginning in mid-1999. And by mid-2000, it was worth only $16 per share. It was around this time that Firstar made the final distribution to the beneficiaries. According to expert testimony based on calculations using an average mutual fund as the basis for estimating value, Firstar's failure to diversify cost Wood $771,099. Wood sued Firstar, asserting that Firstar had violated Ohio law by failing to diversify the assets of the trust. The jury returned a verdict against Wood.

The language of John's last trust was unambiguous. It granted Firstar the power to retain its own stock in the trust even though Firstar would ordinarily not have been permitted to hold its own stock. Specifically, Firstar had the power "[t]o retain any securities in the same form as when received, including shares of a corporate Trustee . . . , even though all of such securities are not of the class of investments a trustee may be permitted by law to make and to hold cash uninvested as they deem advisable or proper."

Wood now presents "The Rule of Undivided Loyalty" to support her claim that the retention language in the trust did not lessen Firstar's duty to diversify. This rule states that "[t]he foremost duty which a fiduciary owes to its beneficiary is undivided loyalty." This rule prohibits the trustee's ownership of its own stock. But it does not apply to prohibit ownership when the trustor gives the trustee the "authority to retain stock received from the trustor." The only restriction to the exception is that the trustee "must not act in bad faith or abuse its discretion." But because the trustee still has the duty to act prudently, and diversification is normally called for, the retention language in this case did not affect the duty to diversify.

The retention clause merely served to circumvent the rule of undivided loyalty. The trust did not say anything about diversification. And the retention language smacked of the standard boilerplate that was intended merely to circumvent the rule of undivided loyalty--no more, no less. There were significant tax consequences that precluded John from diversifying by selling the Firstar stock during his lifetime, but that hurdle was removed upon his death. Had John wanted to eliminate Firstar's duty to diversify, the court stressed, he could simply have said so. He could have mentioned that duty in the retention clause. Or he could have included another clause specifically lessening the duty to diversify. But he did not. The court therefore ruled that the language of a trust

does not alter a trustee's duty to diversify unless the instrument creating the trust clearly indicates an intention to do so.

The court also noted that under Ohio law there is only one exception to the duty to diversify. This duty arises when the trustee "reasonably" determines that that there are "special circumstances." In this case, the question of special circumstances was never presented to the jury, even though identifying special circumstances was the only way that Firstar could possibly have been relieved of its duty to diversify.

"A general authorization in an applicable statute or in the terms of the trust to retain investments received as a part of a trust estate does not ordinarily abrogate the trustee's duty with respect to diversification or the trustee's general duty to act with prudence in investment matters." This is precisely what the retention language here was--a general authorization.

The terms of the trust, however, may permit the trustee to retain all the investments made by the settlor, or a larger proportion of them than would otherwise be permitted. Thus, a trust may be created by a will that directs or authorizes the trustee to retain all of the securities bequeathed to the trustee; or the will may provide that any or all such securities or some specific securities may be retained, as the trustee deems proper, without regard to the ordinary requirement of diversification." But the retention language here did not give the necessary authorization or direction.

The court held that to abrogate the duty to diversify, the trust must contain specific language authorizing or directing the trustee to retain in a specific investment a larger percentage of the trust assets than would normally be prudent. The authorization to "retain" here was not sufficient--it only authorized the trustee to retain its own stock--something it could not otherwise do.

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3. Special Circumstance Exception

The "special circumstances" language generally refers to holdings that are important to a family or a trust. For example, courts have held that there was no duty to diversify when the asset in question was a piece of land that had a special meaning to the family.

4. Purpose of Trust

The purposes of the trust may affect the kind of investments the trustee should make; for example, a trust committed to delivering a certain fixed income might be entirely invested in bonds or other senior securities. Similarly, the high income status of beneficiaries, whether from the trust itself or other sources, might lead a trustee to invest entirely in tax-exempt governmental securities.

For example, if a trust is created for the benefit of both life beneficiaries and remainder beneficiaries, the trustee must balance the income rights of life tenants against the rights of remaindermen, and in seeking this balance a trustee's primary duty is to preserve the assets of the trust and to ensure the safety of the trust principal.

C. COMMON VIOLATIONS OF PRUDENT INVESTOR RULE

1. Overinvestment

Most of the cases in which a trustee has been held liable for failure to diversify have involved overinvestment in the stocks or bonds of one company or in a mortgage on one piece of property.

2. Speculative Investments

Trustees have been held liable for making investments that were deemed too speculative in nature. Since the goal of a trustee is generally to preserve and grow the corpus of the trust, speculative investments are generally frowned upon unless expressly authorized by the language of the trust.

Example.

Conrad's will created three trusts to benefit his mother, wife, and children, and named his CPA, Robert, as trustee. Robert invested a substantial portion of the trust corpus into highly speculative construction and development loans which resulted in substantial losses to the trust. A court will likely hold Robert liable for such speculative losses.

3. Single Locality

Trustees have been held liable for investing the entire trust assets in the securities of a particular locality, none of the stocks being listed on an exchange or sellable outside the local market, in the real estate in one locality, and in mortgages encumbering the real estate of one locality.

Example.

Robert's will creates a trust for the benefit of his surviving wife, children and grandchildren. Robert's brother and trustee, Edwin, invests most of the proceeds in land in Florida. After a heavy hurricane season, the value of the land plummets. Such a large investment in one locale is likely a breach of the prudent investor rule.

4. Failure to Investigate

A trustee must fully investigate each investment. Failure to do so can result in liability. For example, in a California case, Matter of Estate of Collins, 27 Cal.App.3d 663 (1977), the beneficiaries under a testamentary trust successfully sued the trustees for violation of their fiduciary duties. The trustees had invested two-thirds of the principal trust in a single investment in unimproved property, secured only by a second mortgage with no knowledge of the borrower's true financial status and without any other security. The court held that defendant trustees had failed to follow the "prudent investor" standard in their administration of the trust and were subject to a surcharge because they had lacked, and had ignored, information about what was happening at the time of the investment.

D. EFFECT OF TRUST PROVISIONS

Generally, a court will not interfere with the exercise of a discretionary power by a trustee unless the trustee in exercising or failing to exercise the power acts dishonestly, or with an improper even though not a dishonest motive, or fails to use his judgment, or acts beyond the bounds of reasonable judgment. For example under Rhode Island law, grants of absolute or sole and uncontrolled discretion to trustees in making investment decisions render trustees liable for investment decisions only in the event of an abuse of that discretion.

Thus, the express terms of a trust agreement may, in some cases, relieve the trustee of the duty to diversify the assets of the trust. This can occur in several ways. The trust may contain mandatory direction to invest the proceeds of the trust in a single investment or in only a few investments or may give the trustee permission to do so on his or her own. If the trust expressly requires the trustee to limit the number or type of investments, the trustee will generally not be liable for any loss that is occasioned by such lack of diversification. Where the trustee merely has discretion to limit diversification of the assets, he or she must still act prudently under the circumstances.

Example.

Rollie leaves in trust for the benefit of his children $100,000 and 1000 shares of IBM. Rollie's brother Tom is appointed trustee. By the terms of the will, Tom is authorized to invest the money in purchasing additional shares of IBM. Tom subsequently invests $50,000 in the purchase of more shares of IBM. In the absence of any further circumstances, Tom is not liable for breach of the trust provisions in making the purchase.

Whether the requirement for diversification is dispensed with by the terms of the trust is a question of interpretation. The mere fact that the trustee is authorized to make investments in his discretion does not alleviate the trustee's duty to make a reasonable diversification of investments.

E. POOR RESULTS ALONE DO NOT ESTABLISH LIABILITY

A trustee will not automatically be liable for breach of his duties because the value of a trust declines. A reviewing court will focus on the prudence of the investment rather than its result.

Example.

*In **Matter of Fleet Trust Company**, 662 N.Y.S.2d 360 (N.Y.A.D. 1998), the sole beneficiary and son of the trustor sued the trustee, alleging that it committed a breach of fiduciary duty. The son argued that the trustee's management of the trust assets resulted in what the beneficiary believed were inferior returns, as they did not match the Dow Jones Industrial Average for the period at issue. The court held that the test for determining breach of fiduciary duty was the trustee's prudence in investing the assets, not the assets' performance; thus, inferior investment performance could not serve as the basis of beneficiary's claim.*

In reviewing investment choices, a court will ask the trustee to explain his or her rationale for the selected investments.

F. TRUSTEE WITH SPECIAL SKILL

The usual standard of care imposed upon a trustee is that which a man of ordinary prudence would practice in the care of his own estate; however, if a fiduciary has greater skill than that of a person of ordinary prudence, then the fiduciary's standard of care must be judged according to the standard of one having this special skill. Thus, when a corporate trustee holds itself out as possessing greater knowledge and skill than the average man, it places itself under a duty to exercise a skill greater than that of an ordinary man and the manner in which investments were handled must accordingly be evaluated in light of such superior skill.

III. Holding the Trustee Accountable

A. ACCOUNTING REQUIREMENTS

In addition to investing the proceeds of a trust, a trustee has the responsibility to provide a periodic accounting of the trust activities. The frequency of the accounting requirements can be mandated in the trust document or by a court in the absence of such a provision.

B. SURCHARGE

A surcharge is the equitable penalty imposed when a trustee fails to exercise the requisite standard of care and the trust suffers thereby. The purpose of a surcharge imposed on a trustee is to compensate beneficiaries for the loss caused by the fiduciary's want of the appropriate level of care.

A trustee cannot be surcharged for a breach of the relevant duty of care unless the breach caused an actual loss to the trust. However, that loss may be in the form of lost interest or unrealized capital gain as well as direct capital loss.

A trustee can be liable for a particular investment that is not prudent even if the trust as a whole is performing well.

1. Measure of Damages

When determining the proper surcharge to be imposed on a trustee when the trustee fails to exercise the requisite standard of care, courts generally hold that where a trustee violates his or her standard of care, he or she is liable for the following:

- Any loss or depreciation in value of the trust estate resulting from the breach of trust; or
- Any profit made by him or her through the breach of trust; or
- Any profit which would have accrued to the trust estate if there had been no breach of trust.

In choosing among these three remedies, the beneficiary generally has the option of pursuing the remedy that will place him in the position in which he would have been if the trustee had not committed the breach. The surcharge that can be imposed for lost profits and lost interest upon a trustee who has breached a relevant standard of care is not limited to situations where a trustee has failed to follow a specified or court-imposed investment plan.

Generally, where a trustee breaches his or her fiduciary duty by investing too large a sum in a single security or type of investment, the trustee is liable only for the loss that resulted in the amount of the investment that was in excess of what would have been prudent under the circumstances.

Example.

If A, as trustee for B of $50,000, invests $20,000 in bonds of the X railroad company, and under the circumstances, it is not imprudent to invest $5,000, but it is imprudent to invest more than that amount, and X becomes insolvent and the bonds are sold for $10,000, then A is liable to B for $7,500.

A trustee who is authorized to retain assets but sells them is not liable merely because the securities later rise in value, or vice versa. Trustees should not be judged on hindsight. Few would become trustees if they were liable every time they did not sell stock at the most propitious chance.

Even where a trust gives a trustee the discretion to retain the investments placed in the trust, many jurisdictions take the position that the trustee must still diversify where it is prudent to do so. In other words, authority to retain investments does not absolve the trustee of responsibility for failure to diversify when a prudent investor would do so.

2. Burden of Proof

The beneficiary or beneficiaries that seek to surcharge the trustee for a breach of trust must bear the burden of proving the particulars of the trustee's alleged wrongful conduct. After a beneficiary has proved that the trustee committed a breach of duty and that a related loss occurred, the burden shifts to the trustee to prove that the loss would have occurred in the absence of the breach of that duty.

Case-in-Point

*In **First Alabama Bank, N.A. v. Speagins**, 515 So,2d 962 (1987), a trustee bank was properly found to have breached its fiduciary duty to its beneficiaries by investing 70 to 75 percent of the trust assests in its own bank stock. In addition to testimony by the bank's senior trust officer that the needs of the testator's grandchildren had still not been determined eight years after the bank had assumed administration of the trust, the court relied on the testimony of a recognized expert in the field of trust management to show what active, prudent management might have achieved.*

The Spragins family, as beneficiaries, brought suit against First Alabama Bank of Huntsville (hereinafter "First Alabama" or "the Bank"), trustee of a trust created by the last will and testament of Marion Beirne Spragins, Sr., for breach of fiduciary duty and mismanagement of the trust fund. The jury returned a verdict in favor of the Spraginses for $533,000.00 in compensatory damages and $1,500,000.00 in punitive damages. The Bank was then permitted to withdraw as trustee. Damages are not appropriate, the Bank argued on appeal, since the Trust suffered no loss.

The evidence showed that Marion Beirne Spragins, Sr., was formerly the president and later chairman of the board of trustees of the Bank. His last will and testament included a provision for a trust to benefit the plaintiffs and it designated First Alabama Bank of Huntsville as the trustee. After settlement of his estate, the net value of the trust was $556,881.73, at least 70% of which consisted of stock in First Alabama Bank's own holding company.

The Bank did not argue that the trial court's application of the "prudent person" rule to the Bank's alleged breach of fiduciary duty was erroneous under Alabama law. Instead, the Bank contended that the general rule is modified by the terms of the trust. That agreement states, in part:

"(3) POWERS OF TRUSTEE.... I grant the following powers to my Trustee.... "(a) To sell, exchange, transfer, convey, either before or after option granted, all or any part of said Trust Estate and any trust created herein, upon such terms and conditions as it sees fit to invest and reinvest such Trust Estate and any trust created herein and the proceeds of sale or disposal of any portion thereof, in such loans, stocks, common or preferred, bonds, insurance contracts, or other securities, mortgages, common trust funds, or other property, real or personal, whether so-called 'legal' investments of trust funds, or not, as to it may seem suitable, and to change investments and to make new investments from time to time as it may seem necessary or desirable, regardless of any lack of diversification, risk, or nonproductivity."

The Bank argued that the trial court's award of damages was based on First Alabama's failure to diversify the trust holdings, when in fact, the power not to diversify was granted to the Bank by the trust agreement. The alleged "loss" suffered by the trust, the Bank argued, is illusory because the trust principal increased and "substantial income" was earned throughout the Bank's tenure as trustee. First Alabama contended that the court erroneously based its finding that the trust suffered a compensable loss on the Spraginses' calculations of what the trust might have earned had the trust portfolio been more diversified. The Bank argued that no loss was suffered, and, therefore, that the law will not recognize any loss to the trust.

The court noted that although a trustee's duties and obligations are governed largely by the trust agreement, that agreement cannot be employed to vitiate "the duty imposed by the 'prudent person' standard."

The Spraginses argued that a loss was incurred by the trust and that the trial court properly found that damages were due. The Bank's concentration of the trust property in its own stock, First Alabama Bancshares, was a violation of its duty of loyalty to the trust beneficiaries and constituted self-dealing, the Spraginses contended. The Spraginses claim, and the trial court found, that the Bank's failure to diversify the trust portfolio was "at least, insensitivity" by the trustee to the duty of loyalty it owed the trust beneficiaries. The court agreed.

"The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill," the court wrote.

The court said the donor did not intend to vest in the trustee Bank a power to diversify so little as to prejudice the interests of the beneficiaries. Rather, the court found that the bank failed to provide a reasoned plan of investment calculated to accomplish the testator's purpose. That purpose was to provide for present and future generations of the testator's family.

Testimony by the Bank's senior trust officer revealed that eight years after the Bank had assumed administration of the trust, i.e., by 1982, the needs of the testator's grandchildren had still not been determined by the trustee, a basic step which should have preceded formulation of a prudent plan for management of the trust property.

At a time when the trustee Bank's own investment advisory service was recommending that investment in bank stock be limited to five percent of a trust's portfolio, approximately seventy-five percent of the Spragins trust assets were invested in First Alabama Bancshares, the court said. Thus, the court concluded that the trustee Bank's management of the Spragins trust was, "at least, imprudent, and demonstrated the insensitivity of the trustee Bank in the performance of its duty of loyalty to the trust's beneficiaries."

The net value of the Trust was $556,881.73 when the testator's estate was settled. The court found that the trust property, 70 to 75% of which was composed of First Alabama Bancshares during the Bank's tenure as trustee, fluctuated in value from a low of approximately $200,000.00 in 1975 to $776,168.00 by 1983. By contrast, the Spraginses offered the testimony of James C. King, a recognized expert in the field of trust management, to show what active, prudent management might have achieved. The Bank disputes King's conclusion, attributing his estimation of loss suffered by the trust to hindsight and speculation. We conclude that the circuit court was not in error in finding that the trust suffered a compensable loss and, further, that the method employed by Mr. King was not mere speculation and hindsight.

As the circuit court observed, speculation is not a sufficient basis for an award of damages in Alabama. The Spraginses argue that the court correctly determined the amount of the loss by weighing the actual value of the trust principal against what the value would have been had it been prudently managed. The increase in principal cited by the Bank is largely attributable to inflation, the Spraginses contend, and is far less than the increase which would have been realized if the Bank had acted on the investment advice it gave its other customers regarding limiting investment in bank stocks.

The court at trial arrived at its assessment of damages suffered by the trust by calculating the "differences in the principal values of the prudently and imprudently managed estates and the income earned on each estate, taking into consideration trust distributions." Specifically, the court found that prudent management of the trust property would have resulted in a principal value of $1,234,108.00 plus earned income of $455,076.00. By contrast, the trust property, as managed by the Bank, had appreciated from $536,000.00 in March 1974, to $776,168.00 by 1983, plus $227,456.00 in earned income.

The court also assessed interest of $79,224.00 against the Bank, an assessment which, the Bank argues, was erroneously awarded on an "unliquidated sum from an arbitrary day," in violation of the recognized standard. The trial court held that because two years had elapsed since the first judgment in this case, interest should accrue from February 6, 1984, the date of the initial judgment in favor of the Spraginses, through January 15, 1986, the date of Judge Watson's second judgment; a total of $79,224.00. This was proper, the court concluded, in order "to adequately compensate the Trust Estate for the total damages suffered." The Bank contends that the rule for awarding prejudgment interest requires that the principal be certain or be ascertainable.

The Bank argued in its appeal that the amount allegedly due was not made certain until the January 15, 1986, judgment of the trial court; that until January 15, 1986, the date from which interest was to accrue was unknown; and that the amount due and the time of payment was unknown until January 15, 1986. For these reasons, the Bank argues that the trial court's award of pre-judgment interest was reversible error.

The court rejected the Bank's appeal, noting that the rate and amount of interest is a matter in the sound discretion of the court to be determined by the circumstances of each case and should, at a minimum, restore to the beneficiaries the income they otherwise would have received.

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CHAPTER 6 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following statements about trustsee's is correct:

   a) most trusts can exist without a trustee to administer it
   b) courts will order an individual to serve as trustee even if he or she objects to the appointment
   c) a trustor can also serve as trustee in the case of a living trust
   d) once a trustee dies, the trust must be terminated

2. Key characteristics of any trustee are integrity and financial responsibility.

   a) true
   b) false

3. The rule requiring trustees to diversify the assets of a trust is referred to as:

   a) the Prudent Investor Rule
   b) the Rule Against Perpetuities
   c) the Income Maximization Rule
   d) the Investment Purity Rule

4. One of the most common violations of the Prudent Investor Rule is a trustee's overinvestment in the stocks or bonds of one company or in a mortgage on one piece of property.

   a) true
   b) false

5. A trustee will automatically be liable for breach of duties if the value of a trust declines.

   a) true
   b) false

6. Under what circumstances might a court impose a surcharge on a trustee:

   a) any time the value of the trust assets declines
   b) any time the value of the trust assets declines by more than 10 percent
   c) when a trustee fails to fulfill his or her obligations and, as a result, the trust suffers a loss
   d) anytime the trustee abandons his or her duties

CHAPTER 6 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A trust cannot exist without a trustee.

   B: Incorrect. Due to the level of responsibility involved, courts will rarely appoint someone a trustee over his or her objection.

   C: Correct. In the case of a living trust, a trustor can and often will appoint himself or herself as trustee.

   D: Incorrect. Rather than have the trust fail, a successor trustee is typically appointed.

   (See page 6-1 of the course material.)

2. **A: True is correct.** When selecting a trustee, it is important to ask whether the trustee is likely to carry out your wishes, is financially responsible, is knowledgeable in the area of investing and taxes, and is able to say "no" to demands from the beneficiary in the case of a spendthrift trust.

   B: False is incorrect. Trustors should never underestimate the importance of selecting a qualified trustee. The trustee selected should most definitely have integrity and financial responsibility.

   (See page 6-2 of the course material.)

3. **A: Correct.** This rule ensured that assets are adequately diversified to protect the corpus of the trust.

   B: Incorrect. This rule governs the longevity of a trust and how its assets are invested.

   C: Incorrect. There is no such rule.

   D: Incorrect. There is no such rule.

   (See page 6-4 of the course material.)

4. **A: True is correct.** Other common violations of the Prudent Investor Rule include speculative investments, single locality, and failure to investigate.

   B: False is incorrect. There is a common violation of the Prudent Investor Rule.

   (See page 6-10 of the course material.)

5. A: True is incorrect. A reviewing court will focus on the prudence of the investment rather than its result.

   B: False is correct. The courts will review the investments choices, and in doing so they will ask the trustee to explain his or her rationale for the selected investments.

   (See page 6-11 of the course material.)

6. A: Incorrect. A decline in value alone is not sufficient to warrant a surcharge absent some misconduct.

   B: Incorrect. A decline in value alone, regardless of the percentage, is not sufficient to warrant a surcharge absent some misconduct.

   C: Correct. This is the penalty when a trustee fails to fulfill some ethical responsibility and the trust suffers a financial loss.

   D: Incorrect. Not unless there is a financial loss as a result.

   (See page 6-12 of the course material.)

Chapter 7: The Living Trust – Myth and Reality

I. Introduction

Although there are many, many different types of trusts, they can all be generally grouped into two broad categories: living trusts (those that become effective before the death of the trustor) and testamentary trusts (those that do not take effect until the trustor has died). Even within that broad category, however, there are two distinct types of trusts – revocable and irrevocable. This chapter focuses on revocable living trusts.

Some financial and estate planning professionals will have every person believe that they must have a living trust to avoid probate, limit their tax liability, ensure the smooth distribution of their assets upon death, and otherwise save the world. Although they are not required by everyone, there are certainly some important benefits to the use of a living trust.

Like most things, living trusts are not for everyone and will not help in every situation. This chapter will explore the nuts and bolts of living trusts, what they are good for and what they are not good for.

A. FACTORS IN DETERMINING WHETHER A LIVING TRUST IS APPROPRIATE

There are a number of questions that a practitioner must ask when considering whether or not to recommend a living trust to a client. These questions include the following:

- The size and nature of the individual's estate, i.e. whether the gross estate will be below the threshold for probate in his or her state of domicile;
- The health and age of the individual;
- Concerns about competency;
- Costs of establishing and managing a trust, particularly if there is a paid trustee;
- The individual's overall estate plan; and
- The individual's familial status, i.e. whether or not the individual is married.

There is no one-size-fits-all answer for determining whether a revocable living trust is either necessary or even advantageous.

B. REASONS FOR POPULARITY

Revocable living trusts are popular for a number of reasons. First, they allow the trustor to make changes to the trust during his or her lifetime with relative ease. It is also the one type of trust that allows the trustor to act as trustee and beneficiary during his or her lifetime. At common law, these characteristics rendered such a trust invalid because there was no real separation of authority or ownership of the corpus of the trust. The trust was, in essence, illusory. Modernly, such trusts are allowed and have flourished in an environment in which attorneys preach the evils of probate.

Table 7.1 Advantages and Disadvantages of Revocable Living Trusts

Advantages of a Revocable Living Trust	Disadvantages of a Revocable Living Trust
Avoidance of probate for assets within the living trust.	Time and money. It can be time consuming to sell or encumber assets in a trust, i.e. when a couple with a living trust wants to refinance their home that is in a living trust.
Avoidance of guardianship when a successor trustee is appointed in event trustor becomes incapacitated.	Expense of administration. If trustor appoints a bank or trust company as trustee, he or she will have fees to pay. Even in absence of trust fees, time will be spent in maintaining the trust.
Reduction of delays in distribution of the trustor's property after death.	Once the trust is created, the trustee must be sure that trust books are maintained and that all assets continue to be registered to the trustee. In addition, individuals or entities dealing with the trustee (such as banks and title insurance companies) may want to review the trust instrument to check on the trustee's powers and duties.
Continuity of management of the trustor's property after his or her death or incapacity, especially if he or she does not serve as the trustee.	

In addition to the savings in probate expenses, the avoidance of probate administration has other advantages.

1. Privacy

The administration of a revocable living trust at the trustor's death is normally a private matter. Unlike probate, there are few public records to reveal the nature or amount of assets or the identity of any beneficiary.

2. Quick Distribution

Property contained in a living trust can usually be distributed to the beneficiaries shortly after the trustor's death, avoiding much of the delay encountered in some cases with the probate process. In addition, a trustee does not need approval from the probate court to sell or otherwise distribute property within the trust.

3. Support of Incapacitated Trustor

If, instead of dying, a trustor becomes physically or mentally incapacitated, property held in this trust can be used to support the trustor without the necessity of establishing a guardianship or a conservatorship. The successor trustee named in the trust document takes charge to manage the assets in the trust and pay the trustor's bills and otherwise provide for his or her support.

Example.

Mary is a widow, without children and any close relatives. She is no longer able to live alone in her home or to handle her finances. She transfers her property and other assets to a trustee, who will sell the home and invest the proceeds, along with the other assets, under a revocable trust, to provide for Mary's support during her lifetime and to dispose of the same after Mary's death to such persons or charitable organizations as Mary desires. Should Mary change her mind as to any of them, or should an old friend for whom she had provided a gift die, Mary can make a simple amendment to the trust by a written letter or memo signed by her and delivered to the trustee. No witnesses are necessary.

To make the trust workable in the event of incapacitation, assets must be transferred into the trust while the trustor is competent, or an agent, under a durable power of attorney, would be given the authority to make transfers into the trust if the trustor became incapacitated.

At the trustor's death, the trust would become irrevocable, and any remaining assets would be distributed according to the directions in the trust agreement. A will can be drafted to "pour" into the trust any assets that were not transferred before death. The trust agreement needs to describe how and who is to determine if the trustor is incompetent, and directs how their financial affairs are to be managed by the successor trustee.

Alternatives to a revocable living trust for those concerned about incompetency include the durable power of attorney. This is discussed in Chapter 13, *Trust Alternatives: Conservatorships, Powers of Attorney and Life Insurance.*

4. Managing Assets After Trustor's Death

Living trusts can also be used to manage assets long after the death of the trustor. Living trusts, like wills, give an individual latitude in distributing his or her property after death. The trust can specify how the trustee is to distribute the proceeds of the trust and when, i.e. to pay for a college education or to finance the purchase of a new home after marriage.

5. No Initial Funding Required

Finally, a living trust can be established without any initial funding other than a minimal amount. Therefore, it incurs no trustee fees until the fund receives the assets.

6. Not All Assets Can Be Included

Although good for most assets, a revocable living trust may not be appropriate for certain assets. If, for example, stock is owned in a subchapter S corporation, the trust must comply with certain technical income tax requirements to avoid terminating the subchapter S status. Also, if the trust is named as the primary beneficiary of a qualified pension or retirement plan, or an IRA account, a surviving spouse will be precluded from completing a "spousal rollover" and deferring the income tax until later. The more sophisticated an individual's financial position, the more likely a simple revocable living trust will not be sufficient to meet his or her lifetime or estate planning goals.

C. WHEN TO CONSIDER A LIVING TRUST

There are certain situations, however, in which a living trust can be beneficial. Individuals may consider establishing a revocable living trust if:

- They own property in more than one state (a will must be filed and probated in each state in which property is owned);
- They are at the risk of becoming incapacitated;
- They desire to keep the terms of their trust confidential (a will is made public);
- They are concerned that a will might be contested; or
- They own property in such a way that probate could be costly and time-consuming.

II. Creating Revocable Living Trusts

A. BASIC PROCESS

1. State Law Governs

Creating a revocable living trust is a relatively simple process. The particulars are governed by the law of each state. Generally, the trustor (or his or her attorney) prepares a written declaration of trust in which he or she places certain identified property within the trust. In some cases, the trustor will list the property to be placed in the trust. Other assets can be added later. With assets other than tangible personal property (i.e. jewelry) the trustor must place the assets in the name of the trust. This involves changing title to real property or account names in the case of a brokerage or bank account.

2. Both Spouses Must Participate

In some states, including California, a living trust can only be created by the participation of both spouses.

3. Trustor Retains Control

The trustor retains the right to place property inside the trust or to remove property from the trust. It is a flexible vehicle.

Example.

Bridget creates a revocable living trust in which she places her house and her collection of art. Bridget names herself the trustee and the beneficiary. A year after creating the trust, Bridget's father dies and leaves her a home in Martha's Vineyard. Bridget is free to place the new home in the trust. If she chooses to do so, she will need to have title to the home placed in the name of the trust, i.e. "the Bridget Jones Revocable Living Trust."

4. Funding a Living Trust

After a living trust is established, it must generally be funded. This means transferring assets to the trust. A living trust cannot protect property from probate unless the property has been transferred to the trust. All property with ownership documents should be re-titled in the trust's name. This includes bank accounts, money market accounts, stocks, mutual funds, bonds, safe deposit boxes, etc.

In some cases, a trustor will decide not to fund the trust until a later date, or upon his or her death. This type of unfunded trust is referred to as a "standby trust."

5. Title to Property Held in Name of Trust

When a trustor places property into a living trust, the trust becomes its owner. However, where the trustor retains the right to use or dispose of the assets, which is typically the case in a revocable living trust, real ownership of the asset does not change. This is why such arrangements are typically ignored by the IRS and therefore result in no tax savings. This is discussed in greater detail below.

B. TRUSTEE OF A LIVING TRUST

1. Selecting a Trustee

Trustors of revocable living trusts commonly name themselves as trustee. A trustor is free, however, to name another person or entity as trustee or to appoint another person or entity as a successor trustee in the event the trustor becomes incapacitated. It is generally advisable to do so since the future is always uncertain. Some trustors prefer to make a financial institution – such as a bank's trust department or trust company – the successor trustee.

There are circumstances in which a trustor will want the successor trustee to have financial expertise. For example, if any of the trust's beneficiaries are minors or disabled or the trust is to continue, the successor will have to manage the trust property until they reach the ages at which the trustor specified the property would be distributed to them or to their remaindermen (i.e., those who have a future interest in the trust). This may involve preparing tax returns, investing funds, and other financial decisions requiring more expertise.

2. Trust Document Governs

The trust agreement document contains instructions to the trustee regarding investment and management of the trust assets, who is to receive income from the trust, and what happens to the trust if the person creating the trust becomes incompetent or dies. A trustee is required to manage the trust's assets according to the directions in the trust agreement. The trustee can do only what the trust agreement specifies. Ultimately, the trust agreement will provide that the trust be terminated and assets distributed to the beneficiaries.

A living trust is commonly used to avoid the necessity of appointing a guardian or custodianship when an individual, typically an elderly person, is no longer able to make competent financial decisions. A successor trustee is particularly important in such cases.

3. Co-Trustees

When children are beneficiaries of the living trust, parents often choose to make them all equal co-beneficiaries, and therefore it makes sense to name them co-successor trustees as well. However, if there is concern that the children will not agree, this is not advisable. Parents may consider naming only one child as trustee in such a situation but including a mechanism in the trust instrument allowing for a resolution of conflicts.

In the case of a joint marital living trust, both spouses are frequently co-trustees; when the first spouse dies or becomes unable to act, the survivor becomes the sole trustee.

4. Detailed Statement of Authority

The trustor should set forth the successor's powers in as much detail as possible in the trust instrument. Such powers or authority is normally broadly phrased to give the trustee maximum flexibility to deal with unforeseen circumstances that may arise in the future. However, the trustor is free to be as restrictive as possible in granting authority to the trustee.

C. BENEFICIARIES

Beneficiaries of the trust are designated by the trustor and can be individual(s) who formed the trust, friends, family members, a college or university, hospital, library, charity or other organization. Unless the beneficiary is also the trustor, he or she has no control over the trust.

The trust agreement should identify what is to be done with the trust property at the termination of the trust (often at the death of the trustor) and what happens to a beneficiary's share if he or she dies before the trust terminates.

1. Limiting Right of Transfer

A trustor may wish to consider writing safeguards into the trust so that beneficiaries cannot transfer their trust interest to a third party, or to protect beneficiaries' trust interests from creditor claims. The revocable living trust assets are not protected from creditor claims against the trustor nor does a trust insulate the grantor from claims of a surviving spouse.

2. Contingent or Remainder Beneficiaries

A trustor may also elect to name contingent beneficiaries or remainder beneficiaries. A remainder beneficiary is one who receives the assets of the trust following the death of the primary beneficiary.

Example.

Rusty creates a revocable living trust in which he is both trustee and beneficiary. Upon his death, however, the language of the trust provides that a successor trustee, his CPA Rich, is to be appointed and his grandchildren are to become the new beneficiaries of the trust. Upon his death, the trust will become irrevocable. The grandchildren are referred to as the remainder beneficiaries.

III. Myths About Living Trusts

A. MYTH #1: PROBATE AVOIDANCE

Myth #1 about living trusts is that they are necessary to avoid probate when the trustor dies. The topic of probate is discussed in Chapter 2. As we saw in that chapter, there are many ways to avoid probate aside from living trusts. These include holding assets in joint tenancy and pay-on-death bank accounts. Remember also that not all assets require probate and that in many states reforms have lowered the cost and inconvenience of the probate process. There are also exceptions to the probate process for certain small estates.

In addition, paying an attorney to draft a living trust can be expensive. It is therefore prudent to compare the costs of preparing and maintaining a living trust to the probate costs in the trustor's domicile. Those fees are typically based on the size of the estate. Individuals considering a living trust should also take into account the inconvenience of seeing and paying a lawyer every time they want to buy or sell assets.

B. MYTH #2: TAX SAVINGS

There are many advantages of revocable living trusts. However, tax savings is generally not one of them.

1. Income Taxes

A living trust will not remove assets from the trustor's gross estate for federal estate tax purposes, nor will it shift income to lower-bracket beneficiaries for federal income tax purposes. It will also not protect property from the creditors of the trustor.

When an irrevocable living trust is set up, ownership of the assets is turned over to the trustee. The trust becomes, for tax purposes, a separate entity, and the assets cannot be removed, nor can changes be made by the trustor. This type of trust often is used by individuals with large estates to reduce estate taxes and avoid probate. However, if the trustor names himself or herself as trustee or is entitled to trust income, there are typically no tax benefits. The trustor who receives the income from the trust is required to report it as normal income on his or her tax return. The trust is, in such a case,

essentially ignored by the IRS. Therefore, if an individual is considering the use of a trust for tax savings or tax deferral purposes, he or she should consider a different approach.

The bottom line is that during the trustor's lifetime, the revocable living trust has no effect on the income tax that the trustor will owe. In fact, if the trustor is the trustee or a co-trustee, all income earned on assets held in the trust is reported directly on the trustor's income tax return and the trust is not required to file a return. After the trustor's death, the trust is taxed at the same rate as a probate estate. However, as mentioned above, a probate estate may enjoy certain relatively minor income tax advantages.

For the most part, estate tax planning can be equally accomplished through proper drafting in either a will or a revocable living trust. However, there are minor differences. For instance, under current tax rules a lifetime gift directly from a living trust to a donee will be subject to estate tax if the grantor dies within three years of making the gift. This three-year rule does not apply to gifts made directly from an individual to a donee.

2. Gift Tax

A transfer of property to a revocable living trust is not subject to gift tax because the property can be removed from the trust at any time. This means the gift is not complete until such time as the trust becomes irrevocable. However, any payments made out of the trust to individuals other than the trustor will be gifts, potentially subject to gift taxes levied on the trustor.

3. Estate Tax

Assets placed in a revocable living trust will be included in the trustor's gross estate at death. This is because the trustor retained a power to revoke the trust. To avoid the estate tax, an irrevocable trust must be utilized.

4. Generation-Skipping Tax

If the trustor's grandchildren, or individuals deemed to be more than one generation below the grantor, are beneficiaries of the trust, the federal generation-skipping transfer tax may be applicable.

C. MYTH #3: PERSONS WITH A REVOCABLE LIVING TRUST DO NOT NEED A WILL

Some people believe that if they create a living trust, it is not necessary to also have a will. This is false. A revocable living trust, though appropriate and useful under some circumstances, is never an adequate substitute for a valid will.

1. Pour Over Will

It is important to have a will in addition to a living trust so that any assets not in the trust at the time of the trustor's death will be directed into the trust. This type of will, referred to as a "pour over" will, names the revocable living trust as the principal beneficiary. Thus, any property that the trustor failed to transfer to the trust during his or her lifetime is added to the trust upon the trustor's death and distributed to (or held for the benefit of) the beneficiary in accordance with the terms of the revocable living trust.

2. Persons with Minor Children

If an individual has minor children, a will is necessary to appoint a legal guardian in the event of his or her death. A parent cannot appoint a guardian for minor children in a revocable living trust. This can be accomplished only in the will.

3. Unforeseen Assets

In some cases, a trustor may fail to transfer all of his or her property to a living trust during his or her lifetime. For example, the probate estate of an individual who is killed in an airplane crash may be entitled to any insurance settlement proceeds. Such proceeds can only be transferred from the estate to the trust pursuant to the terms of a will. Without a will, the proceeds would be distributed to the heirs under the applicable state laws of descent and distribution.

D. MYTH #4: HAVING A LIVING TRUST SIMPLIFIES LIFE

Many people believe that administering a living trust is no big deal. That is not always the case. A revocable living trust can make managing financial affairs more complicated. If, for example, the trustor elects to act as trustee, he or she must function as a trustee. For the trust to work properly, the trustee must transfer title of all his or her assets to the name of the trustee. As new assets are acquired, they too must be placed in the name of the trust.

If the trustor elects to buy or sell assets, the process can become cumbersome. It may be more difficult to deal with life insurance companies and other financial institutions. When transferring assets into the trust, financial institutions – i.e., brokerages, mutual funds, life insurance companies, credit unions – need to know who has what powers under the trust agreement. It may be necessary to furnish a copy of the trust instrument to these institutions.

Many financial institutions will not loan money to a trust. For example, to refinance a home mortgage when the home is owned by the trust, the trustor may have to transfer the house out of the trust, complete the refinancing, and then transfer the house back into the trust. If an individual has real estate that is used for collateral on business loans, the additional paperwork due to the trust ownership of the property could become burdensome.

IV. Using Revocable Living Trusts to Make Charitable Contributions

As noted above, a trust is a separate legal entity and formalities with respect to trust property and trust operations should be carefully observed. Nevertheless, the trust is not a separate taxpaying entity during the lifetime of the trustor so long as it remains revocable. It is called a "grantor trust" and treats the trustor (also referred to as a “grantor”) as the owner of the trust for federal income tax purposes. Income of the trust, including capital gains, is taxed to the trustor. As a result, it provides the trustor no income tax advantages during his or her lifetime.

A trustor may design his or her revocable living trusts so that charities are beneficiaries of the trust. The trustee may be directed to pay a charity a certain dollar amount at the grantor's death. Alternatively, the trustee may be required to pay a charity a percentage amount of the trust corpus, or the residual of the trust after amounts directed to other beneficiaries have been paid. Following the trustor’s death, a revocable living trust may be converted into a QTIP trust, a charitable lead trust, or a charitable remainder trust, all of which are discussed below.

A. CHARITABLE QTIP TRUST

A Qualified Terminable Interest Property (QTIP) trust is a type of trust that qualifies for the estate tax marital deduction, although the surviving spouse only receives a "terminable interest" in the trust property. Frequently used in connection with second marriages, QTIP trusts must pay all their income at least annually to the surviving spouse.

The donor spouse is free to direct where the trust property will go following the death of the surviving (donee) spouse, including distributions to charity. QTIP property remaining at the death of the donee spouse generally will be included in the donee spouse's estate for estate tax purposes, but the estate tax charitable deduction could offset the tax.

Following the death of the grantor, the trust agreement would provide that all trust income would be paid to the surviving spouse annually or more frequently. The trust document could also provide that the surviving spouse could receive trust principal necessary for the spouse's health, education, maintenance or support. Following the death of the surviving spouse, the residual would be paid to charity. The value of remaining charitable QTIP property at the time it is transferred to charity will be deductible for estate tax purposes.

B. CHARITABLE LEAD TRUSTS

When all or a portion of a revocable living trust is converted to a charitable lead trust (CLT) following the death of the grantor, the charitable interest will precede (or lead) the non-charitable interest. The trustee will be required to pay an annuity (charitable lead annuity trust) or a variable amount (charitable lead unitrust) to a charity each year for a certain number of years. After this interval, the trustee will then distribute the trust property to the non-charitable (usually family) beneficiaries. The present value of the charitable lead interest at the time the revocable living trust (RLT) is converted into a CLT will be deductible for estate tax purposes.

C. CHARITABLE REMAINDER TRUSTS

If all or a portion of a revocable living trust is converted into a charitable remainder trust (CRT) following the death of the grantor, the charitable interest will follow the non-charitable interest. The trustee will pay an annuity (charitable remainder annuity trust) or a variable amount (charitable remainder unitrust) to a non-charitable (usually family) beneficiary for life or for a certain number of years. When these non-charitable interests terminate, the residue will be paid to a charity. The present value of the charitable remainder interest at the time the RLT is converted to a CRT will be deductible for estate tax purposes.

D. PRIVATE CHARITABLE BEQUEST

A trustor may also transfer to his or her revocable living trust property that will be distributed to a charity following the trustor's death. During the trustor's life, he or she will have absolute control over the assets of the trust. The trust itself may be altered, amended, or revoked at the grantor's discretion, and property may be added to or taken from the trust as the trustor directs. At the trustor's death, the trust property will be paid by the trustee to the charity or charities provided by the grantor. Neither the terms of the trust, nor the size of its gifts and the identities of recipient charities, will become matters of public record, unlike bequests made under a will. The value of the trust property transferred to the charity will be deductible for estate tax purposes.

V. Sample Revocable Living Trust

George Washington Revocable Living Trust Agreement

AGREEMENT made this January 1, 2005 between GEORGE WASHINGTON of San Diego, (the creator of the Trust who is sometimes called the "Trustor," hereafter), and GEORGE WASHINGTON of San Diego, California (hereafter sometimes called "Trustee").

I. Successor Trustee

The term "Trustee" as used in this Trust means one or more Trustees as well as any Successor Trustee or Successor Co-Trustees.

A. Successors; Death of Trustor

In the event of the death, resignation, removal, or incapacity of the Grantor, GEORGE WASHINGTON, then his wife, MARTHA WASHINGTON, and his son and daughter, WILLIE WASHINGTON and ROSE WASHINGTON, shall all three serve as Successor Co-Trustees. In the event that any of the three Successor Co-Trustees named immediately above is unable to serve, then the remaining two shall serve as Successor Co-Trustees. In the event that all but one of the three family members named above are unable to serve as Successor Co-Trustees, then the sole remaining family member capable of serving as a Successor Trustee shall serve in his or her individual capacity as the sole Successor Trustee.

B. Removal of Trustee by Grantor

The Grantor reserves the right to remove any Trustee, Trustees, or Successor Co-Trustees.

C. Responsibility of Trustee

A Successor Trustee shall become responsible for the Trust Estate only when the same has been received by it. No Successor Trustee shall be responsible for any act or omission of any prior Trustee, nor shall any Successor Trustee be under a duty to take any proceedings against any prior Trustee for an act or omission of any prior Trustee. In determining what assets constitute the Trust Estate, the Successor Trustee shall be responsible only for the making of reasonable inquiry from records of the prior Trustee.

D. Annual Statements by Successor Trustee

The Successor Trustee agrees to furnish annual statements to the beneficiaries receiving income hereunder, showing all receipts and disbursements during the period covered, and to submit annually a statement of the assets of the Trust.

E. Resignation of Trustee(s)

Any Trustee shall have the right to resign and if a Successor is not named in this Trust, the Trustor shall appoint a Successor Trustee. In the event of the death of the Trustor, or failure or inability of the Trustor to name a Successor, then the Trustee shall deliver notice by certified mail, at least thirty (30) days prior to the effective date of such resignation, to each of the ascertained and then-living beneficiaries of the Trust to, or for, whom income may currently be paid or used, or their guardians, addressed to the last known address of such persons as disclosed by the Trustee's records. Within twenty (20) days after the delivery or mailing of such notice of resignation, a majority of the adult beneficiaries and guardians shall select a Successor Trustee and shall in writing, signed by a majority of the adult beneficiaries or guardians, inform the Trustee of the identity of the selected Successor Trustee. If a majority of the adult beneficiaries and guardians fail to select a Successor Trustee within the twenty (20)-day period, the resigning Trustee shall select a Successor Trustee. The Trustee shall, upon the effective date of the resignation, deliver to the Successor Trustee and each beneficiary of the Trust a statement of the last two years' receipts and disbursements, together with an inventory of the assets belonging to the Trust.

II. Transfer of Property and Beneficiaries

A. Assets Transferred

The Trustor has this day transferred to the Trust the property described on Schedule "A" attached hereto and made a part of this Trust. Later, other property, real or personal, may be transferred, during life or by Will, to the Trust by the Trustor or by someone acting on his behalf. If further property is transferred to the Trust, it should be listed on the attached Schedule that is for reference only. Property transferred to this Trust formally or informally, but not listed on Schedule "A," shall also be part of the Trust.

All property transferred to the Trust formally or informally, together with the investments and reinvestments, constituting additions to the principal of the Trust, and the income therefrom, are sometimes hereafter collectively designated the "Trust Estate." All property transferred to or deposited with the Trustee shall be held by it in trust for the uses and purposes stated hereafter.

B. Beneficiaries

In addition to the Trustor, the primary beneficiaries of this Trust, their birth dates and relationships to the Trustor, are as follows:

Martha Washington, wife

Willie Washington, son

Rose Washington, daughter

III. Rights Reserved by Trustor (Creator)

The Trustor reserves the following rights during his lifetime:

A. Right to Change Trust

The right to change, amend or alter any of the terms or provisions of this Trust Agreement at any time. All changes, amendments or alterations must be written and will not become effective until signed by the Trustee.

B. Right to Terminate

The right to terminate this Trust Agreement, in whole or in part, at any time. Any complete or partial termination shall become effective upon delivery of notice in writing to the Trustee.

C. Right to Withdraw Assets

The right to withdraw and return to the Trustor, all or any, part of the assets transferred to the Trust formally or informally whether or not listed on the Schedule attached. The exercise of this right of withdrawal, in whole or in part, will become effective upon delivery of notice in writing to the Trustee.

IV. Insurance Provisions

A. Policy Beneficiaries

The Trustor may make insurance policies payable to the Trust or the Trustee as primary or contingent beneficiary. Such beneficiary designations may also be amended or terminated by the Trustor. A reference to the potential policy proceeds transferred or made payable to the Trust or the Trustee should be shown on Schedule "B" attached.

B. Payment of Premiums

The owner of the policies shall pay all premiums or assessments on them, and the Trustee shall be under no obligation to see that the premiums or assessments are paid. The Trustee shall be under no obligation with respect to the policies, other than for their safekeeping, unless agreed otherwise. Nothing contained in this Trust shall be interpreted as an obligation on the part of the owner or the Trustee to keep the policies in force.

C. Ownership of Policies

The owner of the policies reserves all incidents of ownership in the insurance policies. It is the intent of the Trustor that the Trust be operative with respect to the proceeds of the policies which are payable to the Trustee or Successor Trustee at the time of the death of the insured.

D. Pledging and Assigning Policies

If the policy owner requests, the Trustee will join with the policy owner in executing instruments assigning or pledging any insurance policies subject hereto. Upon the execution of such instruments by the Trustee, all of the rights and interest of such Trustee, and this Trust, will be and remain subject to the rights and interest of such assignee or pledgee.

E. Collecting Policy Proceeds

Upon the death of the Trustor, the Trustee shall collect the proceeds of the policies payable to this Trust or the Trustee. If necessary, the Trustee may institute legal proceedings to enforce the payment of the policies or do any other acts necessary to collect under the policies. However, the Trustee shall not be required to maintain any litigation to enforce the payment of the policies until reasonably assured of indemnity against expenses and liabilities that may be associated with such litigation. The Trustee is authorized to compromise and adjust claims arising out of the insurance policies upon such terms and conditions as seem just, and the decision of the Trustee shall be binding and conclusive upon all interested persons and corporations.

V. Distribution of Income and Principal of Trust Estate During Trustor's Lifetime

During the lifetime of the Trustor, the Trustee shall hold, administer and distribute the Trust income and principal as follows:

A. Distribution of Income

The Trustee may accumulate all of the income from the assets transferred to the Trust or distribute all or any portion of the income from the Trust to the Trustor. The Trustee may distribute income to third parties as determined by the Trustee or as directed by the Trustor.

B. Distribution of Principal

Unless incapacitated, the Trustor may direct the Trustee to distribute any amount of principal to the Trustor or a third party. This power can be exercised in such a manner that all of the assets may be taken from this Trust.

C. Incapacity of Trustor

If the Trustor becomes incapacitated, the Successor Trustee(s) described in this Trust shall become active in the order and capacity designated. In the event of the Trustor's incapacity, then the Successor Trustee will act in the same capacity as the Trustor could have acted. The Successor Trustee may withdraw principal or income from the Trust for the Trustor's benefit or for those individuals dependent upon the Trustor. Such withdrawals should be consistent with the value of the Trust and the mode of living to which the Trustor and the Trustor's dependents have been accustomed.

D. Life Support Systems

In the event the Trustor is terminally ill or irreversibly comatose and is receiving life-prolonging medical treatment, the health-care provider (physician or hospital staff members) shall consult with the Successor Trustee to determine if such measures should be continued. "Life-prolonging treatment" as used herein means "medication and artificially or technologically supplied respiration, nutrition, or hydration" that prolongs the life of the Trustor. The health-care provider shall consult with the Successor Trustee to determine whether the benefits of continued treatment outweigh the burdens of such treatment.

It is the desire of the Trustor that life-prolonging treatment not be continued for an unreasonable period when it is clear that the condition of the Trustor will not improve and the treatment merely prolongs the Trustor's life without dignity.

VI. Distribution of Income and Principal of Trust Estate Subsequent to Trustor's Death

Upon the death of the Trustor, if the Trustor's spouse is surviving and if there is a possibility that the Trustor's estate will incur Federal estate taxes, the Trustee will divide the assets of this Trust into two parts, sometimes called the "Marital Trust" and the "Family Trust." The allocation of assets to the two Trust portions will be made using a formula in the Marital Trust provisions referred to as a "reduce to zero formula." "Reduce to zero" means to fund the Marital Trust with the smallest amount of property necessary to claim a marital deduction in an amount that, when subtracted from the decedent's taxable estate, will leave a remainder which is subject to no or "zero" Federal estate tax.

A. Marital Trust

(1) Reduce to Zero Formula

If the Trustor's wife, MARTHA WASHINGTON, survives the Trustor, the Trustee will set aside in a separate Trust the following:

(a) The amount of Marital Deduction needed to reduce the U.S. Federal estate tax on the Trustor's estate to zero, after taking into account all credits allowable against such tax; less

(b) The aggregate value of all interests in property, if any, which pass to the Trustor's wife, or which have already passed to or for her benefit, other than through the provisions of this Marital Trust, but only to the extent that such interests are included in

determining the Trustor's gross taxable estate and are allowable as a Marital Deduction for Federal estate tax purposes.

(2) Selection of Assets for Marital Trust

The Trustee will have the power and the sole discretion to fund this Trust wholly or partly in cash or kind and to select the assets which shall constitute this Trust. The assets selected shall be valued at the date they are assigned to the Marital Trust. The Trustee will not include in this Marital Trust any assets or the proceeds of any assets that do not qualify for the Marital Deduction for Federal estate tax purposes, and the Marital Trust shall be reduced to the extent it cannot be funded with such qualifying assets.

In addition, the Trustee shall not include in the Marital Trust portion any assets or the proceeds of any assets (i) with respect to which any estate or death taxes are paid to any foreign country or any of its possessions or subdivisions, or (ii) with respect to which any tax credit or deduction is available because such assets or the proceeds thereof are subject to both Federal estate and income taxes (provided, however, that such assets or the proceeds thereof shall be allocated to this Trust in the order stated to the extent that there are no other assets which may be thus allocated in satisfaction of the formula amount set forth herein). The exercise of the foregoing powers and discretion by the Trustee will not be subject to question by or on behalf of any beneficiary under this Trust, regardless of their effect upon the interest of such beneficiary.

(3) Income from the Marital Trust

Commencing with the Trustor's death, the Trustee shall pay all the income from the Marital Trust in convenient installments, but not less frequently than quarter-annually, to the Trustor's wife, MARTHA WASHINGTON.

(4) Principal of the Marital Trust

The Trustee is hereby authorized to advance to the Trustor's wife, or expend for her benefit or for the benefit of any other person designated by her, such portions of the principal of the Marital Trust as the Trustor's wife directs. This power includes a partial or total withdrawal of principal. If the Trustor's wife is unable to exercise this right, by reason of physical or mental disabilities, the Successor Trustee (other than the Trustor's wife) is hereby authorized to give to the Trustor's wife, or expend for her benefit, such portion of the principal of the Marital Trust (including the balance of the Marital Trust) as the Successor Trustee, in its sole discretion, deems appropriate to suitably support and maintain the Trustor's wife. The intent is that she may continue to have the advantages of the standard of living to which she was accustomed during the lifetime of the Trustor.

(5) Marital Trust Disposed of by Wife's Will

The Trustor's wife shall have the right and authority to direct the disposition of the principal of this Marital Trust by her Will, regardless of the date the Will is executed. She may give the Marital Trust to her estate or to such persons and in such manner as she selects; provided, however, that this power of appointment shall be exercisable only by specific reference to the power in her Will.

(6) Failure to Dispose of Marital Trust Assets

If the Trustor's wife fails to exercise the testamentary power of disposition given her above, or only partially exercises such power of disposition, then after her death, the Successor Trustee shall transfer to her Personal Representative (who may be the Successor Trustee) an amount equal to any additional estate, inheritance, succession and other similar taxes imposed on her estate because of the existence of this power of disposition. The remaining balance of the Marital Trust will be added to the principal of the Family Trust. If the Successor Trustee receives no notice of the existence of a Will for the Trustor's wife within six months (6 months) after her death, the Trustee may proceed without liability as if there was no Will.

(7) Simultaneous Death Provisions

If the Trustor's wife and the Trustor die under such circumstances that the order of death cannot be established by proof, then for the purposes of this Trust Agreement, the Trustor's wife shall be presumed to have survived him.

B. Family Trust

Subject to the foregoing, all of the remainder of the Trust property will be allocated by the Successor Trustee to the Family Trust for the following uses and purposes:

(1) Income from Family Trust

During the lifetime of the Trustor's wife, MARTHA WASHINGTON, the Successor Trustee (other than the Trustor's wife) may distribute to, or for the benefit of, the Trustor's wife and children, so much of the net income from the Family Trust as the Successor Trustee, in its sole discretion, deems necessary utilizing the standards set forth in the following paragraphs. This income shall be distributed quarter-annually or more frequently. Any net income not distributed at the Trust's year end shall be added to the principal of the Trust.

(2) Principal of Family Trust

During the lifetime of the Trustor's wife, if the income from the Family Trust, together with the receipts from other sources known to the Trustee, shall be insufficient for the health, support, maintenance, and education of the Trustor's wife and children, then the Successor Trustee (other than the Trustor's wife) is authorized to pay to the Trustor's wife, or for her benefit, and for the benefit of the Trustor's children, so much of the principal of the Family Trust as may be deemed necessary for such purposes.

C. Distributions at Spouse's Death

Upon the death of the Trustor's Wife, MARTHA WASHINGTON, or upon the Trustor's death if she does not survive the Trustor, the assets of this Trust shall be allocated and distributed as follows.

(1) Division Into Shares

The Trustee shall divide the balance of the Family Trust into as many equal shares as there are children then living, and one share for the then-living issue ("grandchildren" of the Trustor) by right of representation of a deceased child. The portion allocated to an adult child shall be distributed as soon as reasonably practicable after the death of the Trustor or the Trustor's spouse, whoever dies last.

(2) Death of Child Before Receiving Full Share – No Issue

If either of the Trustor's children dies before receiving all of the share of the Trust he would have otherwise received, leaving no issue surviving, then, under such circumstances, all the remainder of that share shall be added to the Family Trust and distributed according to its provisions. If any of the shares of this Trust have expired through the passage of time, then the amount which would have been added to such expired share will go to the beneficiary thereof. The portion added to any existing shares shall constitute principal thereof, and the Trust conditions applicable shall govern the disposition of the principal and income.

(3) Death Before Receiving Full Share With Issue

If either of the Trustor's children dies before he has received all of the Trust assets designated for such deceased child leaving surviving issue (grandchildren of the Trustor), the remainder of that share shall be distributed to the issue of the deceased child by right of representation in accordance with the following provisions:

(a) Sub-Trust(s) for Issue of Deceased Child (Grandchildren)

If any portion of the Trust becomes payable to any issue of a deceased child of the Trustor (grandchildren) who has not yet become thirty (30) years of age, then the entire portion allocable to the deceased child shall be held as a separate share and divided into sub-trusts, one for each issue (grandchild). When each grandchild attains age twenty-five (25), he or she shall receive one-half (50%) of the then balance of the sub-trust. When a grandchild becomes age thirty (30), the sub-trust for that grandchild shall terminate, at which time the remaining assets of the sub-trust shall be distributed to the grandchild. Until the youngest issue (grandchild) of a deceased child of the Trustor receives his or her final distribution, the Trustee shall retain such sub-trust(s) for the benefit of such beneficiaries (grandchildren) with all of the investment and administrative powers herein conferred upon the Trustee. The Trustee will pay to such beneficiaries, or on their behalf, so much of the net income and principal as the Trustee deems reasonably necessary to provide for their health, support, maintenance and education, and will accumulate the remainder of the income, if any, and add it to the principal of such portion.

(b) Death of all Beneficiaries (Grandchildren) of a Particular Share

If the beneficiary of a sub-trust dies prior to receiving the final distribution leaving no surviving issue in that family, then the sub-trust(s) for the deceased issue (grandchild) shall terminate, and all of the then remaining principal of such sub-trust(s) shall be equally divided among and distributed to the Trustor's then surviving child or the then surviving issue of the deceased child. Provided, however, that if there then is in

existence hereunder a sub-trust for any beneficiary, the sub-trust(s) shall be transferred and added to such sub-trust(s), and shall be held, managed and disposed of in the same manner as the share to which it is added.

(4) Guidelines for Family Trust Use

In the administration of the Family Trust to the extent that the funds in the Trust Estate are considered by the Trustee to be sufficient for the purposes described below, the Trustee shall distribute funds to allow any children of the Trustor or their issue an opportunity to:

- Obtain a college or university education or pursue other types of education or higher learning;

- Assist any beneficiary in establishing, operating, or maintaining a business or profession;

- Assist any beneficiary in the acquisition of a home;

- Assist in the event of a financial emergency befalling any of them; or

- For any other purpose that will, in the sole discretion of the Trustee, further the best interest of any beneficiary.

Provided, however, that any such payments, other than payments for the medical needs and education of any beneficiary, shall be deducted from such beneficiary's proportionate share of the Trust Estate at the time the Trustee divides the Trust Estate or Sub-trust into equal shares.

(5) Disaster Provision – All Beneficiaries Dead

In the event that all the named or contingent primary beneficiaries under the Family Trust (spouse, children, and grandchild(ren)) die prior to the distribution of all of the assets, then the Trust shall terminate and all of the then remaining principal of this Trust shall be distributed to those heirs of GEORGE WASHINGTON and in such amounts as would be determined under the rules of descent and distribution that would be applicable if he had died intestate in California.

VII. Administrative and Miscellaneous Provisions

A. Minors

In the event that any of the beneficiaries herein are minors at the time of any distribution by the Trustee, the Trustee is hereby authorized to pay or deliver the same, either directly to the minor or to either parent of the minor, as natural guardian, without the necessity of any judicial appointment. A receipt, in writing, by any such distributee, either guardian or minor, shall constitute a full and binding release of the Trustee.

B. Rule Against Perpetuities

In the event that any of the terms or provisions of this Trust continue beyond the period permitted by any applicable laws regulating restraints on alienation or prohibitions against perpetuities (or any other similar laws), such offending provisions or terms to the extent of their continuance beyond the lawful period, shall be null and void, but the remainder of the terms and provisions of the Trust shall remain valid and binding. The undistributed portion of the Trust Estate held in violation of applicable laws shall immediately be distributed to the beneficiary from such portion.

C. Spend-Thrift Provisions

Excluding the power of appointment under the marital trust provisions, neither the principal of any Trust or sub-trust created hereby nor the income resulting therefrom, while in the hands of the Trustee, shall be subject to any conveyance, transfer, or assignment, or be pledged as security for any debt of any beneficiary, and the same shall not be subject to any claim of creditors of any such beneficiary, through legal process or otherwise. Any such attempted sale, anticipation, assignment or pledge of any of the funds or property held in any such Trust, or the income therefrom, by a beneficiary shall be null and void and shall not be recognized by the Trustee. It is the intention of the Trustor to place absolute title to the property held in trust and the income therefrom in the Trustee, with power and authority to pay out the same only as authorized hereby.

D. Adopted Child

The terms "child," "grandchild," "issue," "heir," "descendant," "beneficiary," or other equivalent term shall be construed to include stepchildren, adopted persons or their descendants.

E. Small Trust Termination

If any Trust or Sub-trust created by this Agreement falls below the sum of Thirty Thousand Dollars ($30,000) in value, and if the beneficiary or beneficiaries entitled to receive the income therefrom have attained their majority, the Trustee may terminate the Trust or Sub-trust. In such event, the Trustee will pay the beneficiary or beneficiaries the entire corpus of the Trust or Sub-trust. In this event, any remainderman will not be considered as having a vested interest in the Trust Estate conveyed to the beneficiary or beneficiaries.

F. Taxes

Upon the death of the Trustor, if the Trustor is the second to die and if the Trustor's estate shall be subject to Federal estate tax, the Trustee hereunder shall pay to the Personal Representative(s) of the Trustor's estate, from the Family Trust, an amount equal to the additional estate, inheritance, succession and other similar taxes, imposed by inclusion of the property in the Family Trust in the Trustor's gross estate for tax purposes. Provided, however, that no such tax shall be paid from assets not subject to the Federal estate tax, such as the Marital Trust portion.

G. Miscellaneous

Words used in the singular or neuter form are to be construed in the plural, masculine or feminine where applicable. Section headings are for reference only.

H. Applicable Law

This Trust is to be interpreted under the laws of the State of Virginia.

VIII. Trustee's Powers

The Trustee has the following powers, in addition to and not in limitation of its common law and statutory powers, all of which may be exercised without application to any court (for prior or subsequent approval).

A. Maintaining and Selling Property

To retain all property in the form in which it was received by the Trustee without liability for any loss that may be incurred thereby. To sell, at public or private sale, for cash or on credit, and upon such terms as it may deem proper, any property at any time held by it.

B. Borrowing

To borrow money upon such terms and conditions as it may determine, from any person, firm or corporation, for the purpose of protecting, preserving or improving this Trust Estate; to execute promissory notes or other obligations for amounts so borrowed and to secure the payment of such amounts by mortgage or pledge of property in this Trust Estate.

C. Lending

To make loans in such amounts, upon such terms, secured or unsecured, at such rates of interest, and to such persons, firms or corporations it deems advisable.

D. Real Property

To manage any real property held by it, in such manner as it determines. This power includes the authority to repair and improve such property; to mortgage or re-mortgage such property in such amount, on such conditions, and at such rates of interest as it deems advisable; to make, renew or modify leases on such property for such rentals, and on such terms and for such periods without reference to the term of any Trust created hereunder, to abandon such property; to adjust boundaries, to erect or demolish buildings thereon; to convert for a different use; to dedicate for public use without compensation; to grant easements; to waive payment for property taken by right of eminent domain; to insure for any and all risks; to grant options; to partition; to enter into party wall contracts; and to insure or perfect title.

E. Investments

To invest and reinvest all funds available for investment and reinvestment in any kind of property, real or personal, and whether or not currently producing income, including by way of illustration: bonds, interest in common trust funds established by the Trustee or any successor, stocks of any class, mortgages, agreements of sale and other investments in property as the Trustee shall deem proper and for the best interest of the Trust Estate.

F. Investment in Brokerage/Money Market Accounts/Commodities

To buy, sell and trade in securities, commodities, commodity futures and short sales on margin, and for such purposes may maintain and operate a margin account with any broker and may pledge any securities, commodities, commodity futures or commodity options held or purchased by it with such broker as security for loans or advances made to the Trustee. In connection with the foregoing, the Trustee is authorized to hold stocks, bonds, commodities, commodity options or other securities in the name of a nominee or in other forms without disclosure of the Trust so that title to the property may pass by delivery.

G. Manner of Holding Assets

To register any security and/or property in the name of a nominee, or in its own name, or to hold it unregistered, or in such form that title shall pass by delivery, but without thereby increasing or decreasing its liability as Trustee.

H. Voting Securities

To vote, in person or by proxy, at corporate meetings, any shares of stock in this Trust Estate; to participate in or consent to any voting trust, reorganization, dissolution, liquidation, merger or other action affecting any such shares of stock and to take any other action which it may deem advisable in connection with any securities.

I. Claim Handling

To pay, extend, renew, modify or compromise upon such terms as it may determine, and upon such evidence as it may deem sufficient, any obligation or claim, including taxes, either in favor of or against this Trust Estate.

J. Bank Accounts

To establish such bank accounts, checking or savings, as such Trustee (or any successor) may deem proper, and to designate any person or persons to sign checks or make withdrawals from savings accounts.

K. Dealing with Trustor's Estate

To purchase for the Trust Estate any securities or other property belonging to the estate of the Trustor, and to loan to the personal representative of the Trustor's estate (whether or not the Trustee hereunder is at the same time personal representative of the Trustor's estate) out of either the principal or the accumulated income of the said Trust Estate, such amounts as the Trustee may deem necessary or advisable to protect and conserve the assets of the Trustor's estate. The Trustee shall not be liable for the losses suffered by the Trust Estate as a result of its exercise of these powers.

L. Payment of Trustee

To incur, and pay from the Trust Estate and to charge against either income or principal thereof, all reasonable expenses in connection with the management of this Trust. The Corporate Trustee, if there is one, may be paid the fees normally charged by it whether or not there are individual Co-Trustees.

M. Continuance of Business

To carry on, as long as, and in such manner as it sees fit, any business enterprise in which the Trustor owned any interest during his lifetime. This power includes the right to name or change officers, directors or employees; to expand, limit, alter, incorporate, merge, or reconstitute such business in any way it deems advisable; and to accept, in the absence of actual notice to the contrary, financial or other statements rendered by the managers of the business from time to time as to its conditions and operations. The Trustee shall in no way be liable for any loss resulting from such retention or continuance or from the operation of such business or the acts of its officers and directors, except where such loss is the result of the Trustee's misconduct or gross negligence.

N. General Power

To do all other acts which, in its sole judgment, may be necessary or appropriate for the proper or advantageous management, investment or disposition of any property included in this Trust Estate.

IN WITNESS WHEREOF, GEORGE WASHINGTON, as Trustor and Trustee, has executed this instrument as of the day and year first above written.

SIGNATURE OF TRUSTOR & TRUSTEE

____
GEORGE WASHINGTON, Trustor

____
GEORGE WASHINGTON, Trustee

CHAPTER 7 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following statements about living trusts is <u>not</u> correct:

   a) they are generally inexpensive to create
   b) they can keep assets from going through probate when the trustor dies
   c) they allow a trustor to control his or her assets even after death
   d) they allow for ease of transfer of assets upon the trustor's death

2. Which of the following is generally a required part of creating a living trust:

   a) the drafting of a written document declaring the existence of the trust
   b) the appointment of an attorney or other fiduciary as trustee
   c) approval by the appropriate court of law
   d) approval of the beneficiaries of the trust

3. Which of the following are eligible to be beneficiaries of a living trust upon the death of the trustor:

   a) family members
   b) friends
   c) alma mater
   d) any of the above

4. A living trust will not remove assets from the trustor's gross estate for federal estate tax purposes.

   a) true
   b) false

5. If an individual creates a living trust, they do not need a will.

   a) true
   b) false

6. A charitable lead trust is identical to a charitable remainder trust.

   a) true
   b) false

CHAPTER 7 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** To the contrary, one of the disadvantages of living trusts is that they can be time consuming and expensive to create and maintain.

   B: Incorrect. Probate avoidance is probably the primary reason for the popularity of living trusts.

   C: Incorrect. This is indeed an attribute of a living trust; it allows the trustor to control how his or her assets are distributed after death and to place certain limitations on their use.

   D: Incorrect. Ease of transfer, in the absence of probate, is an advantage of a living trust.

   (See page 7-2 of the course material.)

2. **A: Correct.** The trustor must establish the trust for it to be effective. This is typically done by having an attorney (although a trustee can do it himself) draft a trust instrument declaring the existence of the trust and its terms.

   B: Incorrect. The trustor can appoint anyone, including himself, to act as trustee.

   C: Incorrect: A court is not required to approve the creation of a trust.

   D: Incorrect. The beneficiaries are not required to approve the trust. Indeed, they need not even be informed of its existence.

   (See page 7-4 of the course material.)

3. A: Incorrect. A trustor is free to name virtually anyone, including family, as a beneficiary of a living trust upon his or her death. However, this is not the best answer.

   B: Incorrect. A trustor is free to name anyone, including friends, as the beneficiary of a living trust. However, this is not the best answer.

   C: Incorrect. A living trust can have an alma mater such as a college or law school as a beneficiary. However, this is not the best answer.

   D: Correct. Because all of the above choices are correct, D is the best answer.

   (See page 7-6 of the course material.)

4. **A: True is correct.** A living trust will also not shift income to lower-bracket beneficiaries for federal income tax purposes.

   B: False is incorrect. For an irrevocable living trust, the trust becomes a separate entity for tax purposes, which can reduce federal estate taxes, but this is not true for a revocable living trust.

   (See page 7-7 of the course material.)

5. A: True is incorrect. A revocable living trust is never an adequate substitute for a valid will.

   B: False is correct. It is important to have a will in addition to a living trust so that any assets not in the trust at the time of the trustor's death will be directed into the trust. This type of will is known as a "pour over" will.

   (See page 7-8 of the course material.)

6. A: True is incorrect. A charitable lead trust occurs when all or a portion of a revocable living trust (RLT) is converted to it following the death of the grantor, and the charitable interest precedes (leads) the non-charitable interest. In a charitable remainder trust, the non-charitable interest of the trust occurs first, and when these interests terminate, the residue is paid to a charity.

   B: False is correct. A charitable lead trust and a charitable remainder trust differ in the order in which the trust will pay out the charitable and non-charitable portions of the trust assets.

   (See page 7-10 of the course material.)

Chapter 8: Spendthrift Trusts

I. <u>Introduction</u>

A. GOALS OF SPENDTHRIFT PROVISIONS

Spendthrift trusts generally have two main purposes, either one or both of which are behind most such trusts:

- To limit access to the trust by persons who do not make good financial decisions; and

- To keep creditors of the beneficiary or beneficiaries from reaching the assets of the trust.

Spendthrift trusts have long been recognized in this country. The lynchpin of a spendthrift provision is the right of a trustor to control the ultimate disposition of his or her property. A spendthrift provision makes property available for the use of a beneficiary or beneficiaries without exposing that property to the beneficiaries' creditors. A Maryland court summed up the key aspects of a spendthrift trust in ***Watterson v. Edgerly,*** 40 Md. App. 230 (1978): "*A spendthrift trust is an American legal creation, designed specifically to afford a beneficiary those things he cannot afford, while simultaneously protecting, him from the claws of cozened creditors. It runs the gamut from the benefactors fortune to the beneficiary's good fortune and the creditors misfortune.*"

> **Example.**
>
> *Paul is a wealthy man nearing the end of his life. He has two sons, Walter and Frank. Frank has always been a good businessman, has followed in his father's footsteps and is very successful. Walter, on the other hand, has been a bit of a playboy and has never been a student of business. He has had two businesses go bankrupt and sold two others at a loss. Paul wants to leave money in a trust for each son. He elects to create two trusts, one for Frank in which he includes no spendthrift provision and a second one for Walter in which he includes a spendthrift provision. He wants to help support Walter but does not want any of his former or future creditors to have access to the trust assets.*

A valid spendthrift trust will protect the beneficiary debtor from almost all debts, even in the event of bankruptcy. ***In re Mackta***, 261 B.R. 189 (Bkrtcy.E.D.Va. 2000), for example, the court ruled that a Chapter 13 debtor's vested remainder interest in a spendthrift trust established by his late mother for benefit both of her husband and the debtor was excluded from "property of the estate," as being in nature of beneficial interest in trust that was subject to restrictions on transfer enforceable under applicable nonbankruptcy law.

A spendthrift trust is also a valuable tool for a trustor to provide support to a beneficiary who might not be the most responsible person. This works in two ways. First, it protects the assets of the trust from the reach of the beneficiary's creditors, as noted above, and it can also limit the amount of income a beneficiary receives from the trust. The following language is an example of this type of trust:

> **Example.**
>
> **BRADFORD N. WORTHINGTON TRUST**
>
> *A. My Trustee may pay to or for the benefit of Bradford N. Worthington during his lifetime as much of the net income or principal of the Trust as my Trustee may deem appropriate for his support and health. My Trustee may distribute principal in kind while income is accumulated and shall annually add any undistributed income to principal.*
>
> *B. Upon Bradford N. Worthington reaching the age of sixty (60), my Trustee shall distribute the remaining principal and any accrued or undistributed income of the trust outright to him upon his written request. If Bradford N. Worthington dies before the termination of his separate trust, my Trustee shall distribute the remaining trust estate to his descendants.*

Had the trustor in the above example had greater faith in Bradford's financial acumen, he probably would have given him access to the corpus of the trust prior to his sixtieth birthday.

II. Creation and Operation

A. STATUTORY AUTHORIZATION

The common law of all states permits the use of a spendthrift trust. In some states, including Virginia, spendthrift provisions are expressly authorized by statute. In such cases, it is important for someone considering a spendthrift provision to look at the specific language. The Virginia statute, below, for example, carves out exceptions when the state is a creditor of the beneficiary.

Va. Code Ann. § 55-19. Estates in trust subject to debts of beneficiaries; exception for certain trusts

A. Except as otherwise provided in this section, all trust estates shall be subject to the debts and charges of the persons who are beneficiaries of such trusts as if those persons owned a similar interest in the trust estate.

B. Any trust estate may be held in trust upon condition that the trust corpus and income, or either of them, shall in the case of a simple trust or, in the case of a complex trust, may in the discretion of the fiduciary be paid to or applied by the fiduciary for the benefit of the beneficiaries without being subject to their liabilities or to alienation by them. However, no such trust shall operate to the prejudice of any existing creditor of the creator of such trust. The exception for spendthrift trusts shall not apply to an interest in a trust, contract, or other fund maintained in conjunction with an employee benefit plan,

as defined in § 1002 (3) of Title 29 of the United States Code, or a similar plan or arrangement regardless of whether the beneficiary may claim the exemption provided under § 34-34. In addition, as to any claim first accruing on or after the effective date of the 1990 amendments to this section, and subject to the limitation of subsection D, no such trust condition shall operate to the prejudice of the United States or this Commonwealth or any county, city or town. As to any claim for child support, no such condition shall operate to the prejudice of a judgment against a beneficiary for the support of the beneficiary's child.

C. If the creator of a trust is also a beneficiary of the trust and the creator's interest is held upon condition that it is not subject to the creator's liabilities or to alienation by the creator, such condition is invalid against creditors and transferees of the creator, but shall not otherwise affect the validity of the trust. A transferee or creditor of the creator may, in addition to amounts required to be paid to or for the benefit of the creator, also reach the maximum amount that the trustee, in the exercise of discretion, could pay to or for the benefit of the creator under the trust instrument, which shall not exceed the amount of the creator's proportionate contribution to the trust. When a trust is funded by amounts attributable to any claim possessed by a beneficiary, whether paid pursuant to a structured settlement or otherwise, the beneficiary shall be considered a creator of the trust to the extent so funded.

D. Notwithstanding any contrary condition in the trust instrument, if a statute or regulation of the United States or the Commonwealth makes a beneficiary liable for reimbursement to the Commonwealth or any agency or instrumentality thereof, for public assistance, including medical assistance, furnished or to be furnished to the beneficiary, the Attorney General or the head of the state agency having responsibility for the program may file a petition in an appropriate circuit court having jurisdiction over the trustee seeking reimbursement without first obtaining a judgment. The beneficiary, or his guardian, conservator or committee, if any, shall be made a party. Following its review of the circumstances of the case, the court may:

1. Order the trustee to satisfy all or part of the liability out of all or part of the amounts to which the beneficiary is entitled, whether presently or in the future, to the extent the beneficiary has the right under the trust to compel the trustee to pay income or principal or both to or for the benefit of the beneficiary. A duty in the trustee under the instrument to make disbursements in a manner or in amounts that do not cause the beneficiary to suffer a loss of eligibility for public assistance to which the beneficiary might otherwise be entitled shall not be considered a right possessed by the beneficiary to compel such payments.

2. Whether or not the beneficiary has the right to compel the trustee to pay income or principal or both to or for the benefit of the beneficiary, order the trustee to satisfy all or part of the liability out of all or part of the future payments, if any, that the trustee chooses to make to or for the benefit of the beneficiary in the exercise of discretion granted under the trust.

No order shall be made pursuant to this subsection D if the beneficiary is an individual who has a medically determined physical or mental disability that substantially impairs his ability to provide for his care or custody and constitutes a substantial handicap.

Several other states, including Alaska and Nevada, have created statutory law that allows a trustor to transfer assets to an irrevocable trust for the benefit of the trustor, those assets designed to be out of a creditor's reach within six months to four years of the transfer.

There are several statutory requirements that must be met to effectively form a spendthrift trust. Both Alaska and Nevada have substantially the same requirements to form a spendthrift trust. The requirements are that:

- The trustor must not retain the right to revoke or terminate the trust;
- The trustor has not been in default by thirty (30) days or more in making a child support payment;
- The trustor's ability to receive distributions from the trust is within the discretion of the trustees rather than mandatory;
- The transfer of property to the trust has not been intended to hinder, delay or defraud creditors; and
- The trustor is not the sole trustee.

These requirements are necessary so that an individual may not use a trust as a vehicle to escape creditors, especially creditors of the individual at the time of the transfer.

Additionally, Nevada and Alaska require that the trustor have some minimal contact with the jurisdiction. Both jurisdictions require that at least one trustee of the trust be either a trust company or a bank with trust powers, with its principal place of business in the jurisdiction. Further, some of the trust assets must be deposited in either a checking, brokerage, or other similar account located in the jurisdiction. Trust records are to be maintained in the jurisdiction and the preparation and arrangement of trust income tax returns must be done in the jurisdiction. Finally, trust administration must occur in the jurisdiction, including the physical maintenance of trust records.

The most important area of statutory trust law for a spendthrift trust is how long a creditor can wait before he brings an action to recover debts against the trustor. If a creditor delays and does not bring a claim against the trustor within the prescribed period, the claim is barred by the statute of limitations.

Nevada has a substantially shorter period than Alaska and provides much more creditor protection. In Nevada, a creditor who was a creditor at the time of a transfer to a spendthrift trust must commence an action to challenge the transfer within the later of (a) two years after the transfer, or (b) six months after he discovers or reasonably should have discovered the transfer. A creditor who is not a creditor at the time of the transfer to a spendthrift trust must commence an action to challenge the transfer within two years.

Alaska Trust Law provides that a creditor existing at the time the trust is created must bring suit within the later of four years from the transfer or one year after the transfer is, or reasonably could have been, discovered. A creditor arising after the transfer to the trust must bring suit within four years from the transfer.

Nevada provides better protection because creditors must bring actions against the settlor in a much shorter period of time. Besides this shortened statute of limitations period, Alaska and Nevada have substantially similar requirements for spendthrift trusts. The spendthrift trust is an excellent device for individuals who may be subject to claims in the future, such as professionals and owners of companies.

B. CREATION

In order to be a valid spendthrift trust, it is essential that the trust first meet the elements of a valid trust:

- A competent trustor;
- Specific trust property;
- A trustee; and
- At least one beneficiary.

Then, the trust must contain a spendthrift clause. The following is an example of a spendthrift clause:

> *Neither principal nor income of any trust nor any beneficiary's interest therein, while undistributed in fact, shall be subject to alienation, assignment, encumbrance, appointment or anticipation by the beneficiary, nor to garnishment, attachment, execution or bankruptcy proceedings, nor to claims for alimony or support or any other claims of any creditor or other person against the beneficiary, nor to any other transfer, voluntary or involuntary, from the beneficiary.*

To be considered a spendthrift trust, the trustor must evidence his or her intent in the trust instrument and must include standards for the trustee to use in determining when to distribute assets from the trust. Thus, to create a spendthrift trust, the trust agreement must simply include a spendthrift clause. No particular form of words is necessary to create a spendthrift trust; it is sufficient if by the terms of the trust the trustor manifests an intention to impose the restrictions common to such trust.

Example 1.

William creates a testamentary trust for the benefit of his two spoiled sons, the language of which provides: “ "All payments hereunder directed to be made to the beneficiaries shall be into their hands and not to others, whether claiming by their authority or otherwise." This language, while simple, will be effective in keeping the beneficiaries’ creditors from reaching the assets of the trust.

Example 2.

Same as Example 1, except the language of the trust provides: "NONALIENATION OF BENEFITS. Benefits payable under this Plan shall not be subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, charge, garnishment, execution, or levy of any kind either voluntary or involuntary, including any such liability which is for alimony or other payments for the support of a spouse or former spouse, or for any relative of the participant, prior to actually being received by the person entitled to the benefit under the terms of the Plan, and any attempt to anticipate, alienate, sell, transfer, assign, pledge, encumber, charge, or otherwise dispose of any right to benefits payable hereunder shall be void. The trust shall not in any manner be liable for, or subject to, the debts contracts, liabilities, engagements, or torts of any person entitled to benefits hereunder."

The key to drafting a spendthrift provision is to carefully express the intent of the trustor within the language of the trust document. Where a trust agreement does not contain a specific spendthrift clause, a court reviewing a case will try to ascertain the intent of the trustor in creating the trust. However, it is not wise to rely on a court inferring the intent of the trustor.

C. INVASION IN LIMITED CIRCUMSTANCES

In limited circumstances, courts have allowed creditors to access assets in a spendthrift trust when mandated by public policy. This has generally occurred where the claim was made against the beneficiary for either alimony or child support. For example, ***Safe Deposit and Trust Company of Baltimore v. Robertson***, 192 Md. 653 (1949), the Court of Appeals permitted permanent alimony to be satisfied by invading a spendthrift trust.: "*This result has been reached on the ground that it is against public policy to permit the beneficiary to have the enjoyment of the income from the trust while he refuses to support his dependents whom it is his duty to support. The claim of a wife and dependent children to support is based on the clearest grounds of public policy*."

Some states, including Nebraska, New Hampshire and Wyoming (below), have created statutory exclusions from spendthrift trusts for this type of situation.

Nebraska Rev.St. § 30-3848 Exceptions to spendthrift provision.

(a) In this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another state.

(b) Even if a trust contains a spendthrift provision, a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance, or a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust, may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary.

(c) A spendthrift provision is unenforceable against a claim of this state or the United States to the extent a statute of this state or federal law so provides.

Wyoming Statutes § 4-10-503 Exceptions to spendthrift provision.

(a) As used in this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another state.

(b) Even if a trust contains a spendthrift provision, a beneficiary's child, who has a judgment or court order against the beneficiary for support or maintenance, or a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust, may obtain from a court an order attaching present or future distributions to, or for the benefit of, the beneficiary.

New Hampshire Rev. Stat. § 564-B:5-503. Exceptions to Spendthrift Provisions.

(a) In this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another state.

(b) A spendthrift provision is unenforceable against:
(1) a beneficiary's child for whom there is a judgment or court order against the beneficiary for support;
(2) a beneficiary's spouse or former spouse who has a judgment or court order against the beneficiary for alimony but only for and to the extent that such judgment or court order expressly specifies the alimony amount attributable to the most basic food, shelter and medical needs of the spouse or former spouse;
(3) a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust;
(4) a claim of this state or the United States to the extent a statute of this state or federal law so provides.

(c) A claimant against whom a spendthrift provision cannot be enforced may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary. The court may limit the award to such relief as is appropriate under the circumstances.

In other situations, even those where the beneficiary has been held liable for the commission of a tort, the courts have been more reluctant to authorize the invasion of a spendthrift trust. For example, in ***Sligh v. First National Bank of Holmes County***, 704 S.O. 2nd 1020 (1997) the Mississippi Court permitted a tort creditor to enforce a judgment. That case stirred debate across the country and was followed by legislation in Mississippi that overruled the ruling and expressly placed spendthrift trusts beyond the reach of tort creditors.

D. MODIFICATION

In many cases, a court will order modification or termination of a trust when all of the beneficiaries consent and when it will not clearly circumvent the intent of the trustor. There is an exception to this in the case of trusts that contain a spendthrift provision. When a trust contains a spendthrift provision, one of the material purposes of the trust is the protection it provides its beneficiaries. As a result, a trust containing a spendthrift provision may generally not be modified by a court regardless of whether all beneficiaries consent.

E. DUAL ROLE OF BENEFICIARY AND TRUSTEE

While it is not advisable where the trustor is concerned about the spending habits of a beneficiary, there is no general prohibition against a beneficiary of a spendthrift trust also serving as trustee.

CHAPTER 8 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following people is most likely to be the beneficiary of a spendthrift trust:

   a) a financially secure middle aged attorney
   b) a married business person who owns his own home and has no debt
   c) a 25 year old college drop out with a large amount of credit card debt
   d) a retired school teacher

2. How many states authorize the use of spendthrift trusts:

   a) five
   b) 20
   c) 25
   d) all 50 states

3. In limited circumstances, courts have allowed creditors to access assets in a spendthrift trust when mandated by public policy.

   a) true
   b) false

CHAPTER 8 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. This is a responsible, financially secure person who would typically not be the subject of a spendthrift trust.

   B: Incorrect. This is a responsible person who would probably not be subject to a spendthrift trust.

   C: Correct. This is exactly the type of person the spendthrift trust is designed to protect and benefit, someone who might blow the money if given full access.

   D: Incorrect. This is probably a responsible person who does need the protection of a spendthrift trust.

   (See page 8-1 of the course material.)

2. A: Incorrect. All states actually allow the use of spendthrift trusts.

   B: Incorrect. All states actually allow the use of spendthrift trusts.

   C: Incorrect. All states actually allow the use of spendthrift trusts.

   D: Correct. The common law of all 50 states authorizes the use of spendthrift trusts.

   (See page 8-2 of the course material.)

3. **A: True is correct.** This has generally occurred where the claim was made against the beneficiary for either alimony or child support.

   B: False is incorrect. Some states have created statutory exclusions from spendthrift trust for claims made against a beneficiary for either alimony or child support.

   (See page 8-6 of the course material.)

Chapter 9: Generation-Skipping Trusts

I. Generation Skipping Tax and Trusts: An Overview

The basic estate tax is designed to tax assets when they are passed from one generation to another, such as a parent to a child. The purpose of the generation-skipping transfer tax is to close a loophole in the estate and gift tax system where property could be transferred to successive generations without intervening estate or gift tax consequences.

Every citizen or resident of the U.S. has a $5,000,000 (for 2010-2012) generation-skipping exemption that may be allocated during one's lifetime or upon death. The 2010 Tax Relief Act, signed by President Obama into law on December 17, 2010, among other changes allows individuals to make aggregate transfers of up to $5 million to "skip persons" outright or in trust tax-free. For generation-skipping transfers in 2010, the Act retroactively imposes a 0% tax and a $5 million exemption amount. The $5 million GST exemption amount available through 2012 can be used to exempt gifts to trusts that are expected to benefit several generations, therefore generation-skipping transfers from trusts in future years are also exempt from the GST tax. One estate planning tool designed to take advantage of the GST tax exemption is a generation-skipping trust. Such a trust can be established:

- During the donor's lifetime. All, or part, of the GST tax exemption will be allocated to the trust on the grantor's gift tax return.
- Upon the grantor's death. The executor or personal representative of the estate would allocate the exemption on the decedent's estate tax return.

Whether an individual establishes a generation-skipping trust during his or her lifetime or at death, assets will also be subject to gift or estate taxes. Therefore, the tax consequences of when the trust is established must be compared. If the trust is established with a lifetime gift, the total transfer tax cost to the donor is the gift tax and the GST tax. If the transfer takes place at death, the total transfer tax is the estimated estate tax on the donor's estate (assuming no lifetime gift) plus the GST tax. If the trust takes advantage of the GST exemption, then there would not be any GST due as the amount in the trust would be covered by the exemption.

However, because an important goal of estate planning is to maximize the amount of wealth passing to subsequent generations while minimizing taxes, generation-skipping trusts are often an attractive component of estate planning. In some cases, more than the amount of the GST tax exemption might ultimately pass to future generations free from the GST tax transfer.

The traditional generation-skipping transfers were trusts established by a parent for the lifetime benefit of the children with the remainder passing to the grandchildren. If properly drafted, no estate or gift tax would be imposed when the trust corpus passed from the original trustor's children to the trustor's grandchildren because the estate tax is not imposed on interests that terminate at death.

There are two basic forms of generation-skipping transfers:

- The indirect skip, where the generation one level below the decedent receives some beneficial interest in the property before the property passes to the generation two or more levels below; and
- The direct skip, where the property passes directly to the generation two or more levels below the decedent.

Example 1.

Richard places property into a trust for the benefit of his grandchildren. This is a direct skip that is subject to GST tax. When property is later distributed to Richard's grandchildren from the trust, there is no taxable distribution and no additional GST tax is payable.

Example 2.

Richard places property into a trust for the benefit of his children during their lifetime, with the remainder to be distributed to his grandchildren. This is an indirect skip.

"Skip persons" are defined in more detail below.

The Tax Reform Act of 1986 repealed the generation-skipping transfer tax, enacted in 1976, as being unduly complicated and replaced it with a simplified flat rate tax. The purpose of the new generation-skipping transfer tax is the same as its 1976 predecessor, to close a loophole in the estate and gift tax system where property could be transferred to successive generations without intervening estate or gift tax consequences. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) corrected many of these loopholes.

Several exemptions are provided in the statutory scheme. For transfers made prior to January 1, 1990, each grantor may exempt $2,000,000 in direct skips per grandchild ($4,000,000 for married individuals who elect to treat the transfers as made one-half by each). The exclusion for tuition and medical expense payments from the gift tax are also excluded from the generation-skipping tax. The $13,000 annual exclusion of the gift tax is recognized against taxation of direct skips only. Starting in 2004, the GST exemption is equal to the estate tax applicable exclusion amount.

The GST exemption may be allocated by the transferor or the executor to any generation-skipping transfer. Once the allocation is made it is irrevocable. Unless a contrary election is made, all or any portion of the exclusion not previously allocated is deemed allocated to a lifetime direct skip to the extent necessary to make the inclusion ratio for the transfer zero.

The inclusion ratio is figured by subtracting from one a fraction, the numerator of which is the portion of the GST exemption allocated to the transfer, the denominator of which is the value of the property transferred. To compute the generation-skipping tax, the value of the transfer is multiplied by the tax rate (35% in 2011) and by the inclusion ratio.

The liability for the tax is determined by the type of transfer. In the case of a taxable distribution, the tax shall be paid by the transferee. The tax on taxable terminations, defined later, or direct skips from a trust shall be paid by the trustee. Direct skips, other than those from a trust, are taxed to the transferor. All of these issues are discussed in more detail below. And, given the complexity of this subject, significant federal regulations are provided at the end of the discussion to assist in understanding the material.

Several states have enacted their own generation-skipping taxes. The federal GST tax allows a tax credit for state taxes paid on other than direct skips when the transfer occurs because of the death of an individual. The maximum credit is 5% of the federal GST.

A. SKIP PERSONS

1. Definition

For GST tax purposes, “skip person” means:

- A natural person assigned to a generation that is two or more generations below the trustor’s generation;
- A non-relative, at least 37½ years younger than the transferor; or
- A trust, if all interests in the trust are held by skip persons.

A non-skip person is any person who is not a skip person.

2. Generation Assignment

A generation is determined along family lines as follows:

- Where the beneficiary is a lineal descendent of a grandparent of the transferor (e.g. the donor’s cousin, niece, nephew, etc.), the number of generations between the transferor and the descendent is determined by subtracting the number of generations between the grandparent and the transferor from the number of generations between the grandparent and the descendents;
- Where the beneficiary is the lineal descendent of a grandparent of a spouse (or former spouse) of the transferor, the number of generations between the transferor and the descendent is determined by subtracting the number of generations between the grandparent and the spouse (or former spouse) from the number of generations between the grandparent and the descendent;
- For this purpose, a relationship of adoption is considered a blood relationship. A relationship by half-blood is considered a relationship by whole blood; and
- The spouse or former spouse of a transferor or lineal descendent is considered to belong to the same generation of the transferor or lineal descendent, as the case may be.

A skip person who is not assigned to a generation according to the rules above is assigned to a generation based on his or her birth date as follows:

- A person who was born not more than 12½ years after the transferor is the transferor's generation;
- A person born more than 12½ years, but not more than 37½ years, after the transferor is in the first generation younger than the transferor.

Similar rules apply for a new generation every 25 years. If more than one of the rules for assigning generations applies to a beneficiary, the beneficiary is generally assigned to the youngest of the generations that apply.

3. Generation Assignment Where Intervening Parent Is Dead

If an individual made a gift or bequest to his or her grandchild and, at the time the gift was made, the grandchild's parent (who is either the child of the donor or the donor's spouse) is dead, then for purposes of the generation assignment, the grandchild will be considered the donor's child rather than his or her grandchild. The donor's grandchildren's children will be treated as the donor's grandchildren rather than his or her great grandchildren.

This rule is also applied to the donor's lineal descendents below the level of grandchild. For example, if the donor's grandchild is dead, the great grandchildren who are lineal descendents of the dead grandchild are considered the donor's grandchildren for purposes of the GST tax.

This rule applies to other lineal descendents as well. For example, if property is transferred to an individual who is a descendent of a parent of the donor, and that individual's parent (who is a lineal descendent of the parent of the donor) is dead at the time the transfer is subject to gift or estate tax, then for purposes of generation assignment, the individual is treated as if he or she is a member of the generation that is one generation below the lower of: (a) the donor's generation, or (b) the generation assignment of the youngest living ancestor of the individual, who is also a descendent of the parent of the donor.

The same rules apply to the generation assignment of any descendent of the individual. On the other hand, the rule does not apply to a transfer to an individual who is not a lineal descendent of the donor if the donor has any living lineal descendents.

If any transfer of property to a trust would have been a direct skip except for these generation assignment rules, then the applicable rule also applies to transfers from the trust attributable to such property.

4. Multiple Skips

If after a generation-skipping transfer the property transferred is held in trust, then for purposes of determining the taxability of subsequent distributions from the trust involving that property, the donor of the property is assigned to the first generation above the highest generation of any person who has an interest in the trust immediately after the initial transfer.

B. DISTRIBUTIONS SUBJECT TO GST TAX

In general, all taxable distributions are subject to the GST tax. A taxable distribution is any distribution from a trust to a skip person (other than a taxable termination or a direct skip). If any GST tax imposed on a distribution is paid out of the trust from which the distribution was made, the amount of tax paid by the trust is also a taxable distribution.

The GST tax applies to a transfer by reason of a change in the designated beneficiary of a qualified tuition program ("QTP," also referred to as a "Section 529 plan,") (or a rollover to the account of a new beneficiary) only if the new beneficiary is assigned to a generation below the generation of the old beneficiary.

26 U.S. C. § 2612. Taxable termination; taxable distribution; direct skip

(a) Taxable termination.--

(1) General rule.*--For purposes of this chapter, the term "taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless--*

(A) *immediately after such termination, a non-skip person has an interest in such property, or*

(B) *at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.*

(2) Certain partial terminations treated as taxable.*--If, upon the termination of an interest in property held in trust by reason of the death of a lineal descendant of the transferor, a specified portion of the trust's assets are distributed to 1 or more skip persons (or 1 or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property.*

(b) Taxable distribution.*--For purposes of this chapter, the term "taxable distribution" means any distribution from a trust to a skip person (other than a taxable termination or a direct skip).*

(c) Direct skip.*--For purposes of this chapter—*

(1) In general.*--The term "direct skip" means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.*

(2) Look-thru rules not to apply.*--Solely for purposes of determining whether any transfer to a trust is a direct skip, the rules of section 2651(f)(2) shall not apply.*

Under proposed IRS regulations, such a transfer is subject to the GST tax if the new beneficiary is assigned to a generation which is two or more levels lower than the generation assignment of the old beneficiary.

A taxable distribution is a distribution from a trust, other than a taxable termination or direct skip, to a skip person. A skip person is a person assigned to a generation two or more generations below the transferor's.

A taxable termination is a termination by death, lapse of time, release of power, or otherwise of an interest in property held in trust, unless immediately after the termination a non-skip person has an interest in the property or at no time after the termination may a distribution be made from the trust to a skip person.

C. GENERATION-SKIPPING TRANSFERS

The generation-skipping tax is a flat-rate tax. This tax rate is applied to three different events, as set forth in IRC Code § 2611, below: (1) taxable distribution; (2) taxable termination, or (3) direct skip.

A generation-skipping transfer does not include any transfer which, if made during an individual's life, would not be treated as a taxable gift because it was made for education or medical expenses of the transferee. Likewise, a "generation-skipping transfer" does not include any transfer to the extent:

- The property transferred was subject to an earlier GST tax;
- The transferee in the earlier transfer was in the same or a lower generation than the transferee in this transfer; and
- The transfer does not have the effect of avoiding the GST tax.

26. U.S.C. § 2611. Generation-Skipping Transfer Defined

(a) In general. – For purposes of this chapter, the term "generation-skipping transfer" means
(1) a taxable distribution,
(2) a taxable termination, and
(3) a direct skip.

(b) Certain transfers excluded. – The term "generation-skipping transfer" does not include –
(1) any transfer which, if made inter vivos by an individual, would not be treated as a taxable gift by reason of section 2503(3) (relating to exclusion of certain transfers for education and medical expenses), and
(2) any transfer to the extent –
(A) the property transferred was subject to a prior tax imposed under this chapter,
(B) the transferee in the prior transfer was assigned to the same generation as (or a lower generation than) the generation assignment of the transferee in this transfer, and
(C) such transfers do not have the effect of avoiding tax under this chapter with respect to any transfer.

D. EXCLUSIONS

1. Exemption

Federal law provides an exemption for a portion of generation-skipping transfers. For 2010-2012, each transferor can shield up to $5,000,000 in either inter vivos or death transfers from GST tax. Married couples may elect to split the transfer, thus treating the GST as having been made 50% by each spouse. The exemption may be allocated to the transferred property at any time before an estate tax return becomes due. Once the allocation election is made, the decision is irrevocable.

Unless the transferor elects otherwise on a gift tax return, any unused GST exemption is allocated automatically to direct skip transfers made during life. In addition, the exemption will be deemed allocated to any trust that involves an "indirect skip" during the donor's lifetime. Any portion of the exemption that remains unallocated at the transferor's death is first allocated to any direct skips that occur at his or her death (e.g. a bequest to a grandchild), and then to trusts from which a taxable distribution or taxable termination may occur by virtue of the individual's death.

2. Certain Lifetime Transfers

The GST tax does not apply to any lifetime transfer that is exempt from gift tax due to the annual exclusion.

3. Irrevocable Trusts

The GST tax does not apply to any distribution from a trust that was irrevocable on September 25, 1985.

4. Medical or Educational Expenses

A distribution is not considered taxable if, had it been made during the lifetime of the donor, it would have been a nontaxable gift because of IRC § 2503, below, which exempts from the definition of "gift" transfers made for certain educational or medical expenses of the recipient.

IRC § 2503. Taxable Gifts

(a) General definition.--*The term "taxable gifts" means the total amount of gifts made during the calendar year, less the deductions provided in subchapter C (section 2522 and following).*
***
(e) Exclusion for certain transfers for educational expenses or medical expenses.--

(1) In general.--*Any qualified transfer shall not be treated as a transfer of property by gift for purposes of this chapter.*

(2) Qualified transfer.--*For purposes of this subsection, the term "qualified transfer" means any amount paid on behalf of an individual--*

(A) *as tuition to an educational organization described in section 170(b)(1)(A)(ii) for the education or training of such individual, or*

(B) *to any person who provides medical care (as defined in section 213(d)) with respect to such individual as payment for such medical care.*

5. Previously Taxed

In addition, a distribution, or any portion thereof, is not a taxable distribution to the extent that:

- The property distributed was previously subject to GST tax; and
- The distributee in the prior distribution is assigned to a generation the same as or lower than the distributee in the current distribution.

This rule does not apply if the transfers have the affect of avoiding the GST tax for any transfer.

E. COMPUTATION AND PAYMENT OF TAX

1. Timing of Payment

The GST tax is paid either when distributions are made to the skip persons or when the trust terminates (termination, for GST tax purposes, is that point when all interests by non-skip persons have terminated).

> **Example.**
>
> *Roger creates a trust for the benefit of his son, Al. Upon Al's death, the trust provides that the trust is to continue for the life of Al's son, Michael. When Al dies, Michael is the sole beneficiary of the trust. Because all non-skip interests have terminated (i.e., the father), a taxable termination has occurred and a GST tax is imposed on the trust. If, prior to the death of the father, a distribution of $100,000 was made to the son, a taxable distribution has occurred. A GST tax is therefore payable on the distribution.*

2. Computation of the GST Tax

The GST tax is computed by multiplying the highest estate tax rate by the taxable gift, distribution, or termination. A lifetime exclusion ($5,000,000 in years 2010-2012) of taxable gifts is available to every taxpayer.

If the transfer is to a trust and a portion (or all) of the GST exemption is allocated to the trust, an "inclusion ratio" is computed at the time of the gift. The computation is set forth in IRC § 2642 and Temp. Reg. 26.2601-1(b)(1)(iv). Its effect, however is to determine the taxable fraction of the trust.

Table 9.1 GST Flat Rate

Year	GST Tax Flat Rate
2005	47 percent
2006	46 percent
2009	45 percent
2010	0 percent
2011	35 percent
2012	35 percent

Table 9.2 Payment of GST Tax

Type of Transfer	Party Responsible for Payment
Taxable Termination	Trustee
Taxable Distribution	Transferee
Direct Skip from Trust	Trustee
Direct Skip not from Trust	Transferor

F. REPORTING REQUIREMENTS

1. Direct Skip

For inter-vivos (lifetime) transfers to direct skip individuals or trusts, the U.S. Gift Tax Return (Form 709) must be filed, and any generation-skipping tax paid, within 3½ months of the taxpayer's year end (April 15 for a calendar year taxpayer). Unless otherwise elected on Form 709, the exemption will automatically be allocated to direct skips. The tax is payable by the donor.

Direct skips that are non-taxable are not subject to the GST tax. However, gifts in trust that are not direct skips are not automatically exempt pursuant to IRC § 2642(c)(2). A common example is the gift to a Crummey trust, which is discussed in Chapter 10. This transfer may not be exempt. If so, Form 709 must be filed if part of the exemption is to be utilized.

If the direct skip occurs not during life, but at death (for example, the gift in the above example is made as a testamentary bequest), the decedent's Federal Estate Gift Tax Return (Form 706) would report the transfer and the application of any unused GST exemption.

2. Termination

If a termination has occurred, a Generation Skipping Transfer Tax Return For Terminations, Form 706GS(T), must be completed by the trustee and the GST tax paid with the form. Remember that a termination generally occurs when all non-skip interests in a trust have ended. The difficult task for a trustee is to determine how much of the termination value is taxable (the "inclusion value"). The instructions to this form provide more specific definitions, exemptions and transitional rules. This form and the associated tax is due April 15 of the year following the termination. The tax is paid by the trust.

3. Distribution

In the event a distribution is made from a trust to a skip person, the trustee must report the distribution to the skip beneficiary and the IRS using the Notification of Distribution From a Generation Skipping Trust, Form 706GS(D-1).

The trustee must include the description of the property distributed, the date of distribution, the "inclusion ratio" of the trust and the value of the distribution on this information form.

The skip beneficiary must use the information on Form 706GS(D-1) to file Generation Skipping Transfer Tax Return for Distributions, Form 706GS(D). The computed GST Tax is paid by the beneficiary with this return.

4. Due Dates

Forms 709, 706GS(D), 706GS(D-1) and 706GS(T) are due on the 15th day of the fourth month following the year the termination or distribution occurs (normally April 15 for calendar year taxpayers). Transfers at death are reported on Form 706, which is due nine months after death.

Form **709**

Department of the Treasury
Internal Revenue Service

United States Gift (and Generation-Skipping Transfer) Tax Return

(For gifts made during calendar year 2010)

▶ **See separate instructions.**

OMB No. 1545-0020

2010

Part 1—General Information

1 Donor's first name and middle initial	2 Donor's last name	**3 Donor's social security number**
4 Address (number, street, and apartment number)		5 Legal residence (domicile)
6 City, state, and ZIP code		7 Citizenship (see instructions)

		Yes	No
8	If the donor died during the year, check here ▶ ☐ and enter date of death ____________ , ________.		
9	If you extended the time to file this Form 709, check here ▶ ☐		
10	Enter the total number of donees listed on Schedule A. Count each person only once. ▶		
11a	Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If "No," skip line 11b		
b	If the answer to line 11a is "Yes," has your address changed since you last filed Form 709 (or 709-A)?		
12	**Gifts by husband or wife to third parties.** Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (See instructions.) (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. **If the answer is "No," skip lines 13–18 and go to Schedule A.**)		
13	Name of consenting spouse — **14** SSN		
15	Were you married to one another during the entire calendar year? (see instructions)		
16	If 15 is "No," check whether ☐ married ☐ divorced or ☐ widowed/deceased, and give date (see instructions) ▶		
17	Will a gift tax return for this year be filed by your spouse? (If "Yes," mail both returns in the same envelope.)		

18 **Consent of Spouse.** I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.

Consenting spouse's signature ▶ **Date**▶

Part 2—Tax Computation

1	Enter the amount from Schedule A, Part 4, line 11	1	
2	Enter the amount from Schedule B, line 3	2	
3	Total taxable gifts. Add lines 1 and 2	3	
4	Tax computed on amount on line 3 (see *Table for Computing Gift Tax* in separate instructions) . .	4	
5	Tax computed on amount on line 2 (see *Table for Computing Gift Tax* in separate instructions) . .	5	
6	Balance. Subtract line 5 from line 4	6	
7	Maximum unified credit (nonresident aliens, see instructions)	7	
8	Enter the unified credit against tax allowable for all prior periods (from Sch. B, line 1, col. C) . .	8	
9	Balance. Subtract line 8 from line 7. Do not enter less than zero	9	
10	Enter 20% (.20) of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977 (see instructions)	10	
11	Balance. Subtract line 10 from line 9. Do not enter less than zero	11	
12	Unified credit. Enter the smaller of line 6 or line 11	12	
13	Credit for foreign gift taxes (see instructions)	13	
14	Total credits. Add lines 12 and 13	14	
15	Balance. Subtract line 14 from line 6. Do not enter less than zero	15	
16	Generation-skipping transfer taxes (from Schedule C, Part 3, col. H, Total)	16	
17	Total tax. Add lines 15 and 16	17	
18	Gift and generation-skipping transfer taxes prepaid with extension of time to file	18	
19	If line 18 is less than line 17, enter **balance due** (see instructions)	19	
20	If line 18 is greater than line 17, enter **amount to be refunded**	20	

Attach check or money order here.

Sign Here

Under penalties of perjury, I declare that I have examined this return, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than donor) is based on all information of which preparer has any knowledge.

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ **Yes** ☐ **No**

▶ Signature of donor — Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see the separate instructions for this form. Cat. No. 16783M Form **709** (2010)

SCHEDULE A Computation of Taxable Gifts (Including transfers in trust) (see instructions)

A Does the value of any item listed on Schedule A reflect any valuation discount? If "Yes," attach explanation . . . . Yes ☐ No ☐

B ☐ ◄ Check here if you elect under section 529(c)(2)(B) to treat any transfers made this year to a qualified tuition program as made ratably over a 5-year period beginning this year. See instructions. Attach explanation.

Part 1—Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions. (see instructions)

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
Gifts made by spouse —*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 1. Add amounts from Part 1, column H . . . . ►							

Part 2—Direct Skips. Gifts that are direct skips and are subject to both gift tax and generation-skipping transfer tax. You must list the gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(b) election out	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
Gifts made by spouse —*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 2. Add amounts from Part 2, column H . . . . ►							

Part 3—Indirect Skips. Gifts to trusts that are currently subject to gift tax and may later be subject to generation-skipping transfer tax. You must list these gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(c) election	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
Gifts made by spouse —*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 3. Add amounts from Part 3, column H . . . . ►							

(If more space is needed, attach additional sheets of same size.)

Part 4—Taxable Gift Reconciliation

1	Total value of gifts of donor. Add totals from column H of Parts 1, 2, and 3	1		
2	Total annual exclusions for gifts listed on line 1 (see instructions)	2		
3	Total included amount of gifts. Subtract line 2 from line 1	3		
	Deductions (see instructions)			
4	Gifts of interests to spouse for which a marital deduction will be claimed, based on item numbers ________ of Schedule A . . 4			
5	Exclusions attributable to gifts on line 4 . . . 5			
6	Marital deduction. Subtract line 5 from line 4 . . . 6			
7	Charitable deduction, based on item nos. ________ less exclusions . 7			
8	Total deductions. Add lines 6 and 7	8		
9	Subtract line 8 from line 3	9		
10	Generation-skipping transfer taxes payable with this Form 709 (from Schedule C, Part 3, col. H, Total)	10	0	00
11	**Taxable gifts.** Add lines 9 and 10. Enter here and on page 1, Part 2—Tax Computation, line 1	11		

Terminable Interest (QTIP) Marital Deduction. (See instructions for Schedule A, Part 4, line 4.)

If a trust (or other property) meets the requirements of qualified terminable interest property under section 2523(f), and:

a. The trust (or other property) is listed on Schedule A, and

b. The value of the trust (or other property) is entered in whole or in part as a deduction on Schedule A, Part 4, line 4,

then the donor shall be deemed to have made an election to have such trust (or other property) treated as qualified terminable interest property under section 2523(f).

If less than the entire value of the trust (or other property) that the donor has included in Parts 1 and 3 of Schedule A is entered as a deduction on line 4, the donor shall be considered to have made an election only as to a fraction of the trust (or other property). The numerator of this fraction is equal to the amount of the trust (or other property) deducted on Schedule A, Part 4, line 6. The denominator is equal to the total value of the trust (or other property) listed in Parts 1 and 3 of Schedule A.

If you make the QTIP election, the terminable interest property involved will be included in your spouse's gross estate upon his or her death (section 2044). See instructions for line 4 of Schedule A. If your spouse disposes (by gift or otherwise) of all or part of the qualifying life income interest, he or she will be considered to have made a transfer of the entire property that is subject to the gift tax. See *Transfer of Certain Life Estates Received From Spouse* in the separate instructions.

12 Election Out of QTIP Treatment of Annuities

☐ ◀ Check here if you elect under section 2523(f)(6) **not** to treat as qualified terminable interest property any joint and survivor annuities that are reported on Schedule A and would otherwise be treated as qualified terminable interest property under section 2523(f). See instructions. Enter the item numbers from Schedule A for the annuities for which you are making this election ▶ ________

SCHEDULE B Gifts From Prior Periods

If you answered "Yes" on line 11a of page 1, Part 1, see the instructions for completing Schedule B. If you answered "No," skip to the Tax Computation on page 1 (or Schedule C, if applicable). See instructions for recalculation of the column C amounts. Attach calculations.

A Calendar year or calendar quarter (see instructions)	B Internal Revenue office where prior return was filed	C Amount of unified credit against gift tax for periods after December 31, 1976	D Amount of specific exemption for prior periods ending before January 1, 1977	E Amount of taxable gifts
1 Totals for prior periods	1			

2	Amount, if any, by which total specific exemption, line 1, column D is more than $30,000	2	
3	Total amount of taxable gifts for prior periods. Add amount on line 1, column E and amount, if any, on line 2. Enter here and on page 1, Part 2—Tax Computation, line 2	3	

(If more space is needed, attach additional sheets of same size.)

SCHEDULE C Computation of Generation-Skipping Transfer Tax

Note. Inter vivos direct skips that are completely excluded by the GST exemption must still be fully reported (including value and exemptions claimed) on Schedule C.

Part 1—Generation-Skipping Transfers

A Item No. (from Schedule A, Part 2, col. A)	B Value (from Schedule A, Part 2, col. H)	C Nontaxable portion of transfer	D Net Transfer (subtract col. C from col. B)
Gifts made by spouse (for gift splitting only)			

Part 2—GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) Election

Check here ▶ ☐ if you are making a section 2652(a)(3) (special QTIP) election (see instructions)

Enter the item numbers from Schedule A of the gifts for which you are making this election ▶ ______________

1	Maximum allowable exemption (see instructions)	1	
2	Total exemption used for periods before filing this return	2	
3	Exemption available for this return. Subtract line 2 from line 1	3	
4	Exemption claimed on this return from Part 3, column C total, below	4	
5	Automatic allocation of exemption to transfers reported on Schedule A, Part 3 (see instructions)	5	
6	Exemption allocated to transfers not shown on line 4 or 5, above. **You must attach a "Notice of Allocation."** (see instructions)	6	
7	Add lines 4, 5, and 6	7	
8	Exemption available for future transfers. Subtract line 7 from line 3	8	

Part 3—Tax Computation

A Item No. (from Schedule C, Part 1)	B Net transfer (from Schedule C, Part 1, col. D)	C GST Exemption Allocated	D RESERVED	E RESERVED	F RESERVED	G Applicable Rate	H Generation-Skipping Transfer Tax (multiply col. B by col. G)
			Not applicable to transfers made in 2010				
Gifts made by spouse (for gift splitting only)							
			Not applicable to transfers made in 2010				
Total exemption claimed. Enter here and on Part 2, line 4, above. May not exceed Part 2, line 3, above			**Total generation-skipping transfer tax.** Enter here; on page 3, Schedule A, Part 4, line 10; and on page 1, Part 2—Tax Computation, line 16				

(If more space is needed, attach additional sheets of same size.)

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CHAPTER 9 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. How much was the generation-skipping exemption in 2011:

   a) $100,000
   b) $1,000,000
   c) $2,000,000
   d) $5,000,000

2. For purposes of GST tax, a skip person must be a relative.

   a) true
   b) false

3. In general, all taxable distributions are subject to the GST tax.

   a) true
   b) false

4. How is the generation-skipping tax calculated:

   a) on a sliding scale based on the value of the estate
   b) on a sliding scale based on the income of the beneficiary
   c) on a flat rate basis
   d) either a or b above, depending on which method would produce the lowest amount of tax owed

5. When must the GST tax be paid:

   a) when distributions are made to the direct skip persons
   b) when the trust terminates
   c) when the trust is created
   d) either a or b above

6. The same form is required to be filed whether a taxable direct skip occurs during the transferor's life or at death.

   a) true
   b) false

CHAPTER 9 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The actual amount is much higher.

   B: Incorrect. The actual amount is much higher.

   C: Incorrect. The actual amount is greater than this.

   D: Correct. Every U.S. citizen is entitled to a $5.0 million generation-skipping exemption for 2011.

   (See page 9-1 of the course material.)

2. A: True is incorrect. A skip person can be a non-relative, at least 37½ years younger than the transferor.

   B: False is correct. A non-relative, at least 37½ years younger than the transferor is included in the definition of a skip person.

   (See page 9-3 of the course material.)

3. **A: True is correct.** A taxable distribution is any distribution from a trust to a skip person (other than a taxable termination or a direct skip).

   B: False is incorrect. A taxable distribution is a distribution from a trust, other than a taxable termination or direct skip, to a direct skip person.

   (See page 9-5 of the course material.)

4. A: Incorrect. The tax is not based on the value of the estate.

   B: Incorrect. The tax is not based on the income of the beneficiary.

   C: Correct. It is a flat-rate tax determined on a year-to-year basis.

   D: Incorrect. This tax is not based on either one of these bases.

   (See page 9-6 of the course material).

5. A: Incorrect. This is one of the times the tax is due. However, this is not the best answer.

   B: Incorrect. This is one of the times the tax is due. However, this is not the best answer.

   C: Incorrect. There can be no tax liability at the time the trust is merely created.

   D: Correct. Because either A or B could be correct, D is the best answer.

   (See page 9-8 of the course material.)

6. A: True is incorrect. If the transfer to the direct skip is during the lifetime of the transferor, Form 709 must be filed. If the transfer to the direct skip is at death, the decedent's Form 706 would report the transfer and the application of any unused GST exemption.

   B: False is correct. If the direct skip occurs not during life, but at death, the decedent's Federal Estate Gift Tax Return (Form 706) will report the transfer. For inter vivos transfers to direct skip individuals or trusts, the U.S. Gift Tax Return (Form 709) must be filed, and any generation-skipping tax paid within 3½ months of the taxpayer's year-end.

   (See page 9-9 of the course material.)

Chapter 10: Estate-Planning Trusts

I. Estate-Planning Trusts: Introduction

The type of trust an individual should establish depends on his or her unique circumstances. Just a few of the relevant considerations include:

- Whether the individual is married;
- Whether the individual has dependents with special needs such as a severe mental or physical disability; and
- Whether the individual has children from a prior marriage whose interests he or she wants to protect.

Some trusts are designed specifically for married persons to be used as part of an overall estate plan. Some trusts are established to benefit both family members and designated charitable organizations. For example, a charitable remainder trust, discussed in detail in Chapter 11, allows the testator to make a large donation to a charity while collecting tax benefits during his or her lifetime. Other common vehicles include an irrevocable life insurance trust, which allows a decedent to keep proceeds from a life insurance policy from being included in the individual's taxable estate or a unified credit or bypass trust, which provides support to a surviving spouse during his or her lifetime and then distributes the remaining assets to specified beneficiaries. These and other vehicles are discussed in more detail below.

II. Irrevocable Life Insurance Trusts

A. TAX IMPLICATIONS OF LIFE INSURANCE

While life insurance proceeds are not subject to income tax when paid to a survivor beneficiary, the benefits are included in a decedent's taxable estate. If the insured is the owner of the policy, the proceeds of the policy are subject to estate tax when the insured dies. On the other hand, if the insured transfers ownership to a life insurance trust, the proceeds will be free of estate tax. In either event, no income tax is due on the proceeds.

Thus, if a decedent is the owner of a life insurance policy upon his or her death, the face value of that policy will be included in the taxable estate of the owner. This can result in the imposition of a large estate tax. One common solution to this problem is the creation of an irrevocable life insurance trust that actually owns the insurance policy. Although the transfer of the policy is technically subject to gift tax, any amount actually owed is almost always significantly less than the tax savings achieved by creating the trust.

B. TRUST MUST BE IRREVOCABLE

To be effective, the trust must be irrevocable. This means that the trustor will be unable to change the beneficiary or beneficiaries of the policy once the trust is established. All authority is transferred to the trustee.

While the insured cannot control the trust, he or she can draft the trust instrument to direct the trustee to use proceeds from the policy to pay designated expenses of the estate. So long as the authority is discretionary on the part of the trustee, the proceeds will not be subject to estate tax. The policy proceeds actually paid pursuant to this discretionary authority, however, may be included in the decedent's gross estate.

C. METHODS OF CREATION

An irrevocable life insurance trust can be done in one of two ways:

- Establish and fund the trust and then have the trust purchase the insurance directly; or
- Establish a trust and transfer a previously purchased insurance policy into the trust.

The first method is the least complicated and therefore the preferred method.

This type of trust requires the use of an independent trustee, i.e. someone other than the trustor. The trustor may continue to make contributions to the trust as necessary to pay the premiums of the insurance policy.

D. TRUST TERMS

Life insurance trusts are generally categorized as either a single-life or a joint and survivor (i.e. "second to die") life insurance trust. A single-life life insurance trust holds insurance on the life of an individual insured. On the other hand, a second-to-die life insurance trust will hold life insurance upon the joint lives of husband and wife. That means the life insurance does not pay until the death of the surviving spouse.

When the proceeds of the policy are paid, the proceeds can either be distributed outright to the beneficiaries of the trust or held further in the trust. In the case of a single-life trust, the surviving spouse is typically the beneficiary of the trust.

If the insured's grandchildren or other skip persons are potential beneficiaries (even contingent remainder beneficiaries) of the life insurance trust, then consideration must be given to the federal generation-skipping transfer tax. Although a trust can be a skip person, the typical life insurance trust is not since the insured's spouse and/or children likely have an interest in the trust. Given these and other complexities, remember that detailed analysis of tax implications needs to be done before establishing any sort of trust.

In some cases, it is also advantageous to include a contingency in the trust to allow it to qualify for the federal estate tax marital deduction. For example, if the insured does not survive for the three-year period after transferring a policy into the trust, the trust could direct the proceeds to be paid directly to the surviving spouse. Under such circumstances, the marital deduction would offset the inclusion of the proceeds of the policy in the decedent's estate.

E. LIMITATIONS

1. <u>Taxable in the Event of Early Death</u>

A significant limitation with this type of trust is that, pursuant to IRC § 2035, below, if the trustor dies within three years of transferring a life insurance policy into a trust, the policy proceeds are considered part of his or her taxable estate. This three-year-rule applies only to existing insurance policies transferred into a trust and not those purchased by a trustee after creation of the trust.

I.R.C. § 2035. Adjustments for certain gifts made within 3 years of decedent's death

(a) Inclusion of certain property in gross estate.*--If--*

(1) *the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3- year period ending on the date of the decedent's death, and*

(2) *the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.*

(b) Inclusion of gift tax on gifts made during 3 years before decedent's death.*-- The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.*

(c) Other rules relating to transfers within 3 years of death.*--*

(1) In general.*--For purposes of--*

(A) *section 303(b) (relating to distributions in redemption of stock to pay death taxes),*

(B) *section 2032A (relating to special valuation of certain farms, etc., real property), and*

(C) *subchapter C of chapter 64 (relating to lien for taxes), the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.*

(2) Coordination with section 6166.*--An estate shall be treated as meeting the 35 percent of adjusted gross estate requirement of section 6166(a)(1) only if the estate meets such requirement both with and without the application of subsection (a).*

(3) Marital and small transfers.*--Paragraph (1) shall not apply to any transfer (other than a transfer with respect to a life insurance policy) made during a calendar year to any donee if the decedent was not required by section 6019 (other than by reason of section 6019(2)) to file any gift tax return for such year with respect to transfers to such donee.*

(d) Exception.*--Subsection (a) and paragraph (1) of subsection (c) shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth.*

(e) Treatment of certain transfers from revocable trusts.*--For purposes of this section and section 2038, any transfer from any portion of a trust during any period that such portion was treated under section 676 as owned by the decedent by reason of a power in the grantor (determined without regard to section 672(e)) shall be treated as a transfer made directly by the decedent.*

2. Trustor Cannot Change Beneficiaries

Also, while the insured has the right to name the beneficiaries of the trust, they cannot be changed since the trust is irrevocable. That means the trust cannot be modified to deal with changes in the insured's family.

3. No Right to Borrow

Any right that an insured would normally have to borrow money from an insurance policy is lost since the insured is no longer the owner of the policy. Other benefits of the policy, including any surrender value, must be given up in order to qualify as an irrevocable life insurance trust. These and other limitations are set forth in Treasury Regulation 20.2042, below.

4. Transfers Subject to Gift Tax

There are two ways that the insured can make premium payments. They can pay the premium directly or make payments to the trust and have the trust make the payments. Such payments to the trust constitute a gift to the beneficiaries of the trust.

Unless the gifts are covered by the annual exclusion, the transfers will be taxable gifts. As a result, some of the insured's unified credit will be used or gift tax may be owed. Gifts of future interests do not qualify for the annual exclusion. Gifts made in trust are, generally, at least partially future interests. Thus, gifts to the trust to pay the premiums will not, in and of themselves, qualify for the annual exclusion.

However, the trustor may be able to exempt these premium payments from gift or estate taxes by setting the life insurance trust up as a Crummey Trust (discussed below). Under such circumstances, each premium payment can be sheltered by the trustor's annual gift tax exclusion (currently $13,000 per trust beneficiary).

5. Insured Cannot Be Trustee

The insured cannot serve as trustee of an irrevocable life insurance trust. In some cases, the trustor will have to hire an independent trustee such as a bank or other financial institution.

Treas. Reg. § 20.2042-1. Proceeds of life insurance.

(a) In general. (1) Section 2042 provides for the inclusion in a decedent's gross estate of the proceeds of insurance on the decedent's life (i) receivable by or for the benefit of the estate (see paragraph (b) of this section) and (ii) receivable by other beneficiaries (see paragraph (c) of this section). The term "insurance" refers to life insurance of every description, including death benefits paid by fraternal beneficial societies operating under the lodge system.

(2) Proceeds of life insurance which are not includable in the gross estate under section 2042 may, depending upon the facts of the particular case, be includable under some other section of part III of subchapter A of chapter 11. For example, if the decedent possessed incidents of ownership in an insurance policy on his life but gratuitously transferred all rights in the policy in contemplation of death, the proceeds would be includable under section 2035. Section 2042 has no application to the inclusion in the gross estate of the value of rights in an insurance policy on the life of a person other than the decedent, or the value of rights in a combination annuity contract and life insurance policy on the decedent's life (i.e., a "retirement income" policy with death benefit or an "endowment" policy) under which there was no insurance element at the time of the decedent's death (see paragraph (d) of § 20.2039-1).

(3) Except as provided in paragraph (c)(6), the amount to be included in the gross estate under section 2042 is the full amount receivable under the policy. If the proceeds of the policy are made payable to a beneficiary in the form of an annuity for life or for a term of years, the amount to be included in the gross estate is the one sum payable at death under an option which could have been exercised either by the insured or by the beneficiary, or if no option was granted, the sum used by the insurance company in determining the amount of the annuity.

(b) Receivable by or for the benefit of the estate. (1) Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life receivable by the executor or administrator, or payable to the decedent's estate. It makes no difference whether or not the estate is specifically named as the beneficiary under the terms of the policy. Thus, if under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full (to the extent of the beneficiary's obligation) of such taxes, debts, or other charges is includable in the gross estate. Similarly, if the decedent purchased an insurance policy in favor of another person or a corporation as collateral security for a loan or other accommodation, its proceeds are considered to be receivable for the benefit of the estate. The amount of the loan outstanding at the date of the decedent's death, with interest accrued to that date, will be deductible in determining the taxable estate. See § 20.2053-4.

(2) If the proceeds of an insurance policy made payable to the decedent's estate are community assets under the local community property law and, as a result, one-half of the proceeds belongs to the decedent's spouse, then only one-half of the proceeds is considered to be receivable by or for the benefit of the decedent's estate.

(c) Receivable by other beneficiaries. (1) Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life not receivable by or for the benefit of the estate if the decedent possessed at the date of his death any of the incidents of ownership in the policy, exercisable either alone or in conjunction with any other person. However, if the decedent did not possess any of such incidents of ownership at the time of his death nor transfer them in contemplation of death, no part of the proceeds would be includible in his gross estate under section 2042. Thus, if the decedent owned a policy of insurance on his life and, 4 years before his death, irrevocably assigned his entire interest in the policy to his wife retaining no reversionary interest therein (see subparagraph (3) of this paragraph), the proceeds of the policy would not be includible in his gross estate under section 2042.

(2) For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel

the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. See subparagraph (6) of this paragraph for rules relating to the circumstances under which incidents of ownership held by a corporation are attributable to a decedent through his stock ownership.
(3) The term "incidents of ownership" also includes a reversionary interest in the policy or its proceeds, whether arising by the express terms of the policy or other instrument or by operation of law, but only if the value of the reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy.

As used in this subparagraph, the term "reversionary interest" includes a possibility that the policy or its proceeds may return to the decedent or his estate and a possibility that the policy or its proceeds may become subject to a power of disposition by him. In order to determine whether or not the value of a reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy, the principles contained in paragraph (c)(3) and (4) of § 20.2037-1, insofar as applicable, shall be followed under this subparagraph. In that connection, there must be specifically taken into consideration any incidents of ownership held by others immediately before the decedent's death which would affect the value of the reversionary interest. For example, the decedent would not be considered to have a reversionary interest in the policy of a value in excess of 5 percent if the power to obtain the cash surrender value existed in some other person immediately before the decedent's death and was exercisable by such other person alone and in all events. The terms "reversionary interest" and "incidents of ownership" do not include the possibility that the decedent might receive a policy or its proceeds by inheritance through the estate of another person, or as a surviving spouse under a statutory right of election or a similar right.
(4) A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. Moreover, assuming the decedent created the trust, such a power may result in the inclusion in the decedent's gross estate under section 2036 or 2038 of other property transferred by the decedent to the trust if, for example, the decedent has the power to surrender the insurance policy and if the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.
(5) As an additional step in determining whether or not a decedent possessed any incidents of ownership in a policy or any part of a policy, regard must be given to the effect of the State or other applicable law upon the terms of the policy. For example, assume that the decedent purchased a policy of insurance on his life with funds held by him and his surviving wife as community property, designating their son as beneficiary but retaining the right to surrender the policy. Under the local law, the proceeds upon surrender would have inured to the marital community. Assuming that the policy is not surrendered and that the son receives the proceeds on the decedent's death, the wife's transfer of her one-half interest in the policy was not considered absolute before the decedent's death. Upon the wife's prior death, one-half of the value of the policy would have been included in her gross estate. Under these circumstances, the power of surrender possessed by the decedent as agent for his wife with respect to one-half of the policy is not, for purposes of this section, an "incident of ownership", and the

decedent is, therefore, deemed to possess an incident of ownership in only one-half of the policy.
(6) In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling stockholders, the corporations' incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation. Any proceeds payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of such proceeds, shall be deemed to be payable to the corporation for purposes of the preceding sentence. See § 20.2031-2(f) for a rule providing that the proceeds of certain life insurance policies shall be considered in determining the value of the decedent's stock. Except as hereinafter provided with respect to a group-term life insurance policy, if any part of the proceeds of the policy are not payable to or for the benefit of the corporation, and thus are not taken into account in valuing the decedent's stock holdings in the corporation for purposes of section 2031, any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through his stock ownership where the decedent is the sole or controlling stockholder. Thus, for example, if the decedent is the controlling stockholder in a corporation, and the corporation owns a life insurance policy on his life, the proceeds of which are payable to the decedent's spouse, the incidents of ownership held by the corporation will be attributed to the decedent through his stock ownership and the proceeds will be included in his gross estate under section 2042. If in this example the policy proceeds had been payable 40 percent to decedent's spouse and 60 percent to the corporation, only 40 percent of the proceeds would be included in decedent's gross estate under section 2042. For purposes of this subparagraph, the decedent will not be deemed to be the controlling stockholder of a corporation unless, at the time of his death, he owned stock possessing more than 50 percent of the total combined voting power of the corporation. Solely for purposes of the preceding sentence, a decedent shall be considered to be the owner of only the stock with respect to which legal title was held, at the time of his death, by (i) the decedent (or his agent or nominee); (ii) the decedent and another person jointly (but only the proportionate number of shares which corresponds to the portion of the total consideration which is considered to be furnished by the decedent for purposes of section 2040 and the regulations thereunder); and (iii) by a trustee of a voting trust (to the extent of the decedent's beneficial interest therein) or any other trust with respect to which the decedent was treated as an owner under subpart E, part I, subchapter J, chapter I of the Code immediately prior to his death. In the case of group-term life insurance, as defined in the regulations under section 79, the power to surrender or cancel a policy held by a corporation shall not be attributed to any decedent through his stock ownership.

III. <u>Crummey Trust Powers</u>

A. BASIC OPERATION

The annual gift exclusion currently allows individuals to make a tax free gift of up to $13,000 per year per recipient. If the gift is made outright, the annual exclusion clearly applies. If, on the other hand, a parent or grandparent wants to make the gift to a trust (typically to restrict the way the donee can use the funds), the gift tax exclusion will not apply. To qualify for the exemption, the Internal Revenue Code requires the gift be of a "present interest." Typically, gifts to a trust do not qualify because the beneficiary's

access to the funds is usually limited (i.e., until the beneficiary reaches a specified age). Gifts of future interest do not qualify for the exemption.

A Crummey Trust, named after the taxpayer whose case with the IRS created this mechanism, provides a vehicle for making donations to a trust and being able to utilize the annual gift tax exemption.

B. RIGHT TO REVOKE

A Crummey Trust allows a donor to make a gift to a trust so long as the beneficiary retains the right to revoke the gift to the trust and remove the current contribution for a limited period of time, i.e., 60 days. If the beneficiary fails to revoke the gift within the prescribed time period, the beneficiary may not later revoke that specific gift. The proceeds of that gift become subject to the terms of the trust. The same procedure applies to every subsequent contribution to the trust.

Example.

Bill and Linda establish an irrevocable trust for their two grandchildren. Their accountant Tom is appointed trustee. Every year, Bill and Linda each give $13,000 per child to the trust, for a total contribution of $52,000. After each contribution is made, Tom notifies each of the beneficiaries that they have 30 days in which to notify him and revoke the gift. If the gift is not revoked within that period, each beneficiary's right to revoke at a later date lapses. The trustee is then free to determine how and when to use the proceeds of the trust, i.e., for educational expenses, according to the terms of the trust instrument. Any assets remaining at the time the trust expires are distributed to the child at the age specified in the trust, i.e., age 30.

Over a 10-year period, Bill and Linda will be able to contribute $520,000 to the trust based on the current exemption. This can result in significant tax savings.

The courts have never addressed the minimum amount of time a beneficiary must have to revoke a trust without making the gift subject to gift tax. In most cases, a Crummey Trust gives the beneficiary 30 days within which to revoke the gift. It is unlikely a shorter time period will pass muster with the IRS.

C. NOTICE OF REVOCATION RIGHTS

A beneficiary must have knowledge of his or her right to revoke the gift and withdraw the proceeds in order for the Crummey Trust to work. Although there is no express requirement in the law that written notice be provided, it is generally advisable to do so. Such notice should include, at a minimum:

- The amount of the gift;
- The date the beneficiary's right to revoke will lapse; and
- The extent of the beneficiary's power.

In the event the beneficiary is a minor or incompetent, the notice should be sent to his or her guardian.

IV. Spousal Trusts

In general terms, transfers between spouses qualify for a marital deduction and thus are exempt from gift or estate tax. However, if the transfer is in the form of a life estate or other terminable interest, the marital deduction is generally not allowed. Given this restriction, several different types of trusts have been used to limit taxes and provide for the support of a surviving spouse.

A. AB TRUSTS

For married persons with grown children, the best and most popular way to avoid estate taxes may be through an AB Trust, sometimes referred to as a marital life trust. In an AB Trust, each spouse places their property in a trust. When the first spouse dies, the surviving spouse receives the income from the trust and, upon the surviving spouse's death, the entire trust is distributed outright to the designated beneficiaries, typically the couple's surviving children.

> **Example.**
>
> *Norma and Henry are a married couple with one adult child, Steve. They have been married for over 40 years. They decide to create an AB trust in which the surviving spouse will receive a life interest in the assets. Upon the death of the surviving spouse, the proceeds of the trust will be distributed outright to Steve. The trust also names Steve's children as contingent beneficiaries in the event Steve predeceases the surviving spouse.*

One potential disadvantage of the AB trust is that it may be years before the remainder beneficiaries are able to receive the proceeds of the trust. For example, the surviving spouse could live for several decades, or even remarry or have additional children. Any of these events could significantly deplete the corpus of the trust for the other beneficiaries.

It is therefore often better for the first-to-die spouse to pass his or her exemption amount to a credit shelter trust. The surviving spouse can use income generated by the trust assets, and at the survivor's death, the assets pass to the trust's beneficiaries tax free. In addition, the estate of the second spouse also saves the additional exemption amount. Thus, for example, if both spouses died in 2010, they could have exempted $10.0 million between them instead of only $5.0 million.

B. QTIP TRUST

Like an AB trust, a Qualified Terminable Interest Trust (QTIP) is established for a surviving spouse. A QTIP trust is a trust that a donor establishes for the sole benefit of his or her spouse for the surviving spouse's lifetime. A QTIP trust can be established either during lifetime (an inter vivos QTIP trust) or at death (a testamentary QTIP trust).

Generally, property transfers between spouses during life (IRC § 2523) or at death (IRC § 2056) qualify for the marital deduction. The marital deduction is based on the assets that pass between spouses, and defers the assessment of transfer taxes. Because the tax is merely deferred and not avoided, the property received by the transferee spouse will eventually be subject to estate tax in this spouse's estate at death.

Not all types of property interests are treated equally for estate and gift tax purposes. For example, an outright gift in a will to the surviving spouse qualifies for the marital deduction. However, if the property interest given to the surviving spouse is restricted in some manner by the decedent, such property may be classified as "terminable interest property." Generally, a terminable interest does not qualify for the marital deduction. Terminable interest property is defined as an interest that will terminate or fail through the passage of time or on the occurrence (or failure to occur) of some contingency.

Terminable interest property can qualify for the marital deduction, provided that the property received by the surviving spouse meets the requirements of IRC § 2056(b)(7). Such property is therefore considered "qualified terminable interest property," more commonly referred to as a QTIP. A provision of the Internal Revenue Code allows, as a marital deduction, a gift tax exemption of transfers of certain life estates to spouses. For the exemption to apply, the donor must create a QTIP Trust.

In order for property to qualify as QTIP, the following requirements must be met:

- The property must "pass" from the decedent to the surviving spouse;
- The surviving spouse must be entitled to all the income from the property, which must be paid to the spouse at least annually for her lifetime;
- Neither the surviving spouse nor any other person can have the power to appoint any part of the property to a person other than the surviving spouse during such spouse's lifetime; and
- The personal representative must make an irrevocable election to treat the property as QTIP.

If the requirements of IRC § 2056(b)(7), below, are met, all of the assets of the QTIP trust are treated as passing to the surviving spouse. However, in return for the deferral on paying estate tax at the death of the first spouse, the entire value of the QTIP trust remaining at the surviving spouse's death is included in the surviving spouse's gross estate.

IRC § 2523. Gift to spouse

(a) Allowance of deduction.--*Where a donor transfers during the calendar year by gift an interest in property to a donee who at the time of the gift is the donor's spouse, there shall be allowed as a deduction in computing taxable gifts for the calendar year an amount with respect to such interest equal to its value.*

(b) Life estate or other terminable interest.--*Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, such interest transferred to the spouse will terminate or fail, no deduction shall be allowed with respect to such interest--*

> ***(1)*** *if the donor retains in himself, or transfers or has transferred (for less than an adequate and full consideration in money or money's worth) to any person other than such donee spouse (or the estate of such spouse), an interest in such property, and if by reason of such retention or transfer the donor (or his heirs or assigns) or such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest transferred to the donee spouse; or*
> ***(2)*** *if the donor immediately after the transfer to the donee spouse has a power to appoint an interest in such property which he can exercise (either alone or in conjunction with any person) in such manner that the appointee may possess or enjoy any part of such property after such termination or failure of the interest transferred to the donee spouse. For purposes of this paragraph, the donor shall be considered as having immediately after the transfer to the donee spouse such power to appoint even though such power cannot be exercised until after the lapse of time, upon the occurrence of an event or contingency, or on the failure of an event or contingency to occur.*

An exercise or release at any time by the donor, either alone or in conjunction with any person, of a power to appoint an interest in property, even though not otherwise a transfer, shall, for purposes of paragraph (1), be considered as a transfer by him. Except as provided in subsection (e), where at the time of the transfer it is impossible to ascertain the particular person or persons who may receive from the donor an interest in property so transferred by him, such interest shall, for purposes of paragraph (1), be considered as transferred to a person other than the donee spouse.

(c) Interest in unidentified assets.--*Where the assets out of which, or the proceeds of which, the interest transferred to the donee spouse may be satisfied include a particular asset or assets with respect to which no deduction would be allowed if such asset or assets were transferred from the donor to such spouse, then the value of the interest transferred to such spouse shall, for purposes of subsection (a), be reduced by the aggregate value of such particular assets.*

(d) Joint interests.--*If the interest is transferred to the donee spouse as sole joint tenant with the donor or as tenant by the entirety, the interest of the donor in the property which exists solely by reason of the possibility that the donor may survive the donee spouse, or that there may occur a severance of the tenancy, shall not be considered for purposes of subsection (b) as an interest retained by the donor in himself.*

(e) Life estate with power of appointment in donee spouse.--*Where the donor transfers an interest in property, if by such transfer his spouse is entitled for life to all of the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals, with power in the donee spouse to appoint the entire interest, or such specific portion (exercisable in favor of such donee spouse, or of the estate of such donee spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of such interest, or such portion, to any person other than the donee spouse--*

(1) *the interest, or such portion, so transferred shall, for purposes of subsection (a) be considered as transferred to the donee spouse, and*
(2) *no part of the interest, or such portion, so transferred shall, for purposes of subsection (b)(1), be considered as retained in the donor or transferred to any person other than the donee spouse.*

This subsection shall apply only if, by such transfer, such power in the donee spouse to appoint the interest, or such portion, whether exercisable by will or during life, is exercisable by such spouse alone and in all events. For purposes of this subsection, the term "specific portion" only includes a portion determined on a fractional or percentage basis.

(f) Election with respect to life estate for donee spouse.--

(1) In general.--*In the case of qualified terminable interest property--*
(A) *for purposes of subsection (a), such property shall be treated as transferred to the donee spouse, and*
(B) *for purposes of subsection (b)(1), no part of such property shall be considered as retained in the donor or transferred to any person other than the donee spouse.*
(2) Qualified terminable interest property.--*For purposes of this subsection, the term "qualified terminable interest property" means any property--*
(A) *which is transferred by the donor spouse,*
(B) *in which the donee spouse has a qualifying income interest for life, and*
(C) *to which an election under this subsection applies.*
(3) Certain rules made applicable.--*For purposes of this subsection, rules similar to the rules of clauses (ii), (iii), and (iv) of section 2056(b)(7)(B) shall apply and the rules of section 2056(b)(10) shall apply.*
(4) Election.--
(A) Time and manner.--*An election under this subsection with respect to any property shall be made on or before the date prescribed by section 6075(b) for filing a gift tax return with respect to the transfer (determined without regard to section 6019(2)) and shall be made in such manner as the Secretary shall by regulations prescribe.*
(B) Election irrevocable.--*An election under this subsection, once made, shall be irrevocable.*
(5) Treatment of interest retained by donor spouse.--
(A) In general.--*In the case of any qualified terminable interest property--*
(i) *such property shall not be includible in the gross estate of the donor spouse, and*
(ii) *any subsequent transfer by the donor spouse of an interest in such property shall not be treated as a transfer for purposes of this chapter.*
(B) Subparagraph (A) not to apply after transfer by donee spouse.-- *Subparagraph (A) shall not apply with respect to any property after the donee spouse is treated as having transferred such property under section 2519, or such property is includible in the donee spouse's gross estate under section 2044.*
(6) Treatment of joint and survivor annuities.--*In the case of a joint and survivor annuity where only the donor spouse and donee spouse have the right to receive payments before the death of the last spouse to die--*
(A) *the donee spouse's interest shall be treated as a qualifying income interest for life,*

(B) *the donor spouse shall be treated as having made an election under this subsection with respect to such annuity unless the donor spouse otherwise elects on or before the date specified in paragraph (4)(A),*
(C) *paragraph (5) and section 2519 shall not apply to the donor spouse's interest in the annuity, and*
(D) *if the donee spouse dies before the donor spouse, no amount shall be includible in the gross estate of the donee spouse under section 2044 with respect to such annuity.*

An election under subparagraph (B), once made, shall be irrevocable.

(g) Special rule for charitable remainder trusts.--

(1) In general.--*If after the transfer, the donee spouse is the only noncharitable beneficiary (other than the donor) of a qualified charitable remainder trust, subsection (b) shall not apply to the interest in such trust which is transferred to the donee spouse.*
(2) Definitions.--*For purposes of paragraph (1), the term [FN1] "noncharitable beneficiary" and "qualified charitable remainder trust" have the meanings given to such terms by section 2056(b)(8)(B).*

(h) Denial of double deduction.--*Nothing in this section or any other provision of this chapter shall allow the value of any interest in property to be deducted under this chapter more than once with respect to the same donor.*

(i) Disallowance of marital deduction where spouse not citizen.*--If the spouse of the donor is not a citizen of the United States--*

(1) *no deduction shall be allowed under this section,*
(2) *section 2503(b) shall be applied with respect to gifts which are made by the donor to such spouse and with respect to which a deduction would be allowable under this section but for paragraph (1) by substituting "$100,000" for "$10,000", and*
(3) *the principles of sections 2515 and 2515A (as such sections were in effect before their repeal by the Economic Recovery Tax Act of 1981) shall apply, except that the provisions of such section 2515 providing for an election shall not apply.*

This subsection shall not apply to any transfer resulting from the acquisition of rights under a joint and survivor annuity described in subsection (f)(6).

IRC § 2056. Bequests, etc., to surviving spouse

(a) Allowance of marital deduction.*--For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.*

(b) Limitation in the case of life estate or other terminable interest.--

(1) General rule.*--Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest--*

(A) *if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and*

(B) *if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse;* and no deduction shall be allowed with respect to *such interest (even if such deduction is not disallowed under subparagraphs (A) and (B))--*

(C) *if such interest is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust.*

For purposes of this paragraph, an interest shall not be considered as an interest which will terminate or fail merely because it is the ownership of a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term.

(2) Interest in unidentified assets.*--Where the assets (included in the decedent's gross estate) out of which, or the proceeds of which, an interest passing to the surviving spouse may be satisfied include a particular asset or assets with respect to which no deduction would be allowed if such asset or assets passed from the decedent to such spouse, then the value of such interest passing to such spouse shall, for purposes of subsection (a), be reduced by the aggregate value of such particular assets.*

(3) Interest of spouse conditional on survival for limited period.--*For purposes of this subsection, an interest passing to the surviving spouse shall not be considered as an interest which will terminate or fail on the death of such spouse if--*

(A) *such death will cause a termination or failure of such interest only if it occurs within a period not exceeding 6 months after the decedent's death, or only if it occurs as a result of a common disaster resulting in the death of the decedent and the surviving spouse, or only if it occurs in the case of either such event; and*

(B) *such termination or failure does not in fact occur.*

(4) Valuation of interest passing to surviving spouse.*--In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section--*

(A) *there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession, legacy, or inheritance tax, has on the net value to the surviving spouse of such interest; and*

(B) *where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.*

(5) Life estate with power of appointment in surviving spouse.*--In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the entire interest, or such specific portion (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either,*

whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of the interest, or such specific portion, to any person other than the surviving spouse--

(A) *the interest or such portion thereof so passing shall, for purposes of subsection (a), be considered as passing to the surviving spouse, and*

(B) *no part of the interest so passing shall, for purposes of paragraph (1)(A), be considered as passing to any person other than the surviving spouse.*

This paragraph shall apply only if such power in the surviving spouse to appoint the entire interest, or such specific portion thereof, whether exercisable by will or during life, is exercisable by such spouse alone and in all events.

(6) Life insurance or annuity payments with power of appointment in surviving spouse.--*In the case of an interest in property passing from the decedent consisting of proceeds under a life insurance, endowment, or annuity contract, if under the terms of the contract such proceeds are payable in installments or are held by the insurer subject to an agreement to pay interest thereon (whether the proceeds, on the termination of any interest payments, are payable in a lump sum or* in annual or *more frequent installments), and such installment or interest payments are payable annually or at more frequent intervals, commencing not later than 13 months after the decedent's death, and all amounts, or a specific portion of all such amounts, payable during the life of the surviving spouse are payable only to such spouse, and such spouse has the power to appoint all amounts, or such specific portion, payable under such contract (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), with no power in any other person to appoint such amounts to any person other than the surviving spouse--*

(A) *such amounts shall, for purposes of subsection (a), be considered as passing to the surviving spouse, and*

(B) *no part of such amounts shall, for purposes of paragraph (1)(A), be considered as passing to any person other than the surviving spouse.*

This paragraph shall apply only if, under the terms of the contract, such power in the surviving spouse to appoint such amounts, whether exercisable by will or during life, is exercisable by such spouse alone and in all events.

(7) Election with respect to life estate for surviving spouse.--

(A) In general.*--In the case of qualified terminable interest property--*

(i) *for purposes of subsection (a), such property shall be treated as passing to the surviving spouse, and*

(ii) *for purposes of paragraph (1)(A), no part of such property shall be treated as passing to any person other than the surviving spouse.*

(B) Qualified terminable interest property defined.*--For purposes of this paragraph--*

(i) In general.*--The term "qualified terminable interest property" means property--*

(I) *which passes from the decedent,*

(II) *in which the surviving spouse has a qualifying income interest for life, and*

(III) *to which an election under this paragraph applies.*

(ii) Qualifying income interest for life.*--The surviving spouse has a qualifying income interest for life if--*

(I) *the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and*

(II) *no person has a power to appoint any part of the property to any person other than the surviving spouse.*

Subclause (II) shall not apply to a power exercisable only at or after the death of the surviving spouse. To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).

(iii) Property includes interest therein.*--The term "property" includes an interest in property.*

(iv) Specific portion treated as separate property.*--A specific portion of property shall be treated as separate property.*

(v) Election.--*An election under this paragraph with respect to any property shall be made by the executor on the return of tax imposed by section 2001. Such an election, once made, shall be irrevocable.*

(C) Treatment of survivor annuities.*--In the case of an annuity included in the gross estate of the decedent under section 2039 (or, in the case of an interest in an annuity arising under the community property laws of a State, included in the gross estate of the decedent under section 2033) where only the surviving spouse has the right to receive payments before the death of such surviving spouse--*

(i) *the interest of such surviving spouse shall be treated as a qualifying income interest for life, and*

(ii) *the executor shall be treated as having made an election under this subsection with respect to such annuity unless the executor otherwise elects on the return of tax imposed by section 2001.*

An election under clause (ii), once made, shall be irrevocable.

(8) Special rule for charitable remainder trusts.--

(A) In general.*--If the surviving spouse of the decedent is the only beneficiary of a qualified charitable remainder trust who is not a charitable beneficiary nor an ESOP beneficiary, paragraph (1) shall not apply to any interest in such trust which passes or has passed from the decedent to such surviving spouse.*

(B) Definitions.*--For purposes of subparagraph (A)--*

(i) Charitable beneficiary.*--The term "charitable beneficiary" means any beneficiary which is an organization described in section 170(c).*

(ii) ESOP beneficiary.*--The term "ESOP beneficiary" means any beneficiary which is an employee stock ownership plan (as defined in section 4975(e)(7)) that holds a remainder interest in qualified employer securities (as defined in section 664(g)(4)) to be transferred to such plan in a qualified gratuitous transfer (as defined in section 664(g)(1)).*

(iii) Qualified charitable remainder trust.*--The term "qualified charitable remainder trust" means a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664).*

(9) Denial of double deduction.*--Nothing in this section or any other provision of this chapter shall allow the value of any interest in property to be deducted under this chapter more than once with respect to the same decedent.*

(10) Specific portion.*--For purposes of paragraphs (5), (6), and (7)(B)(iv), the term "specific portion" only includes a portion determined on a fractional or percentage basis.*

(c) Definition.*--For purposes of this section, an interest in property shall be considered as passing from the decedent to any person if and only if--*

(1) *such interest is bequeathed or devised to such person by the decedent;*

(2) *such interest is inherited by such person from the decedent;*

(3) *such interest is the dower or curtesy interest (or statutory interest in lieu thereof) of such person as surviving spouse of the decedent;*

(4) *such interest has been transferred to such person by the decedent at any time;*

(5) *such interest was, at the time of the decedent's death, held by such person and the decedent (or by them and any other person) in joint ownership with right of survivorship;*

(6) *the decedent had a power (either alone or in conjunction with any person) to appoint such interest and if he appoints or has appointed such interest to such person, or if such person takes such interest in default on the release or nonexercise of such power; or*

(7) *such interest consists of proceeds of insurance on the life of the decedent receivable by such person.*

Except as provided in paragraph (5) or (6) of subsection (b), where at the time of the decedent's death it is not possible to ascertain the particular person or persons to whom an interest in property may pass from the decedent, such interest shall, for purposes of subparagraphs (A) and (B) of subsection (b)(1), be considered as passing from the decedent to a person other than the surviving spouse.

(d) Disallowance of marital deduction where surviving spouse not United States citizen.--

(1) In general.--*Except as provided in paragraph (2), if the surviving spouse of the decedent is not a citizen of the United States--*

(A) *no deduction shall be allowed under subsection (a), and*

(B) *section 2040(b) shall not apply.*

(2) Marital deduction allowed for certain transfers in trust.--

(A) In general.--*Paragraph (1) shall not apply to any property passing to the surviving spouse in a qualified domestic trust.*

(B) Special rule.*--If any property passes from the decedent to the surviving spouse of the decedent, for purposes of subparagraph (A), such property shall be treated as passing to such spouse in a qualified domestic trust if--*

(i) *such property is transferred to such a trust before the date on which the return of the tax imposed by this chapter is made, or*

(ii) *such property is irrevocably assigned to such a trust under an irrevocable assignment made on or before such date which is enforceable under local law.*

(3) Allowance of credit to certain spouses.*--If--*

(A) *property passes to the surviving spouse of the decedent (hereinafter in this paragraph referred to as the "first decedent"),*

(B) *without regard to this subsection, a deduction would be allowable under subsection (a) with respect to such property, and*

(C) *such surviving spouse dies and the estate of such surviving spouse is subject to the tax imposed by this chapter, the Federal estate tax paid (or treated as paid under section 2056A(b)(7)) by the first decedent with respect to such property shall be allowed as a credit under section 2013 to the estate of such surviving spouse and the amount of such credit shall be determined under such section without regard to when the first decedent died and without regard to subsection (d)(3) of such section.*

(4) Special rule where resident spouse becomes citizen.*--Paragraph (1) shall not apply if--*

(A) *the surviving spouse of the decedent becomes a citizen of the United States before the day on which the return of the tax imposed by this chapter is made, and*

(B) *such spouse was a resident of the United States at all times after the date of the death of the decedent and before becoming a citizen of the United States.*

(5) Reformations permitted.

(A) In general.--*In the case of any property with respect to which a deduction would be allowable under subsection (a) but for this subsection, the determination of whether a trust is a qualified domestic trust shall be made--*

(i) *as of the date on which the return of the tax imposed by this chapter is made, or*

(ii) *if a judicial proceeding is commenced on or before the due date (determined with regard to extensions) for filing such return to change such trust into a trust which is a qualified domestic trust, as of the time when the changes pursuant to such proceeding are made.*

(B) Statute of limitations.*--If a judicial proceeding described in subparagraph (A)(ii) is commenced with respect to any trust, the period for assessing any deficiency of tax attributable to any failure of such trust to be a qualified domestic trust shall not expire before the date 1 year after the date on which the Secretary is notified that the trust has been changed pursuant to such judicial proceeding or that such proceeding has been terminated.*

1. Advantages of QTIP Trust

There are several tax and nontax benefits to qualifying property as QTIP. For example, the QTIP election may provide the personal representative with the flexibility to engage in postmortem tax planning. In addition, unlike an outright gift to the surviving spouse, a QTIP trust allows the first spouse to die the ability to determine the ultimate disposition of the trust property at the death of the surviving spouse.

Moreover, the personal representative can choose to make either a full or partial QTIP election. The election can be delayed until the decedent's estate tax return is filed (an estate tax return is due within nine months of the decedent's date of death or, if extended, within 15 months of the date of death).

For generation skipping transfer (GST) tax purposes, the personal representative may also make what is known as a 'reverse QTIP election,' which allows the personal representative to fully use each spouse's GST exemption by treating the QTIP as if it still belonged to the decedent spouse for GST tax purposes.

2. <u>Disadvantages of a QTIP Trust</u>

A disadvantage of creating a QTIP trust is that the decedent spouse (not the surviving spouse) controls the ultimate disposition of the QTIP. This can be unsettling for a surviving spouse who desires to have unfettered access to the trust property. Furthermore, a separate tax return is required each year that the QTIP trust is in existence. Invariably, the QTIP trust will limit the surviving spouse's flexibility as to access and possibly control over the trust. Lastly, a QTIP trust may be a source of contentious feelings and possible litigation between the surviving spouse and the children of the deceased spouse (especially in the case of a second marriage) with respect to investment strategies that benefit the surviving spouse to the detriment of the remainder beneficiaries.

Many of these concerns may be addressed through careful drafting which might include:

- Permissible trust distributions to the surviving spouse for purposes of making gifts; and

- Liability limitation clauses which give the trustee wide discretion to invest.

Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: September 10, 1999
June 14, 1999

This is in response to your letter dated May 14, 1999, and prior correspondence, in which you request a ruling concerning the application of §§ 2511 and 2519 of the Internal Revenue Code to a proposed transaction.

Under Decedent's will, executed on Date 1, Decedent bequeathed the residue of his estate to a revocable trust that Decedent and Spouse had created on Date 2. On Date 3, prior to Decedent's death, the revocable trust, was amended, restated, and renamed (Trust).

Under the terms of Trust, if Decedent predeceases Spouse, then the trustee is to divide the trust estate into a Marital Trust, Decedent's Trust, and a Survivor's Trust. After funding the Survivor's Trust and Decedent's Trust, the residue of the Trust property is to be allocated to the Marital Trust. The Marital Trust provides that the trust income is to be paid to Spouse for life. Upon the death of Spouse, the Marital Trust property is divided into equal shares to be held in separate trusts, one share to be held for each living child of the settlor and one share to be held for the surviving issue of a deceased child. Under the terms of each trust, after the child attains age 21, the trustee shall pay to the child the net income of the trust. If the income is not sufficient for the child's reasonable support, health, maintenance and education, in accordance with the child's accustomed

standard of living, the trustee is to pay the child as much of the principal as is necessary for such purpose. When the child attains age 30, the trustee is to distribute 1/6 of the principal to the child. When the child attains age 35, the trustee is to distribute 1/5 of the remaining principal to the child. When the child attains age 40, 1/2 of the balance is to be distributed to the child. If the child has attained age 30, 35, or 40 when the Spouse dies and the trust is divided into shares, the trustee is to distribute to the child 1/6, 1/3, or 1/2 of the trust share, as the case may be.

On the death of a child, the balance of the child's share is to be divided into a number of trusts equal to the number of child's surviving issue (grandchildren) and deceased issue with living issue. If a grandchild has attained age 40, the grandchild's trust is to be distributed outright to the grandchild. If a grandchild has not attained age 21, then the trustee is to distribute as much of the net income and principal as the trustee considers necessary for the grandchild's proper support, health, maintenance and education. After the grandchild attains age 21, the trustee is to distribute all the net income to the grandchild. The trustee also has discretion to distribute corpus to the grandchild. When a grandchild attains age 30 the trustee is to distribute 1/3 of the corpus to the grandchild; at age 35, 1/2 of the balance is to be distributed; and at age 40, the balance is to be distributed. If a grandchild predeceases a child, but is survived by issue, the trustee is to pay as much of the net income and principal as the trustee considers necessary for the issues' proper support, health, maintenance and education. When the youngest issue attains age 25, the trustee is to distribute the trust corpus to the grandchild's issue, by right of representation.

Decedent died on Date 4. On a timely filed estate tax return, Decedent's executor elected to treat the assets passing to the Marital Trust as qualified terminable interest property (QTIP) under § 2056(b)(7).

Decedent is survived by Spouse (age 59), Child A (age 43), Child B (age 42), and Child C (age 31). Child A has two children (ages 17 and 21) and Child B has one child (age 2). Spouse proposes to purchase the remainder interest in the Marital Trust. A guardian ad litem will be appointed to represent any minor and unborn issue. Spouse will transfer cash equal to the present value of the right to receive the trust corpus on the Spouse's death. Under the terms of the transaction, Spouse will be reimbursed for the gift tax imposed on the transaction. The trustee of the Marital Trust will then distribute all the trust assets to Spouse.

You have requested a ruling that if Spouse purchases the remainder interest in the Marital Trust, as proposed, then Spouse will make a gift for gift tax purposes equal to the greater of (i) (under § 2519) the present value of the remainder interest, or (ii) (under §§ 2511 and 2512) the amount transferred by Spouse in exchange for the remainder interest.

Section 2044(a) provides that the value of the gross estate includes the value of any property described in s 2044(b) in which the decedent had a qualifying income interest for life. Section 2044(b) provides that § 2044 applies to any property if a deduction was allowed with respect to the transfer of the property to the decedent under § 2056(b)(7). Section 2056(a) provides that the value of the taxable estate is, except as limited by § 2056(b), determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse.

Under § 2056(b)(1), if an interest passing to the surviving spouse will terminate, no deduction is allowed with respect to such interest if, after termination of the spouse's interest, an interest in the property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than the surviving spouse (or the estate of such spouse).

Section 2056(b)(7)(A) provides that qualified terminable interest property (QTIP), for purposes of § 2056(a), is treated as passing to the surviving spouse, and no part of such property is treated as passing to any person other than the surviving spouse. In general, qualified terminable interest property is property in which the spouse receives a qualifying income interest for life, and with respect to which the executor makes an election to treat the property as QTIP.

Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift.

Section 2519(a) provides that any disposition of all or part of a qualifying income interest for life in any property to which the section applies is treated as a transfer of all interests in the property other than the qualifying income interest. Section 2519(b) provides that the section applies to any property if a deduction was allowed with respect to the transfer of such property to the donor under § 2056(b)(7).

Under § 2519, if a surviving spouse disposes of any part of the qualifying income interest, the spouse is treated as making a gift of the remainder interest in the underlying property (i.e., all interests in the property other than the income interest). Correspondingly, under § 2511, the disposition of the income interest by the spouse is treated as a gift, to the extent the income interest is transferred to another for less than adequate consideration.

Under § 25.2519-1(c)(1), the amount treated as a transfer upon disposition of all or part of a qualifying income interest for life in qualified terminable interest property is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under § 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition.

The term "disposition," as used in § 2519, applies broadly to circumstances in which the surviving spouse's right to receive the income is relinquished or otherwise terminated, by whatever means. H. Rep. No. 201, 97 superth Cong., 1 superst Sess. 161 (1981). In Rev. Rul. 98-8, 1998-7 I.R.B. 24, the surviving spouse acquired the remainder interest in a QTIP trust by transferring to the remainderman a promissory note equal to the actuarial value of the remainder interest. Subsequently, the trustee distributed the trust assets to the spouse and the spouse paid the balance due on the note with trust assets. The revenue ruling concludes that the transaction constitutes a disposition of the spouse's income interest for purposes of § 2519, resulting in a gift of the present value of

the remainder interest, or in the alternative, a transfer of the promissory note for less than adequate consideration, resulting in a gift equal to the value of the promissory note. Accordingly, the revenue ruling concludes that the spouse made a gift equal to the greater of (i) the present value of the remainder interest (pursuant to § 2519), or (ii) the value of the property or cash transferred in exchange for the remainder interest (pursuant to §§ 2511 and 2512). The ruling notes that the result would be the same if the Spouse transferred cash in exchange for the remainder interest, rather than issuing a note.

In the present case, the proposed transaction is similar to the one considered in Rev. Rul. 98-8. Therefore, Spouse will be regarded as making a gift equal to the greater of (i) the present value of the remainder interest (i.e., the amount of the transfer under § 2519 and § 25.2519-1(c)(1)), or (ii) the amount transferred by Spouse in exchange for the remainder interest (pursuant to §§ 2511 and 2512). However, the amount subject to gift tax must be adjusted to reflect any reimbursement Spouse receives under the terms of the transaction for the gift tax imposed on the transfer.

Except as we have specifically ruled herein, we express no opinion under the cited provisions or under any other provision of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Internal Revenue Bulletin: 2004-32

August 9, 2004

Internal Rev. Proc. 2004-47

SECTION 1. PURPOSE

This revenue procedure provides a simplified alternate method for certain executors of estates and trustees of trusts to request relief to make a late reverse qualified terminable interest property (QTIP) election under § 2652 of the Internal Revenue Code. This alternate method may be used in lieu of the normal letter ruling process. No user fee is charged for requests filed under this revenue procedure.

SECTION 2. BACKGROUND

.01 Under § 2001(a), the estate tax is imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States. Section 2056(a) provides that for purposes of § 2001, the value of the taxable estate shall, except as limited by § 2056(b), be determined by deducting from the value of the gross estate the value of any interest in property that passes or has passed from the decedent to the decedent's surviving spouse. Section 2056(b) generally provides that no deduction is allowed for an interest passing to the surviving spouse if, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, the interest will terminate or fail. Section 2056(b)(7) provides an exception for property meeting the QTIP requirements in § 2056(b)(7)(B).

.02 Section 2056(b)(7)(B)(i) defines “qualified terminable interest property” as property: (1) that passes from the decedent; (2) in which the surviving spouse has a qualifying income interest for life; and (3) to which an election under § 2056(b)(7) applies. Property for which a QTIP election is made is treated as passing to the surviving spouse for purposes of determining the decedent’s taxable estate. The value of any property that was deducted under § 2056(b)(7) from the decedent’s gross estate and that remains on the surviving spouse’s death will be included in the surviving spouse’s gross estate under § 2044. If the surviving spouse makes a lifetime disposition of all or a portion of the qualifying income interest, § 2519 provides that the surviving spouse is treated for estate and gift tax purposes as transferring all interests in the property other than the qualifying income interest. Furthermore, the transfer of the qualifying income interest is subject to the gift tax under § 2511 and § 25.2511-2.

Chapter 13 imposes a generation-skipping transfer (GST) tax on all transfers, whether made directly or indirectly, to skip persons. Under § 2613(a), a skip person is a person who is two or more generations younger than the transferor or is a trust if all of the interests are held by skip persons. Under § 2652, the transferor generally is the individual who transfers property in a transaction subject to the federal gift or estate tax. Under § 2611(a), transfers that are subject to the GST tax include direct skips, taxable distributions, and taxable terminations.

Section 2631 allows every transferor a GST tax exemption of $1,000,000 that may be allocated by the individual (or the individual’s executor) to any property with respect to which the individual is the transferor. For calendar years after 1998, this exemption amount has been indexed for inflation. For transfers made between January 1, 2004, and December 31, 2009 (inclusive), the GST exemption will equal the amount that is exempted from transfer tax by the applicable credit amount described in § 2010. With respect to transfers made at death, the allocation of a decedent’s GST tax exemption is made on the decedent’s Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*. A decedent’s unused GST tax exemption is automatically allocated on the due date for filing the decedent’s Form 706 to the extent not otherwise allocated by the decedent’s executor on or before that date.

Section 2632(e) and § 26.2632-1(d)(2) of the Generation-Skipping Transfer Tax Regulations supply the method for the automatic allocation of any unused GST tax exemption. The exemption is first allocated *pro rata* to direct skips treated as occurring on death on the basis of the value of property as finally determined for federal estate tax purposes. The balance, if any, is then allocated *pro rata*, on the basis of estate tax value, to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made. In the case of trusts that are not included in the gross estate, the GST tax exemption is allocated on the basis of the date of death value of the trust. No automatic allocation is made to a trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust. The automatic allocation of GST tax exemption is irrevocable.

With respect to QTIP, the decedent's surviving spouse will become the new transferor with respect to the entire trust before the occurrence of any GST from the trust. Accordingly, a decedent's GST tax exemption is not automatically allocated to property for which a QTIP election was made. Section 2652(a)(3) provides, however, that if an election is made to treat property as QTIP under § 2056(b)(7), the person making the election may, for purposes of chapter 13, elect to treat the property as if the QTIP election had not been made (reverse QTIP election). As a result of the reverse QTIP election, the decedent remains, for GST tax purposes, the transferor of the QTIP trust or property. The decedent's GST tax exemption, accordingly, may be allocated to the QTIP trust or property, either by an affirmative allocation or by the automatic allocation of the decedent's remaining GST tax exemption. The reverse QTIP election is made on the same return on which the QTIP election is made.

To date, the Internal Revenue Service has issued several private letter rulings providing relief to taxpayers who failed to make a reverse QTIP election on a timely filed Form 706 and who have satisfied the requirements of § 301.9100-3 of the Procedure and Administration Regulations. Section 301.9100-3(a) generally provides that requests for extensions of time for regulatory elections will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the Government.

SECTION 3. SCOPE

In General. Except as otherwise provided in sections 3.02 and 3.03 of this revenue procedure, the alternate simplified procedure authorized in this revenue procedure for obtaining permission to file a late reverse QTIP election is available if the requirements of sections 4.02 and 4.03 of this revenue procedure are met.

.02 *Certain Late Reverse QTIP Elections*. This revenue procedure does not apply to intervivos transfers to or for the benefit of a spouse, or to transfers to or for the benefit of a non-citizen spouse in the form of a qualified domestic trust. Relief under this revenue procedure does not include or grant permission to make a late severance of a trust included in the gross estate or to allocate GST exemption. Accordingly, permission to file a late reverse QTIP election in conjunction with a late severance or an allocation of GST exemption must be requested through the letter ruling process as described in section 3.03 of this revenue procedure.

.03 *Failure to Qualify for Relief Under This Revenue Procedure*. An executor who is denied relief or is otherwise outside the scope of this revenue procedure may request relief under § 301.9100-3 by requesting a letter ruling. The procedural requirements for requesting a letter ruling are described in Rev. Proc. 2004-1, 2004-1 I.R.B. 1 (or its successor). If a letter ruling is requested after relief has been denied under this revenue procedure, the letter ruling request must indicate that relief was requested and denied under this revenue procedure. Rev. Proc. 2004-1, Appendix C, 2004-1 I.R.B. 1, 70.

SECTION 4. RELIEF FOR UNTIMELY REVERSE QTIP ELECTIONS

.01 *Definitions*.

1. *Executor*. Solely for purposes of this revenue procedure, the term executor includes: an executor of an estate as defined in § 2203 and §§ 20.2203-1 and § 20.2056(b)-7(b)(3) of the Estate Tax Regulations; the trustee of the QTIP trust; or any other person in actual or constructive possession of the property, for which the reverse QTIP election will be made.

2. *Decedent*. For purposes of this revenue procedure, the term decedent refers to the individual for whose estate the reverse QTIP election was not timely made.

3. *Reverse QTIP Election*. For purposes of this revenue procedure, a reverse QTIP election refers to the affirmative indication on Schedule R of Form 706 by the executor to treat the decedent as the transferor for GST purposes of the QTIP trust or property to which the election pertains. As a result of this election, the decedent's GST tax exemption may be allocated to the QTIP trust or property. This is the case even though the surviving spouse or the surviving spouse's estate will be subject to the gift or estate tax with respect to the property before the property passes to a skip person.

4. *Due Date of the Reverse QTIP Election*. Section 26.2652-2(b) provides that the reverse QTIP election is made on the return on which the QTIP election is made. Section 20.2056(b)-7(b)(4)(i) provides that the QTIP election under § 2056(b)(7) must be made on the last estate tax return filed by the executor on or before the due date of the return, including extensions (if any). If a timely return is not filed, the election must be made on the first estate tax return filed by the executor after the due date. Estate tax returns must be filed within 9 months after the date of the decedent's death, not including extensions.

.02 *Eligibility for Relief*. Relief is available under section 4.02 of this revenue procedure if, on the date of the filing of the request described in 4.03 of this revenue procedure, the following requirements are met:

1. A valid QTIP election under § 2056(b)(7) was made for the property or trust on the federal estate tax return filed for the decedent's estate;

2. The reverse QTIP election was not made on the estate tax return as filed because the taxpayer relied on the advice and counsel of a qualified tax professional and that qualified tax professional failed to advise the taxpayer of the need, advisability, or proper method to make a reverse QTIP election;

3. The decedent has a sufficient amount of unused GST exemption, after the automatic allocation of the GST exemption under § 2632(e) and § 26.2632-1(d)(2), to result in a zero-inclusion ratio for the reverse QTIP trust or property;

4. The estate is not eligible under § 301.9100-2(b) for an automatic 6-month extension;

5. The surviving spouse has not made a lifetime disposition of all or any part of the qualifying income interest for life in the QTIP trust or property;

6. The surviving spouse is alive or no more than 6 months have passed since the death of the surviving spouse; and

7. Relief is requested by the executor in accordance with section 4.03 of this revenue procedure.

.03 *Procedural Requirements for Relief*.

1. The estate must file with the Internal Revenue Service a request for an extension of time to make a reverse QTIP election. The request should have a cover sheet requesting relief that states at the top of the document "REQUEST FOR EXTENSION FILED PURSUANT TO REV. PROC. 2004-47." The following items must be attached to the request for relief:

    a. Copies of Parts 1 through 5 and Schedule M of the original estate tax return filed with the Service;

    b. A properly completed Schedule R as required to make the reverse QTIP election;

    c. A statement describing why the reverse QTIP election was not made on the estate tax return as filed;

    d. A statement affirming that all of the requirements in section 4.02 of this revenue procedure have been met;

    e. A dated declaration, signed by the executor of the estate (as defined above), that states: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete. In addition, all attachments provided in support of this request for relief are true and correct copies of the original documents."; and

    f. A signed statement from the qualified tax professional on whom the taxpayer relied when preparing the original estate tax return. The statement should establish the tax professional's qualifications as a qualified tax professional and must include a dated declaration that states: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this request for relief are true, correct, and complete."

2. Subject to any contrary instructions in future forms, instructions, or guidance published by the Service, the request should be sent to the Cincinnati Service Center for processing.

a. If a private delivery service is used, the request should be sent to:

   Internal Revenue Service Center
   201 W. Rivercenter Blvd.
   Covington, KY 41012;

b. If a private delivery service is not used, the request should be sent to:

   Internal Revenue Service Center
   Cincinnati, OH 45999.

.04 *Relief for Late Reverse QTIP Election*. Upon receipt of a request for relief under section 4.03 of this revenue procedure, the Service Center will determine whether the requirements for granting additional time to file the reverse QTIP election under this revenue procedure have been satisfied and will notify the executor of the result of this determination.

.05 *Effect of Relief*. An extension of time to make the reverse QTIP election under § 2652(a)(3) does not extend the time to make an allocation of any remaining GST exemption. However, once the election is made, the decedent remains, for GST tax purposes, the transferor of the QTIP trust or property. As a result, the decedent's remaining GST tax exemption will be automatically allocated pursuant to § 2632(e) and § 26.2632-1(d)(2) to the QTIP trust or property for which the reverse QTIP election was made, based on the value of the trust or property as finally determined for federal estate tax purposes. The relief provided by this revenue procedure does not include or grant permission to allocate retroactively the decedent's remaining GST exemption or to make a late severance of a trust included in the gross estate.

SECTION 5. EFFECTIVE DATE

.01 *In General*. This revenue procedure is effective August 9, 2004.

.02 *Transition Rule for Pending Letter Ruling Requests*. If an executor has filed a request for a letter ruling seeking relief to file a reverse QTIP election under § 301.9100-3 and that letter ruling request is pending in the national office on August 9, 2004, the executor may withdraw the letter ruling request and receive a refund of its user fee if prior to September 23, 2004, the executor notifies the national office that it will withdraw the letter ruling request. If the executor does not so notify the national office by September 23, 2004, the national office will process letter ruling requests pending on August 9, 2004, and will retain the user fee paid.

SECTION 6. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1898.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is in section 4. This information is required to be submitted to the applicable service center in order to obtain an extension of time to make a late reverse QTIP election. This information will be used to determine whether the eligibility requirements for obtaining relief have been met. The collection of information is required to obtain a benefit. The likely respondents are estates and trusts.

The estimated total annual reporting burden is 54 hours.

The estimated average annual burden per respondent is 9 hours to complete the statements required under this revenue procedure. The estimated number of respondents is 6.

There is no estimated annual frequency of responses as the reverse QTIP election is a one-time election.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is DeAnn K. Malone of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact DeAnn K. Malone at (202) 622-7830 (not a toll-free call).

CHAPTER 10 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following statements about the income tax implications of life insurance is true:

   a) life insurance proceeds are subject to income tax when paid to a survivor beneficiary
   b) life insurance proceeds of up to $500,000 are not subject to income tax when paid to a survivor beneficiary
   c) life insurance proceeds paid to a survivor beneficiary are exempt from income tax
   d) the value of life insurance proceeds is not included when calculating the value of a decedent's estate

2. In order for a life insurance trust to be effective, it must be irrevocable.

   a) true
   b) false

3. What happens if a trustor dies within three years of creating a life insurance trust:

   a) nothing, this is a silly question
   b) the proceeds are subject to a 10 percent federal surcharge
   c) nothing, so long as the policy does not pay off more than $500,000
   d) the proceeds are considered part of the decedent's taxable estate if the policy was purchased prior to the creation of the trust

4. What type of trust allows the donor to make a gift and still receive the benefit of the annual gift exclusion:

   a) a Totten trust
   b) a Crummey trust
   c) a life insurance trust
   d) a revocable trust

5. AB trusts are used to limit taxes and provide for the support of a surviving spouse when there is a transfer in the form of a life estate or other terminable interest.

   a) true
   b) false

6. An advantage of a QTIP trust is that the surviving spouse controls the ultimate disposition of the QTIP.

   a) true
   b) false

CHAPTER 10 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Life insurance proceeds paid to a surviving beneficiary are not subject to income tax.

   B: Incorrect. Life insurance proceeds of any amount are not subject to income tax when paid to a surviving beneficiary.

   C: Correct. Such proceeds are exempt from tax.

   D: Incorrect. Even though life insurance proceeds are not subject to income tax when paid to a survivor beneficiary, the benefits are included in a decedent's taxable estate.

   (See page 10-1 of the course material.)

2. **A: True is correct.** This means that the trustor will be unable to change the beneficiary or beneficiaries of the policy once the trust is established.

   B: False is incorrect. This means that all authority is passed to the trustee. Even though the insured cannot control the trust, he or she can draft the trust instrument to direct the trustee to use proceeds from the policy to pay designated expenses of the estate.

   (See page 10-2 of the course material.)

3. A: Incorrect. This is not a silly question.

   B: Incorrect. There is no such surcharge.

   C: Incorrect. The amount of the policy is not relevant to this question.

   D: Correct. That is why it is best to purchase a policy after the formation of the trust. In such a case, it does not matter when the insured dies.

   (See page 10-3 of the course material.)

4. A: Incorrect. A Totten trust is actually a type of bank account that allows the account holder to name a beneficiary.

   B: Correct. A Crummey Trust, named after the person who brought a case before the IRS, allows the donor to make a gift to a trust and remove the contribution for a limited period of time. It therefore allows the donor to create a trust and receive the benefit of the annual gift tax exclusion.

   C: Incorrect. A life insurance trust does not have this effect.

   D: Incorrect. A revocable trust does not have this effect.

   (See page 10-8 of the course material.)

5. **A: True is correct.** For married persons with grown children, an AB trust is one of the most popular ways to avoid estate taxes. In an AB Trust, each spouse places his or her property in a trust. When the first spouse dies, the surviving spouse receives the income from the trust and, upon the surviving spouse's death, the entire trust is distributed outright to the designated beneficiaries, typically the couple's surviving children.

   B: False is incorrect. This is one of the types of trusts used to limit taxes and provide for the support of a surviving spouse.

   (See page 10-9 of the course material.)

6. A: True is incorrect. The decedent spouse, not the surviving spouse, controls the ultimate disposition of the QTIP.

   B: False is correct. Although there are several advantages of using a QTIP trust, this is not one of them. In a QTIP trust, the decedent spouse, not the surviving spouse, has the ultimate decision regarding the disposition of the property.

   (See page 10-19 of the course material.)

Chapter 11: Charitable Trusts

I. Introduction

Charitable giving is a common component of estate planning. Regardless of their level of income or the value of their estates, many people want to make gifts to one or more of the many religious, educational, charitable, or philanthropic organizations and institutions that qualify as charities.

Charitable gifts given during a person's lifetime are also common and can reduce the giver's estate and subsequently lower estate and inheritance taxes when the person's estate is settled. Itemized deductions for charitable gifts are deductible limited to a percentage of the taxpayer's contribution base.

For CPAs helping a client to consider a charitable donation, either during life or after death, it is important to consider the following questions. The answers will help the individual to develop a plan, including the use of charitable trusts:

- What is the purpose of the gift?
- What assets do you want to donate?
- Which charity or charities do you want to receive the gift?
- How many charitable gifts do you want to make?
- When do you want to make the gifts?

In the course of planning charitable gifts, individuals will want to consider all of these questions, and probably others as well. This chapter will first focus on federal law governing charitable contributions. This is extremely important because a donor's tax planning can be for naught if the designated charity does not meet IRS guidelines. The details of charitable trusts will then be discussed.

II. Charitable Gifts: Federal Rules

A. ORGANIZATIONS THAT QUALIFY TO RECEIVE DEDUCTIBLE CONTRIBUTIONS

The tax purpose of any charitable trust is defeated if the organization for whose benefit the trust is created does not meet the federal guidelines of a charity. The first consideration in the creation of a charitable trust, therefore, is whether the intended beneficiary or beneficiaries qualifies to receive tax-deductible contributions. An individual can only deduct his or her contributions if they are made to a qualified organization. To become a qualified organization, most organizations – other than churches and governments – must apply to the IRS.

1. Types of Qualified Organizations

Generally, only the five following types of organizations can be qualified organizations:

- A community chest, corporation, trust, fund, or foundation organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). It must be organized and operated only for one or more of the following purposes: (a) religious, (b) charitable, (c) educational, (d) scientific, or (e) literary; or (f) the prevention of cruelty to animals. Certain organizations that foster national or international amateur sports competition also qualify;

- War veterans' organizations, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions; and

- Domestic fraternal societies, orders, and associations operating under the lodge system[1];

- Certain nonprofit cemetery companies or corporations[2]; and

- The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions[3].

Example 1.

Michael contributes cash to his city's police department to be used as a reward for information about a crime. The city police department is a qualified organization, and Michael's contribution is for a public purpose. He can deduct the contribution.

Example 2.

Cindy makes a voluntary contribution to the Social Security trust fund, not earmarked for a specific account. Because the trust fund is part of the U.S. Government, Cindy contributed to a qualified organization. She can deduct her contribution.

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[1] Note that an individual's contribution to this type of organization is deductible only if it is to be used solely for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

[2] A taxpayer's contribution to this type of organization is not deductible if it can be used for the care of a specific lot or mausoleum crypt.

[3] To be deductible, a taxpayer's contribution to this type of organization must be made solely for public purposes.

2. Sample Qualified Organizations

The following list gives some examples of qualified organizations:

- Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations;

- Most nonprofit charitable organizations such as the Red Cross and the United Way;

- Most nonprofit educational organizations, including the Boy (and Girl) Scouts of America, colleges, museums, and day-care centers if substantially all the child care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public. However, if an individual's contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution;

- Nonprofit hospitals and medical research organizations;

- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs;

- Nonprofit volunteer fire companies;

- Public parks and recreation facilities; and

- Civil defense organizations.

3. Canadian Charities

A taxpayer may be able to deduct contributions to certain Canadian charitable organizations covered under an income tax treaty with Canada. To deduct contributions to a Canadian charity, a taxpayer generally must have income from sources in Canada.

4. Mexican Charities

A taxpayer may be able to deduct contributions to certain Mexican charitable organizations under an income tax treaty with Mexico. The organization must meet tests that are essentially the same as the tests that qualify U.S. organizations to receive deductible contributions. The organization may be able to tell you if it meets these tests. In addition, to deduct a contribution to a Mexican charity, a taxpayer must have income from sources in Mexico.

5. Israeli Charities

A taxpayer may be able to deduct contributions to certain Israeli charitable organizations under an income tax treaty with Israel. To qualify for the deduction, the contribution must be made to an organization created and recognized as a charitable organization under the laws of Israel. The deduction will be allowed in the amount that would be allowed if

the organization was created under the laws of the United States, but is limited to 25% of the taxpayer's adjusted gross income from Israeli sources.

Table 11.1 Examples of Charitable Contributions

Deductible as Charitable Contributions		Not Deductible as Charitable Contributions	
Money or property given to:	**In-Kind or Other Contributions**	**Money or property given to:**	**In-Kind or Other Contributions**
churches, synagogues, temples, mosques or other religious organizations	expenses paid for a student living with you, sponsored by a qualified organization	civic leagues, social and sports clubs, labor unions and chambers of commerce	cost of raffle, bingo or lottery tickets
federal, state and local governments, provided the contribution is for a purely public purpose	out-of-pocket expenses when you serve a qualified organization as a volunteer	foreign organizations (except certain Canadian, Israeli and Mexican charities)	dues, fees or bills paid to country clubs, lodges, fraternal orders or similar groups
non-profit schools and hospitals		groups or organizations that are run for personal profit	tuition
public parks and recreation facilities		groups whose purpose is to lobby for changes to the law	value of your time of services performed for a charity
registered charities such as the Salvation Army, American Red Cross, United Way, etc.		homeowners' associations	value of blood given to a blood bank
		political groups or candidates for elective office	

B. DEDUCTIBLE CONTRIBUTIONS

Generally, a taxpayer can deduct the contributions of money or property that he or she makes to, or for the use of, a qualified organization. A gift or contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement. The contributions must be made to a qualified organization and not set aside for use by a specific person. If an individual gives property to a qualified organization, he or she can generally deduct the fair market value of the property at the time of the contribution.

A taxpayer's deduction for charitable contributions is generally limited to 50% of his or her adjusted gross income, but in some cases 20% and 30% limits may apply. In addition, the total of an individual's charitable contributions deduction and certain other itemized deductions may be limited.

1. Contributions From Which the Individual Benefits

If an individual receives a benefit as a result of making a contribution to a qualified organization, the individual can deduct only the amount of his or her contribution that is more than the value of the benefit he or she receives. If an individual pays more than fair market value to a qualified organization for merchandise, goods, or services, the amount paid that is more than the value of the item can be a charitable contribution. For the excess amount to qualify, the individual must pay it with the intent to make a charitable contribution.

Example 1.

Ralph pays $65 for a ticket from his charitable trust to a dinner-dance at a church. All the proceeds of the function go to the church. The ticket to the dinner-dance has a fair market value of $25. When Ralph buys his ticket, he knows that its value is less than his payment. To figure the amount of his charitable contribution, Ralph subtracts the value of the benefit he received ($25) from his total payment ($65). Ralph can deduct $40 as a charitable contribution to the church.

Example 2.

At a fund-raising auction conducted by a charity, Lauren pays $600 from her charitable trust for a week's stay at a beach house. The amount she pays is no more than the fair rental value. Lauren has not made a deductible charitable contribution from her trust.

2. Charity Benefit Events

If an individual pays a qualified organization more than fair market value for the right to attend a charity ball, banquet, show, sporting event, or other benefit event, he or she can deduct only the amount that is more than the value of the privileges or other benefits he or she receives.

If there is an established charge for the event, that charge is the value of the contributor's benefit. If there is no established charge, the contribution is that part of the individual's payment that is more than the reasonable value of the right to attend the event. Whether the tickets are used or not has no effect on the amount the donor can deduct. However, if the individual returns the tickets to the qualified organization for resale, the individual can deduct the entire amount he or she paid for the ticket.

Example.

Michael pays $40 from his charitable trust to see a special showing of a movie for the benefit of a qualified organization. Printed on the ticket is "Contribution – $40." If the regular price for the movie is $8, his contribution is $32 ($40 payment – $8 regular price).

C. NON-DEDUCTIBLE CONTRIBUTIONS

There are some contributions that are not deductible or that are only partially deductible. Making a non-deductible contribution from a charitable trust can have negative tax implications. It is therefore important to understand what contributions are allowed. The following are examples of contributions that are not considered charitable:

- A contribution to a specific individual;
- A contribution to a nonqualified organization;
- The part of a contribution from which you receive or expect to receive a benefit;
- The value of your time or services;
- The donor's personal expenses;
- Appraisal fees; or
- Certain contributions of partial interests in property.

1. Contributions to Individuals

An individual cannot deduct contributions to specific individuals, including:

- Contributions to fraternal societies made for the purpose of paying medical or burial expenses of deceased members;
- Contributions to individuals who are needy or worthy. This includes contributions to a qualified organization if the donor indicates that his or her contribution is for a specific person. But an individual can deduct a contribution that he or she gives to a qualified organization that in turn helps needy or worthy individuals if the donor does not indicate that the contribution is for a specific person. For example, an individual can deduct contributions earmarked for flood relief, hurricane relief, or other disaster relief to a qualified organization. However, an individual cannot deduct contributions earmarked for relief of a particular individual or family.

Example.

In the wake of Hurricane Katrina, William donated from his charitable trust $500 to a family he knew in the devastated area to help pay for food and shelter. William also donated $1,500 to the American Red Cross to help hurricane victims. While the latter donation is a charitable donation, the first one, as it was provided to a specific family, is not.

- Payments to a member of the clergy that can be spent as he or she wishes, such as for personal expenses;

- Expenses an individual pays for another person who provided services to a qualified organization; and

Example.

Roger's son, Mason, performs missionary work for a local church. Roger cannot claim as a charitable deduction expenses he pays for his son's food and lodging while performing work for the church.

- Payments to a hospital that are for a specific patient's care or for services for a specific patient. Individuals cannot deduct these payments even if the hospital is operated by a city, state, or other qualified organization.

2. Contributions to Nonqualified Organizations

Individuals cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions, including the following.

- Certain state bar associations if:
    - The state bar is not a political subdivision of a state,
    - The bar has private, as well as public, purposes, such as promoting the professional interests of members, and
    - The contribution is unrestricted and can be used for private purposes;

- Chambers of commerce and other business leagues or organizations;

- Civic leagues and associations;

- Communist organizations;

- Country clubs and other social clubs;

- Foreign organizations other than a U.S. organization that transfers funds to a charitable foreign organization if the U.S. organization controls the use of the funds or if the foreign organization is only an administrative arm of the U.S. organization, or certain Canadian, Israeli, or Mexican charitable organizations;

- Homeowners' associations;

- Labor unions; or

- Political organizations and candidates.

3. Contributions From Which the Donor Benefits

If a donor receives or expects to receive a financial or economic benefit as a result of making a contribution to a qualified organization, the donor cannot deduct the part of the contribution that represents the value of the benefit he or she receives. These contributions include:

- Contributions for lobbying. This includes amounts that are earmarked for use in, or in connection with, influencing specific legislation;

- Contributions to a retirement home that are clearly for room, board, maintenance, or admittance. Also, if the amount of the contribution depends on the type or size of apartment the donor will occupy, it is not a charitable contribution;

- Costs of raffles, bingo, lottery, etc. An individual cannot deduct as a charitable contribution amounts paid to buy raffle or lottery tickets or to play bingo or other games of chance;

- Dues to fraternal orders and similar groups;

- Tuition, or amounts paid instead of tuition, even if the donor pays them for children to attend parochial schools or qualifying nonprofit day-care centers. Individuals also cannot deduct any fixed amount that they may be required to pay in addition to the tuition fee to enroll in a private school, even if it is designated as a “donation”;

- Contributions connected with split-dollar insurance arrangements. An individual cannot deduct any part of a contribution to a charitable organization if, in connection with the contribution, the organization directly or indirectly pays, has paid, or is expected to pay any premium on any life insurance, annuity, or endowment contract for which the donor, any member of the donor’s family or any other person chosen by the donor (other than a qualified charitable organization) is a beneficiary.

Example.

Rollie donates money to a charitable organization. The charity uses the money to purchase a cash value life insurance policy. The beneficiaries under the insurance policy include members of Rollie's family. Even though the charity may eventually get some benefit out of the insurance policy, Rollie cannot deduct any part of the donation.

4. Value of Time or Services

Individuals generally cannot deduct the value of their time or services, including:

- Blood donations to the Red Cross or to blood banks; and
- The value of income lost while the individual worked as an unpaid volunteer for a qualified organization.

5. Personal Expenses

An individual cannot deduct personal, living, or family expenses, such as the following items:

- The cost of meals the individual eats while they perform services for a qualified organization, unless it is necessary for the individual to be away from home overnight while performing the services; or
- Adoption expenses, including fees paid to an adoption agency and the costs of keeping a child in the individual's home before adoption is final. However, an individual may be able to claim a tax credit for these expenses.

6. Appraisal Fees

Fees that an individual pays to find the fair market value of donated property are not deductible as contributions. An individual can claim them, subject to the 2%-of-adjusted-gross-income limit, as a miscellaneous itemized deduction on Schedule A (Form 1040).

7. Partial Interest in Property

Generally, an individual cannot deduct a contribution of less than the individual's entire interest in property.

8. Contributions of Property

If an individual contributes property to a qualified organization, the amount of the charitable contribution is generally the fair market value of the property at the time of the contribution. However, if the property has increased in value, the donor may have to make some adjustments to the amount of his or her deduction.

9. Contributions Subject to Special Rules

It is important to remember that special rules apply if an individual contributes any of the following:

- Property subject to a debt;
- A partial interest in property;
- A future interest in tangible personal property; or
- Inventory from his or her business.

a. Property subject to a debt.

If an individual contributes property subject to a debt (such as a mortgage), he or she must reduce the fair market value of the property by any allowable deduction for interest that the individual paid (or will pay) attributable to any period after the contribution, and, if the property is a bond, the lesser of: (1) any allowable deduction for interest the individual paid (or will pay) to buy or carry the bond that is attributable to any period before the contribution, or (2) the interest, including bond discount, receivable on the bond that is attributable to any period before the contribution, and that is not includible in the individual's income due to his or her accounting method. This prevents a double deduction of the same amount as investment interest and also as a charitable contribution.

If the debt is assumed by the recipient (or another person), the individual must also reduce the fair market value of the property by the amount of the outstanding debt. If the individual sold the property to a qualified organization at a bargain price, the amount of the debt is also treated as an amount realized on the sale or exchange of property.

b. Partial interest in property.

Generally, an individual cannot deduct a charitable contribution (not made by a transfer in trust) of less than his or her entire interest in property.

c. Right to use property.

A contribution of the right to use property is a contribution of less than the donor's entire interest in that property and is not deductible.

Example 1.

Lester owns a 10-story office building and donates rent-free use of the top floor to a charitable organization. Since Lester still owns the building, the trust has contributed a partial interest in the property and cannot take a deduction for the contribution.

Example 2.

Mandy White owns a vacation home at the beach that she sometimes rents to others. For a fund-raising auction at her church, she donated the right to use the vacation home for 1 week. At the auction, the church received and accepted a bid from Lauren Green equal to the fair rental value of the home for 1 week. Mandy cannot claim a deduction because of the partial interest rule. Lauren cannot claim a deduction either, because she received a benefit equal to the amount of her payment.

There is an exception that allows an individual to deduct a charitable contribution of a partial interest in property only if that interest represents one of the following listed items:

- A remainder interest in the individual's personal home or farm. A remainder interest is one that passes to a beneficiary after the end of an earlier interest in the property;
- An undivided part of the donor's entire interest. This must consist of a part of every substantial interest or right he or she owns in the property and must last as long as the donor's interest in the property lasts;
- A partial interest that would be deductible if transferred in trust; or
- A qualified conservation contribution (defined under *Qualified conservation contribution* in IRS Publication 561).

Example 1.

Monty keeps the right to live in his home during his lifetime and gives his church a remainder interest that begins upon his death. This is a remainder interest.

Example 2.

Lucinda contributes voting stock to a qualified organization but keeps the right to vote the stock. The right to vote is a substantial right in the stock. Lucinda has not contributed an undivided part of her entire interest and cannot deduct the contribution.

d. Future interest in tangible personal property.

An individual can deduct the value of a charitable contribution of a future interest in tangible personal property only after all intervening interests in and rights to the actual possession or enjoyment of the property have either expired or been turned over to someone other than the donor, a related person, or a related organization. Related persons include the donor's spouse, children, grandchildren, brothers, sisters, and parents. Related organizations may include a partnership or corporation that the donor has an interest in, or an estate or trust that the donor has a connection with.

Tangible personal property is any property, other than land or buildings, that can be seen or touched. It includes furniture, books, jewelry, paintings, and cars. A future interest is any interest that is to begin at some future time, regardless of whether it is designated as a future interest under state law.

Example.

Margaret owns an antique car that she contributes to a museum. She gives up ownership, but retains the right to keep the car in her garage with her personal collection. Since Margaret retains an interest in the property, she cannot deduct the contribution. If she turns the car over to the museum in a later year, giving up all rights to its use, possession, and enjoyment, she can take a deduction for the contribution in that later year.

e. Inventory.

If an individual contributes inventory (property that the donor sells in the course of his or her business), the amount the donor can claim as a contribution deduction is the smaller of its fair market value on the day it is contributed or its basis. The basis of donated inventory is any cost incurred for the inventory in an earlier year that the donor would otherwise include in the donor's opening inventory for the year of the contribution. The donor must remove the amount of his or her contribution deduction from his or her opening inventory. It is not part of the cost of goods sold.

If the cost of donated inventory is not included in the donor's opening inventory, the inventory's basis is zero and the individual cannot claim a charitable contribution deduction. A donor should treat the inventory's cost as he or she would ordinarily treat it under his or her method of accounting. For example, include the purchase price of inventory bought and donated in the same year in the cost of goods sold for that year.

III. Giving Through Charitable Trusts

Nonexempt charitable and charitable remainder trusts are two common trust vehicles used to make distributions to the charitable sector. A nonexempt charitable trust is one that designates all of its interests, or beneficiaries, as charitable. With few exceptions, all of its financial outlays are distributed for charitable purposes. Charitable contributions are made annually until all of the trust's assets and income have been expended. A charitable remainder trust is a type of "split-interest trust" – so-called because its interests are both charitable and noncharitable. Charitable remainder trusts are complex trusts that pay a lifetime interest to noncharitable beneficiaries and a remainder interest to a designated charitable organization. Each of these topics is discussed in more detail below.

A. CHARITABLE TRUSTS: IN GENERAL

1. Duration

In most cases, a trust lasts only a limited amount of time. The major exception to this rule is charitable trusts, which, in theory, can be created to last indefinitely.

2. Tax Consequences

A charitable gift is 100% tax deductible. Thus, the giving of a charitable gift saves both the amount of the gift in income from the donors other income sources as well as the extinction of the tax that would have been owed had the donor retained the charitable sum in his or her estate.

3. Charitable Purposes

A charitable trust must have a valid charitable purpose. States have adopted legislation requiring the trustee of a charitable trust to file documentation regarding the trust with the state. Likewise, the statutes generally require the trustee file periodic statements of the transactions of the trust.

4. Cy Pres Doctrine

With respect to most trusts, human greed assures the fulfillment of the trust. However, when charitable trusts are involved, there are generally no identifiable beneficiaries. The Cy Pres Doctrine allows the Attorney General of the state to prosecute the enforcement of the trust. In order for the Cy Pres Doctrine to apply, three conditions must be met:

- The gift must be to a charitable organization for a charitable purpose;
- The gift must be impossible, impractical or illegal to carry out the donor's stated charitable purpose; and
- It must appear that the donor had a *general* charitable intent as opposed to a specific charitable intent.

All states have a *cy pres* law, either in common law or adopted in statute. Maryland, for example, has adopted a statutory *cy pres* provision in § 14-302, Estates and Trusts Article. It provides as follows:

(a) If a trust for charity is or becomes illegal, or impossible or impracticable of enforcement or if a devise or bequest for charity, at the time it was intended to become effective, is illegal, or impossible or impracticable of enforcement, and if the settler or testator manifested a general intention to devote the property to charity, a court of equity, on application of any trustee, or any interested person, or the Attorney General of the state, may order an administration of the trust, devise or bequest as nearly as possible to fulfill the generally charitable intention of the settler or testator.

(b) This section shall be interpreted and construed to effectuate its general purpose to make uniform the law of those states which enacted it.

(c) This section may be cited as the Maryland Uniform Charitable Trusts Administration Act.

B. CHARITABLE REMAINDER TRUSTS

A charitable remainder trust is an arrangement in which a donor irrevocably places money or property with a trustee, such as The American Cancer Society, with instructions to pay income to the donor or other chosen beneficiaries, generally for life. The income is a fixed amount or a fixed percentage of the trust's value. When all persons receiving the income die the property remaining, the "remainder," passes to the American Cancer Society.

There are two types of charitable remainder trusts – annuity trusts and unitrusts. Both annuity trusts and unitrusts pay a fixed percentage that is between 5 and 50 percent of the fair market value of trust assets. Payments must be made annually to one or more noncharitable beneficiaries. For annuity trusts, the amount to be paid is based on the fair market value of the assets initially placed in trust, while for unitrusts the payment is based on the net fair market value of assets as valued annually. When a specified triggering event occurs, such as the death of the donor or non-charitable beneficiary, the trust ceases to exist and its remaining assets are transferred to a specific charity. While the precise amount that the charity receives cannot be determined until the expiration of the trust, the Internal Revenue Code states that the amount transferred to the charity must be at least 10 percent of the fair market value of the assets initially placed in the trust. The donor receives a tax deduction when the trust is created based on the estimated amount that will be donated to charity in the future.

1. Establishing a CRT

Documents establishing a charitable remainder trust (CRT) must be carefully prepared to satisfy the requirements set by applicable portions of the Internal Revenue Code and Regulations. As a split-interest trust (see the discussion below), the trustee has complete financial management responsibility for the donor's property placed in a CRT. Generally, the trust must qualify as an annuity trust, a unitrust, or a pooled income fund. The donor retains an income interest for which he, she, or they receive income payments for a period that generally cannot exceed 20 years, or the remaining lifetime of the income beneficiaries. The charity receives the remainder interest upon termination of the income beneficiary's life interest in the trust assets – usually this occurs upon the death of the beneficiary or beneficiaries.

2. Valuing Donation for Tax Purposes

Starting with the tax year the CRT is established, the value of the remainder interest qualifies as a charitable gift deduction for purposes of the donor's income tax return. This deduction is subject to the 30-percent rule or the 50-percent rules discussed earlier as applicable according to the nature of the charity receiving the remainder interest. Excess contributions can be carried forward to the donor's income tax returns for up to five years. Any unused charitable deduction lapses at the end of the fifth tax year after the year the trust is established.

The amount of the tax-deductible remainder interest is determined from tables in the Internal Revenue Service Publication 1457. Primary determining factors are the age of the income beneficiary or beneficiaries at the time income payments start, the applicable federal interest rate, and the qualification of the trust as an annuity trust, a unitrust, or a pooled income fund. Generally, the size of the remainder interest increases with the age of the beneficiary at the time income payments are to start. For a given age at the time income payments start, the size of the remainder interest is greater when the applicable federal interest rate is lower. When they have data on the type, amount, timing, recipient, and income beneficiary of a proposed gift, your legal and tax advisers can use Publication 1457 tables to provide you with an estimate of the remainder interest value for tax purposes.

Assets placed in a CRT meeting annuity trust or unitrust requirements are not included in the donor's estate for gift or estate tax purposes. If the donor's spouse is an annuity beneficiary, there are no adverse gift or estate tax consequences upon the death of the spouse. The trust assets are included in the spouse's estate and also are deductible from that estate as a charitable gift.

Income earned by an annuity trust or a unitrust CRT is not subject to income tax unless the CRT has business taxable income not related to the charity beneficiary. Payments from the CRT to the annuity beneficiary generally are taxable as ordinary income or capital gain income (short-term or long-term depending on the circumstances). If annuity payments to the donor exceed the earning capacity of the assets in the CRT, part of the payment may be nontaxable distribution of the corpus of the trust. There are numerous other specific aspects of charitable giving using a CRT that may or may not be important depending on each individual’s situation.

C. SPLIT INTEREST TRUSTS

Split-interest trusts make distributions to both charitable and noncharitable beneficiaries, while providing tax benefits to their donor. Based on the method and timing of distributions, split-interest trusts are divided into the following four categories:

- Charitable remainder annuity trusts;
- Charitable remainder unitrusts;
- Charitable lead trusts; and
- Pooled income funds.

1. Charitable Remainder Annuity Trusts

This type of trust distributes income in a series of fixed payments to one or more noncharitable beneficiaries for a defined period of time, after which the remaining value of the trust is transferred to a charitable beneficiary.

2. <u>Charitable Remainder Unitrusts</u>

This type of trust distributes a percentage of the fair market value to one or more noncharitable beneficiaries for a defined period of time, after which the remaining value of the trust is transferred to a charitable beneficiary.

3. <u>Charitable Lead Trust</u>

This type of trust distributes a sequence of payments to a charitable beneficiary for a period of time, after which the remaining trust assets are transferred to a noncharitable beneficiary.

4. <u>Pooled Income Funds</u>

These funds allow donors to donate assets to a charity. The pooled assets are invested as a group and each donor receives income based on the ratio of his or her contribution to the total value of the investment pool. After the death of the donor, his or her prorated share of the investment pool is withdrawn and given to the charitable organization.

5. <u>Treatment After Expiration of Non-Charitable Interests</u>

A split-interest trust in which all of the unexpired interests are charitable remainder interests and in which some or all of the charitable beneficiaries are not entitled to distributions of corpus will continue to be treated as a split-interest trust for a reasonable period of settlement after the expiration of the noncharitable interest. A split-interest trust that under its terms is to continue to hold assets for charitable beneficiaries after the expiration of the noncharitable interest rather than distributing them is allowed a reasonable period of time for settlement before being treated as a charitable trust.

A reasonable period of settlement is that period reasonably required (or if shorter, actually required) by the trustee of a split-interest trust to perform the ordinary duties of administration necessary for the settlement of the trust. For example, these duties include the collection of assets, the payment of debts, taxes, and distributions, and the determination of the rights of the subsequent beneficiaries.

> **Example**.
>
> *On January 15, 2004, Cyril Elmwood created a charitable remainder annuity trust under which the trustees were required to distribute $10,000 a year to Betty, Cyril's wife, for life and to hold the remainder in trust for the use of M, an organization described in § 501(c)(3). Cyril was allowed a deduction for the amount of the charitable interest, and the trust was treated as a split-interest trust from the date of its creation. Betty died on February 10, 2009. On April 15, 2009, the trustees completed the ordinary duties of administration necessary for the settlement of the trust brought about by Betty's death. These duties include, for example, an accounting for and payment to Betty's estate of amounts accrued by Betty while alive during 2009. However, the trustees did not distribute the corpus to M by April 15, 2009. The trust would continue to be treated as a split-interest trust until April 15, 2009. After April 15, 2009, the trust would be treated as a charitable trust.*

6. Distribution of All Assets

If an estate, from which the executor or administrator is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries, is considered terminated for federal income tax purposes, then the estate will be treated as a split-interest trust or charitable trust (if applicable) between the date on which the estate is considered terminated and the date on which final distribution of the net assets to the last remaining charitable beneficiary is made. This does not affect the determination of the tax liability of either charitable or noncharitable beneficiaries of the estates.

> ***Example***.
>
> *Henry Post died on January 15, 2004, and bequeathed $10,000 to M, an organization described in section 501 (c)(3), and the remainder of his estate to Wilma, his wife. A deduction for the charitable bequest was allowed to Henry's estate. Substantially all of Henry's estate consisted of 100% of the stock of a wholly owned corporation, certain liquid assets such as marketable stocks and securities and bank accounts, and Henry's home, automobile, and other personal property. Henry's will gave his executor a full range of powers, including the power to sell the stock. After Henry's death, his executor continued to manage the wholly owned corporation while attempting to sell the stock of the corporation.*
>
> *During this period, the executor made no distributions to M. On May 24, 2009, the Internal Revenue Service determined that the administration of the estate has been unnecessarily prolonged and the estate is considered terminated as of that date for federal income tax purposes. Henry's estate will be treated as a split-interest trust between May 24, 2009, and the date on which the $10,000 bequest to M is satisfied. Henry's estate will be subject to the private foundation provisions that apply during that period. For example, a sale of the house by the estate to any disqualified person would be an act of self-dealing.*

7. Filing Requirements

Each year, nonexempt charitable and charitable remainder trusts must provide information regarding their charitable activities to the IRS on an information return, using Form 990-PF and Form 5227, respectively. While these returns are not used to determine or pay income tax, they must be filed annually to provide financial data, information on charitable contributions, and various other items. Some nonexempt charitable and charitable remainder trusts may be required to file an income tax return, Form 1041, in addition to the required information return.

a. Form 990-PF

While some charitable trusts receive a large degree of public support and operate much like public charities, most are treated as private foundations and are, therefore, subject to the private foundation filing requirements. Most nonexempt charitable trusts are required to file Form 990-PF, *Return of Private Foundation (or § 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation).* This information return is used by

nonexempt charitable trusts and private foundations to provide information regarding their charitable operations, determine their taxable participation in political or lobbying activities, and calculate the excise tax on net investment income.

Additionally, private foundations and charitable trusts report their charitable outlays on this form in order to determine whether or not they have met the annual "payout" requirement. Nonexempt charitable trusts that distribute all of their income for charitable purposes and, therefore, have no taxable income for a given year are required to file this form only.

b. Form 5227

Form 5227, *Split-Interest Trust Information Return*, is filed annually by all split-interest trusts classified under § 4947(a)(2) of the Internal Revenue Code. The return is used to report financial activity within a given calendar year and to determine if a trust is treated as a private foundation and, therefore, subject to the excise tax. Three main types of trusts file Form 5227: (1) charitable lead trusts, (2) charitable remainder trusts, and (3) pooled income funds classified in § 642(c)(5).

Charitable remainder trusts are the only type of split-interest trust that is required to indicate if any unrelated business income was earned during the tax year.

c. Form 1041

In order to report income and determine tax liability for estates and trusts, their managers, also known as fiduciaries, file Form 1041, *U.S. Income Tax Return for Estates and Trusts*. This form is used to report income and deductions of an estate or trust, including any income that is distributed to beneficiaries, charitable or noncharitable. Income, deductions, and tax liability, as well as any applicable payments or credits are reported on the return. A fiduciary must file Form 1041 for a domestic estate or trust that meets specific income or beneficiary requirements. The form is filed by nonexempt charitable and split-interest trusts and five additional types of entities. Nonexempt charitable trusts with taxable income and charitable remainder trusts with unrelated business income for a given year are required to file this form to report all income and pay any income tax due.

D. CHARITABLE ANNUITY

Charitable annuities are offered by many charitable organizations. In using this form of charitable giving, the owner of the assets transfers (donates) them to the charity and the charity agrees to pay the donor or other beneficiary (beneficiaries) a lifetime annuity. The present value of the annuity contract is calculated using Internal Revenue Service tables and varies with the age of the donor and the applicable federal interest rate. A portion of each annuity payment received by the donor is taxable income. The remainder is a nontaxable return of assets.

If the fair market value of assets donated to the charity is greater than the present value of the annuity contract, the donor receives an immediate charitable deduction equivalent to the difference. If the value of the annuity contract exceeds the fair market value of the donated assets, there will be a taxable gain to the donor – a taxable gain that can be avoided by using a charitable remainder trust instead of a charitable annuity.

If the charity has an established charitable annuity program, the donation and establishment of the annuity are easily accomplished. Donors are attracted to charitable annuities when the fair market value of the donation will exceed the value of the annuity contract and the donor is receiving significant levels of taxable income. The certainty of lifetime income in combination with an immediate tax deduction make the charitable annuity particularly attractive.

In circumstances where it is likely that a surviving spouse will be unable or unwilling to manage family assets, a charitable annuity or a charitable remainder trust can be a means of ensuring an income stream throughout the remainder of the lifetime of the annuity beneficiary or beneficiaries.

E. NOTE ON PRIVATE FOUNDATIONS

Nonexempt charitable and split-interest trusts are distinguished under regulation from certain types of organizations deemed tax-exempt by virtue of their charitable activities under Internal Revenue Code § 501(c)(3). The majority of § 501(c)(3) organizations are defined, for tax purposes, as public charities, meaning that they are largely controlled and supported by a variety of sources within the general public.

Another type of § 501(c)(3) organization is the private foundation, which resembles a public charity in that its mission is exclusively charitable, but differs in that it is narrowly supported and controlled by an individual, corporation, or family. Since private foundations have less inherent accountability to the general public than charities, they were thought to provide more opportunities for individuals wishing to engage in tax-avoidance schemes and thus required additional oversight.

Prior to 1969, however, little legislation had been enacted to deter charitable organizations from engaging in abusive practices. With the Tax Reform Act of 1969 (TRA69), Congress addressed problems within the charitable sector by developing a new set of rules and definitions for charitable giving. Specifically, the legislation created stricter tax requirements for private foundations to meet in exchange for their tax-exempt status.

TRA69 introduced some noteworthy tax legislation, including an annual excise tax on the income that private foundations receive solely from investment assets, known as net investment income, and a requirement to distribute a minimum amount each year or face a tax penalty. Section 4947 was added to ensure that private foundations could not intentionally avoid the new requirements by organizing as nonexempt (or taxable) "charitable trusts" and take advantage of the unlimited charitable deduction made available to charitable trusts in order to avoid all tax liability. Section 4947(a)(1) required that nonexempt charitable trusts be subject to the same rules as those private foundations or, in fewer cases, public charities, described under § 501(c)(3). Additionally, split interest trusts were defined for the first time in § 4947(a)(2). Although some of these trusts were made subject to the private foundation requirements, those organized as charitable remainder trusts were excluded from § 4947 requirements and granted tax exemption under § 664.

Nonexempt charitable and charitable remainder trusts may be subject to certain income tax requirements. Because not all of the income reported by nonexempt charitable and charitable remainder trusts is collected and distributed for charitable purposes, certain

income is reported and taxed each year. Since a nonexempt charitable trust is not, by definition, tax-exempt, any income it receives and does not subsequently distribute for charitable purposes is taxable under Subtitle A, regardless of the source. In contrast, a tax-exempt charitable remainder trust incurs tax liability only on unrelated business income – income received from an activity that constitutes a trade or business that is regularly carried on and is not substantially related to the organization's exempt purpose.

IV. <u>Sample Trusts</u>

The following sample trusts are published by the Internal Revenue Service.

A. SAMPLE INTER VIVOS CHARITABLE REMAINDER UNITRUST — ONE LIFE

The following document is a sample declaration of trust for an inter vivos CRUT with one measuring life that is created by an individual who is a citizen or resident of the United States.

On this ______ day of ______, 20___, I, ________ (hereinafter “the Donor”), desiring to establish a charitable remainder unitrust within the meaning of Rev. Proc. 2005-52 and § 664(d)(2) of the Internal Revenue Code (hereinafter “the Code”), hereby enter into this trust agreement with _______ as the initial trustee (hereinafter “the Trustee”). This trust shall be known as the ___________ Charitable Remainder Unitrust.

1. *Funding of Trust*. The Donor hereby transfers and irrevocably assigns, on the above date, to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property, and any property subsequently transferred, under the terms set forth in this trust instrument.

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to [*permissible recipient*] (hereinafter “the Recipient”) a unitrust amount equal to [*a number no less than 5 and no more than 50*] percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter “the valuation date”). The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Recipient’s death. The unitrust amount shall be paid in equal quarterly installments at the end of each calendar quarter from income and, to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the correct value is finally determined, the Trustee shall pay to the Recipient (in the case of an undervaluation) or receive from the Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.

3. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in paragraph 2, or, if an additional contribution is made to the trust, the unitrust amount described in paragraph 5.

4. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient under the terms of this trust) to [*designated remainderman*] (hereinafter "the Charitable Organization"). If the Charitable Organization is not an organization described in §§ 170(c), 2055(a), and 2522(a) of the Code at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in §§ 170(c), 2055(a), and 2522(a) of the Code as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

5. *Additional Contributions*. If any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be [*same percentage used in paragraph 2*] percent of the sum of (a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day in such taxable year or the last day of the unitrust period. In a taxable year in which an additional contribution is made on or after the valuation date, the assets so added shall be valued as of the date of contribution, without regard to any post-contribution income or appreciation, rather than as of the valuation date.

6. *Deferral of the Unitrust Payment Allocable to Testamentary Transfer*. All property passing to the trust by reason of the death of the Donor (hereinafter "the testamentary transfer") shall be considered to be a single contribution that is made on the date of the Donor's death. Notwithstanding the provisions of paragraphs 2 and 5 above, the obligation to pay the unitrust amount with respect to the testamentary transfer shall commence with the date of the Donor's death. Nevertheless, payment of the unitrust amount with respect to the testamentary transfer may be deferred from the date of the Donor's death until the end of the taxable year in which the funding of the testamentary transfer is completed. Within a reasonable time after the end of the taxable year in which the testamentary transfer is completed, the Trustee must pay to the Recipient (in the case of an underpayment) or receive from the Recipient (in the case of an overpayment) the difference between any unitrust amounts allocable to the testamentary transfer that were actually paid, plus interest, and the unitrust amounts allocable to the testamentary transfer that were payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under § 664 of the Code prescribe for this computation.

7. *Unmarketable Assets*. Whenever the value of a trust asset must be determined, the Trustee shall determine the value of any assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents (hereinafter "unmarketable assets"), by either (a) obtaining a current "qualified appraisal" from a "qualified appraiser," as defined in § 1.170A-13(c)(3) and § 1.170A-13(c)(5) of the Income Tax Regulations, respectively, or (b) ensuring the valuation of these

unmarketable assets is performed exclusively by an “independent trustee,” within the meaning of § 1.664-1(a)(7)(iii) of the Income Tax Regulations.

8. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of § 4941(d) of the Code, as modified by § 4947(a)(2)(A) of the Code, and shall not make any taxable expenditures within the meaning of § 4945(d) of the Code, as modified by § 4947(a)(2)(A) of the Code.

9. *Taxable Year*. The taxable year of the trust shall be the calendar year.

10. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _______. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder unitrust under § 664(d)(2) of the Code and the corresponding regulations.

11. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder unitrust within the meaning of § 664(d)(2) of the Code.

12. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

13. *Definition of Recipient*. References to the Recipient in this trust instrument shall be deemed to include the estate of the Recipient with regard to all provisions in this trust instrument that describe amounts payable to and/or due from the Recipient. The prior sentence shall not apply to the determination of the last day of the unitrust period.

B. SAMPLE INTER VIVOS CHARITABLE REMAINDER UNITRUST — TWO LIVES, CONCURRENT AND CONSECUTIVE INTERESTS

The following document is a sample declaration of trust for an inter vivos CRUT having consecutive unitrust interests for two measuring lives that is created by an individual who is a citizen or resident of the United States.

On this ______ day of _______, 20___, I, ___________ (hereinafter “the Donor”), desiring to establish a charitable remainder unitrust within the meaning of Rev. Proc. 2005-55 and § 664(d)(2) of the Internal Revenue Code (hereinafter “the Code”), hereby enter into this trust agreement with __________ as the initial trustee (hereinafter “the Trustee”). This trust shall be known as the ___________ Charitable Remainder Unitrust.

1. *Funding of Trust*. The Donor hereby transfers and irrevocably assigns, on the above date, to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property, and any property subsequently transferred, under the terms set forth in this trust instrument.

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to [*permissible recipient*] and to [*permissible recipient*] (hereinafter “the Recipients”) in equal shares during their joint lives, a unitrust amount equal to [*a number no less than 5 and no more than 50*] percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter “the valuation date”) and, upon the death of one (hereinafter “the Predeceasing Recipient”), the Trustee shall pay the entire unitrust amount to the survivor (hereinafter “the Survivor Recipient”). The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient’s death. The unitrust amount shall be paid in equal quarterly installments at the end of each calendar quarter from income and, to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the correct value is finally determined, the Trustee shall pay to the Predeceasing Recipient and/or the Survivor Recipient (in the case of an undervaluation) or receive from the Predeceasing Recipient and/or the Survivor Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.

3. *Payment of Federal Estate Taxes and State Death Taxes*. The lifetime unitrust interest of the Survivor Recipient will take effect upon the death of the Predeceasing Recipient only if the Survivor Recipient furnishes the funds for payment of any federal estate taxes and state death taxes for which the Trustee may be liable upon the death of the Predeceasing Recipient. If the funds are not furnished by the Survivor Recipient, the unitrust period shall terminate on the death of the Predeceasing Recipient, notwithstanding any other provision in this instrument to the contrary.

4. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in paragraph 2, or, if an additional contribution is made to the trust, the unitrust amount described in paragraph 6. Upon the death of the Predeceasing Recipient, the Trustee shall prorate on a daily basis the next regular unitrust payment due after the death of the Predeceasing Recipient between the estate of the Predeceasing Recipient and the Survivor Recipient.

5. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Predeceasing Recipient and/or the Survivor Recipient under the terms of this trust) to [*designated remainderman*] (hereinafter “the Charitable Organization”). If the Charitable Organization is not an organization described in §§ 170(c), 2055(a), and 2522(a) of the Code at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in §§ 170(c), 2055(a), and 2522(a) of the Code as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee’s sole discretion.

6. *Additional Contributions*. If any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be [*same percentage used in paragraph 2*] percent of the sum of (a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during

that year) and (b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day in such taxable year or the last day of the unitrust period. In a taxable year in which an additional contribution is made on or after the valuation date, the assets so added shall be valued as of the date of contribution, without regard to any post-contribution income or appreciation, rather than as of the valuation date.

7. *Deferral of the Unitrust Payment Allocable to Testamentary Transfer*. All property passing to the trust by reason of the death of the Donor (hereinafter "the testamentary transfer") shall be considered to be a single contribution that is made on the date of the Donor's death. Notwithstanding the provisions of paragraphs 2 and 6 above, the obligation to pay the unitrust amount with respect to the testamentary transfer shall commence with the date of the Donor's death. Nevertheless, payment of the unitrust amount with respect to the testamentary transfer may be deferred from the date of the Donor's death until the end of the taxable year in which the funding of the testamentary transfer is completed. Within a reasonable time after the end of the taxable year in which the testamentary transfer is completed, the Trustee must pay to the Predeceasing Recipient and/or the Survivor Recipient (in the case of an underpayment) or receive from the Predeceasing Recipient and/or the Survivor Recipient (in the case of an overpayment) the difference between any unitrust amounts allocable to the testamentary transfer that were actually paid, plus interest, and the unitrust amounts allocable to the testamentary transfer that were payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under § 664 of the Code prescribe for this computation.

8. *Unmarketable Assets*. Whenever the value of a trust asset must be determined, the Trustee shall determine the value of any assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents (hereinafter "unmarketable assets"), by either (a) obtaining a current "qualified appraisal" from a "qualified appraiser," as defined in § 1.170A-13(c)(3) and § 1.170A-13(c)(5) of the Income Tax Regulations, respectively, or (b) ensuring the valuation of these unmarketable assets is performed exclusively by an "independent trustee," within the meaning of § 1.664-1(a)(7)(iii) of the Income Tax Regulations.

9. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of § 4941(d) of the Code, as modified by § 4947(a)(2)(A) of the Code, and shall not make any taxable expenditures within the meaning of § 4945(d) of the Code, as modified by § 4947(a)(2)(A) of the Code.

10. *Taxable Year*. The taxable year of the trust shall be the calendar year.

11. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _______. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder unitrust under § 664(d)(2) of the Code and the corresponding regulations.

12. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder unitrust within the meaning of § 664(d)(2) of the Code.

13. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

14. *Definition of Predeceasing Recipient and Survivor Recipient*. References to the Predeceasing Recipient and/or the Survivor Recipient in this trust instrument shall be deemed to include the estate of the Predeceasing Recipient and/or the Survivor Recipient with regard to all provisions in this trust instrument that describe amounts payable to and/or due from the Predeceasing Recipient and/or the Survivor Recipient. The prior sentence shall not apply to the determination of the last day of the unitrust period.

C. SAMPLE TESTAMENTARY CHARITABLE REMAINDER UNITRUST — TERM OF YEARS

The following document is a sample declaration of trust for a testamentary CRUT that is created by an individual who is a citizen or resident of the United States and that provides for a term of years unitrust period.

I give, devise, and bequeath [*property bequeathed*] to my Trustee in trust to be administered under this provision. I intend this bequest to establish a charitable remainder unitrust, within the meaning of Rev. Proc. 2005-57 and § 664(d)(2) of the Internal Revenue Code (hereinafter "the Code"). The trust shall be known as the ________ Charitable Remainder Unitrust and I hereby designate ________ as the initial trustee (hereinafter "the Trustee").

1. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to [*permissible recipient*] (hereinafter "the Recipient") a unitrust amount equal to [*a number no less than 5 and no more than 50*] percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date"). The unitrust period shall be a period of [*a number not more than 20*] years. The first day of the unitrust period shall be the date of my death and the last day of the unitrust period shall be the day preceding the [*ordinal number corresponding to the length of the unitrust period*] anniversary of that date. The unitrust amount shall be paid in equal quarterly installments at the end of each calendar quarter from income and, to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the correct value is finally determined, the Trustee shall pay to the Recipient (in the case of an undervaluation) or receive from the Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.

2. *Deferral Provision*. The obligation to pay the unitrust amount shall commence with the date of my death, but payment of the unitrust amount may be deferred from this date until the end of the taxable year in which the trust is completely funded. Within a reasonable time after the end of the taxable year in which the trust is completely funded, the Trustee must pay to the Recipient (in the case of an underpayment) or receive from the Recipient (in the case of an overpayment) the difference between any unitrust amounts actually paid, plus interest, and the unitrust amounts payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under § 664 of the Code prescribe for this computation.

3. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in paragraph 1.

4. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient under the terms of this trust) to [*designated remainderman*] (hereinafter "the Charitable Organization"). If the Charitable Organization is not an organization described in §§ 170(c) and 2055(a) of the Code at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in §§ 170(c) and 2055(a) of the Code as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

5. *Additional Contributions*. No additional contributions shall be made to the trust after the initial contribution. The initial contribution, however, shall be deemed to consist of all property passing to the trust by reason of my death.

6. *Unmarketable Assets*. Whenever the value of a trust asset must be determined, the Trustee shall determine the value of any assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents (hereinafter "unmarketable assets"), by either (a) obtaining a current "qualified appraisal" from a "qualified appraiser," as defined in § 1.170A-13(c)(3) and § 1.170A-13(c)(5) of the Income Tax Regulations, respectively, or (b) ensuring the valuation of these unmarketable assets is performed exclusively by an "independent trustee," within the meaning of § 1.664-1(a)(7)(iii) of the Income Tax Regulations.

7. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of § 4941(d) of the Code, as modified by § 4947(a)(2)(A) of the Code, and shall not make any taxable expenditures within the meaning of § 4945(d) of the Code, as modified by § 4947(a)(2)(A) of the Code.

8. *Taxable Year*. The taxable year of the trust shall be the calendar year.

9. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _______. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder unitrust under § 664(d)(2) of the Code and the corresponding regulations.

10. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder unitrust within the meaning of § 664(d)(2) of the Code.

11. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

12. *Definition of Recipient*. References to the Recipient in this trust instrument shall be deemed to include the estate of the Recipient with regard to all provisions in this trust instrument that describe amounts payable to and/or due from the Recipient. The prior sentence shall not apply to the determination of the last day of the unitrust period.

<u>CHAPTER 11 – REVIEW QUESTIONS</u>

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. A contribution made to which of the following organizations would <u>not</u> be considered a tax deductible "charitable" contribution:

   a) The American Cancer Society
   b) the local chamber of commerce
   c) a city parks district
   d) all of the above

2. If John donates $1,000 to the American Red Cross and, in return, receives a television set valued at $100, how much of a charitable deduction can he take on his federal income tax return:

   a) $500
   b) $750
   c) $900
   d) $1,000

3. Charitable contributions include the value of an individual's time and services.

   a) true
   b) false

4. How is the amount of a tax deductible donation computed when an individual donates to a qualified charity property that is subject to debt:

   a) the donor is entitled to a deduction equal to the fair market value of the property irrespective of the debt because society wants to encourage charitable donations
   b) the donor is not entitled to a charitable donation unless the debt to equity ratio is less than 50 percent
   c) the donor must reduce the fair market value of the property by any allowable interest deduction
   d) either b or c above, whichever yields the largest deduction

5. Charitable trusts can be created to last indefinitely.

   a) true
   b) false

6. What type of charitable trust allows for a beneficiary to receive income distributions for a period of time after which the rest of the proceeds are distributed to a charity:

   a) charitable remainder annuity trust
   b) charitable lead trust
   c) pooled income fund
   d) charitable remainder unitrust

7. A disadvantage of charitable annuities is that the income stream is unknown.

   a) true
   b) false

CHAPTER 11 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The American Cancer Society is a charity registered by the IRS and can receive tax deductible contributions.

   B: Correct. A chamber of commerce is a business organization and is not a charity that can receive tax deductible donations.

   C: Incorrect. When contributions are made to a government entity for a public purpose, they are considered tax deductible.

   D: Incorrect. Only one of the responses is correct.

   (See page 11-4 of the course material.)

2. A: Incorrect. The donor is entitled to a deduction of the value of his deduction less the value of what he received.

   B: Incorrect. The donor is entitled to a deduction of the value of his deduction less the value of what he received.

   C: Correct. John must deduct the $100 value of the television he received from the $1,000 he donated when calculating his tax deductible donation.

   D: Incorrect. John is not entitled to 100 percent of his donation because he received value in return.

   (See page 11-5 of the course material.)

3. A: True is incorrect. Other examples of contributions that are not considered charitable include a contribution to a specific individual, a contribution to a nonqualified organization, the part of a contribution from which the donor receives or expects to receive a benefit, the donor's personal expenses, appraisal fees, or certain contributions of partial interests in property.

   B: False is correct. There are some contributions that are not deductible or that are only partially deductible. The value of an individual's time or services is not deductible as a charitable contribution.

   (See page 11-6 of the course material.)

4. A: Incorrect. This may allow the donor to double dip in certain cases.

   B: Incorrect. There is no such rule.

   C: Correct. This is done to prevent the donor from benefiting twice.

   D: Incorrect. Since both B and C are not correct, this cannot be true.

   (See page 11-10 of the course material.)

5. **A: True is correct.** Most trusts last only a limited amount of time, but a major exception to this rule is charitable trusts.

   B: False is incorrect. Charitable trusts differ from other trusts in that they can be created to last indefinitely.

   (See page 11-12 of the course material.)

6. **A: Correct.** This is a way of providing income to an individual or individuals for a period of time (typically during their lifetime) and then provide for a charitable donation.

   B: Incorrect. This type of trust actually distributes a sequence of payments to a charitable beneficiary for a period of time after which any remaining assets are distributed to a noncharitable beneficiary.

   C: Incorrect. These funds allow donors to allocate funds to a charity.

   D: Incorrect. This type of trust distributes a percentage of the fair market value to one or more noncharitable beneficiaries for a certain time period, after which the remaining balance goes to a charity.

   (See pages 11-15 to 11-16 of the course material.)

7. A: True is incorrect. One of the advantages of a charitable annuity is the certainty of lifetime income.

   B: False is correct. A charitable annuity trust can be a means of ensuring an income stream throughout the remainder of the lifetime of the annuity beneficiary or beneficiaries.

   (See page 11-19 of the course material.)

Chapter 12: Abusive Trusts

I. Introduction

There is something about the word "trust" that makes one feel comfortable and secure. That is usually the case. In the financial world, however, the word "trust" can be deceiving. If in doubt, ask the Internal Revenue Service's Criminal Investigation Division, the agency responsible for stopping tax crime. If asked whether your financial portfolio should include "too good to be true" trusts, the IRS will tell you "just because it's a trust, doesn't mean it's trustworthy!"

A trust is a form of ownership that completely separates responsibility and control of assets from all the benefits of ownership. A trust is controlled and managed by a designated independent trustee. Under federal tax laws, a trust is generally a separate entity subject to income tax (except for certain charitable or pension trusts that are expressly exempted by the tax laws and certain grantor trusts).

Talking Points

- Trust/estate matters are the third highest area of growth among top CPA firms.
- Since the mid-1970s the number of Form 1041 returns filed has doubled and there has been a proliferation of abusive trust schemes marketed to avoid or evade income taxes.

The IRS recognizes numerous types of legal trust arrangements. As we have seen in previous chapters, these legal trusts are commonly used in such matters as estate planning, charitable giving, and holding assets for minors and those unable to handle their own financial affairs. Under a legal trust arrangement, the donor must give up control over income and assets. An independent trustee is designated to hold legal title to the trust assets, to exercise independent control over the trust, and to manage the trust. Taxes must be paid on the income or assets held in trust, including the income generated by the property held in trust. The responsibility to pay taxes may fall to either the trust, the beneficiary, or the trustee. All trusts must comply with the tax laws as set forth in the Internal Revenue Code, Sections 641-683.

A fraudulent trust has only the appearance of a trust. It is typically promoted by the promise of tax benefits or avoidance with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets. In some fraudulent trust arrangements, the taxpayer indirectly controls the activities of the trust through another individual designated as the trustee.

A. COMMON USES OF FRAUDULENT TRUSTS

Fraudulent trusts often hide the true ownership of assets and income or disguise the substance of transactions. Specific examples are provided later.

B. CIVIL AND CRIMINAL SANCTIONS

Violations of the Internal Revenue Code related to illegal trusts may result in civil penalties and/or criminal prosecution. Civil sanctions can include a fraud penalty up to 75 percent of the underpayment of tax attributable to the fraud in addition to the taxes owed. Criminal convictions may result in fines up to $250,000 and/or up to five years in prison for such offenses.

The Internal Revenue Service's criminal division is currently focusing enforcement activities on investigations that reduce the tax gap and increase voluntary compliance, in part by clamping down on illegal trusts.

II. Background

It is estimated that $4.8 trillion in wealth will be inherited or transferred from one generation to the next by 2015, with much of it transferred through a variety of trusts. Although the vast majority of these transfers are legal, there is widespread potential for fraud.

In the last few years, the Internal Revenue Service has detected a proliferation of abusive trust tax evasion schemes. These promotions are targeted towards wealthy individuals, small business owners, and professionals such as doctors and lawyers. Abusive trust arrangements typically are promoted by the promise of such benefits as:

- Reduction or elimination of income subject to tax;
- Deductions for personal expenses paid by the trust;
- Depreciation deductions of an owner's personal expenses paid by the trust;
- Depreciation deductions of an owner's personal residence and furnishings;
- A stepped-up basis for property transferred to the trust;
- The reduction or elimination of self-employment taxes; and
- The reduction or elimination of gift and estate taxes.

Abusive trust arrangements often use trusts to hide the true ownership of assets and income or to disguise the substance of transactions. Although these schemes give the appearance of separating responsibility and control from the benefits of ownership, as would be the case with legitimate trusts, the taxpayer in fact controls them.

These arrangements frequently involve more than one trust, each holding different assets of the taxpayer (the taxpayer's business, equipment, home, automobile, etc.), as well as interests in other trusts. The trusts are vertically layered, with each trust

distributing income to the next layer. Funds may flow from one trust to another trust by way of rental agreements, fees for services, purchase and sale agreements, and distributions. The goal is to use inflated or nonexistent deductions to reduce taxable income to nominal amounts.

Although the individual abusive promotions vary, two basic schemes have been identified: (1) the domestic package, and (2) the foreign package.

These schemes are often promoted by a network of promoters and sub-promoters who have charged $5,000 to $70,000 for their packages. This fee enables taxpayers to have trust documents prepared, to utilize foreign and domestic trustees as offered by promoters, and to use foreign bank accounts and corporations. In some instances, tax preparation services are also made available.

III. Abusive Domestic Trust Schemes

Domestic trusts are trusts created in the U.S. Described below are some common abusive domestic trust schemes.

A. DOMESTIC TRUSTS

1. Business Trust

This involves the transfer of an ongoing business to a trust. Also called an "unincorporated business organization", a "pure trust" or a "constitutional trust", it gives the appearance that the taxpayer has given up control of his or her business. In reality, through trustees or other entities controlled by the taxpayer, he or she still runs the day-to-day activities and controls the business's income stream. Such arrangements provide no tax relief. The courts have held that the business income is taxable to the taxpayer under a variety of legal concepts, including lack of economic substance (sham theory), assignment of income, or that the arrangement is a grantor trust. In some circumstances, the trust could even be taxed as a corporation.

2. Equipment or Service Trust

This trust is formed to hold equipment that is rented or leased to the business trust, often at inflated rates. The business trust reduces its income by claiming deductions for payments to the equipment trust. This type of arrangement has the same pitfalls as the business trust, and it will result in no tax reduction.

3. Family Residence Trust

Taxpayers transfer family residences and furnishings to a trust, which sometimes rents the residence back to the taxpayer. The trust deducts depreciation and the expenses of maintaining and operating the residence including gardening, pool service and utilities. The courts have consistently collapsed these types of trusts, taxing income to the taxpayer and disallowing personal expenses.

4. Charitable Trust

Taxpayers transfer assets or income to a trust claiming to be a charitable organization. The trust or organization pays for personal, education or recreation expenses on behalf of the taxpayer or family members. The trust then claims the payments as charitable deductions on its tax returns. These alleged charitable organizations often are not qualified and have no IRS exemption letter; hence, contributions are not deductible. Charitable deductions are not allowed when the donor receives personal benefit from the alleged gift.

5. Asset Protection Trust

These trusts are promoted as a means of avoiding liability for judgments against an individual or business. However, beware of any asset protection trust marketed as part of a package to reduce federal income or employment taxes. The courts can ignore such trusts and order the taxpayer's property sold to satisfy the outstanding liabilities.

B. ABUSIVE FOREIGN TRUST SCHEMES

Abusive foreign trusts are often formed in foreign countries that impose little or no tax on trusts and also provide financial secrecy. These are usually "tax haven" countries, supposedly outside the jurisdiction of the U.S. Typically, abusive foreign trust arrangements enable taxable funds to flow through several trusts or entities until the funds ultimately are distributed or made available to the original owner, purportedly tax-free. In actuality, the income from these arrangements is fully taxable.

Foreign packages often begin with an Asset Management Company, a business trust, and then distribution of income to several trust layers. These schemes also involve offshore bank accounts and International Business Corporations (IBC's). A typical abusive foreign trust scheme has the following steps:

1. Asset Management Company

In many promotions, taxpayers are advised to create asset management companies (AMCs). The AMC, which lists the taxpayer as the director, is formed as a domestic trust. An individual on the promoter's staff is usually the trustee of the AMC, but the taxpayer quickly replaces this individual. The purpose of the AMC is to give the appearance that the taxpayer is not managing his or her business and to start the layering process.

2. Business Trust

The next step is to form the business trust, again very similar to the domestic scheme.

3. Foreign Trust One

Next, a foreign trust is formed in a tax haven country and the income from the business trust is distributed to this trust. We will refer to this foreign trust as "foreign trust one". In many cases, the AMC will be the trustee of foreign trust one. Because the source of income is U.S.-based and there is a U.S. trustee, this foreign trust has filing requirements as discussed earlier in this section.

4. Foreign Trust Two

The next step is to form a second foreign trust or "foreign trust two". All income of foreign trust one is distributed to foreign trust two. Either foreign trust one or a foreign member of the promoter's staff becomes the trustee of foreign trust two. If the trustee is foreign trust one, the taxpayer still controls foreign trust two by the fact that he/she is in control of foreign trust one's trustee, by the directorship of the AMC. If a foreigner is the trustee of foreign trust two, the taxpayer is empowered by the promoter to overrule any decisions by this trustee. In either case, the taxpayer is in control of foreign trust two.

Promoters will claim that since the trustee and the sources of income are now foreign, there are no U.S. filing requirements. Promoters also advise taxpayers that since the trusts are formed in tax haven countries it is impossible for the IRS to determine who is in control of the trusts. In actuality, the taxpayer has never relinquished control of the taxpayer’s business, but has set up, with the assistance of a promoter, an elaborate scheme to subvert and evade U.S. tax laws.

5. Asset Protection Trust

Either as part of the second foreign trust or as a separate trust, an asset protection trust is formed. The taxpayer supposedly transfers all of his assets to it including his home and other assets actually located within the United States. According to the promoter, this will make the taxpayer judgment-proof. In actuality, the courts look at the economic substance of the transaction and, if the taxpayer continues to reside in his home and control his assets, those assets may be seized and sold in satisfaction of his liabilities. This definition of an asset protection trust is not meant to imply that all are formed as part of an abusive tax scheme. However, beware of any asset protection trust marketed as part of a package to reduce federal income or employment taxes. The courts can ignore such trusts and order the taxpayer's property sold to satisfy the outstanding liabilities.

C. ACCESSING THE OFFSHORE FUNDS

There are several methods to repatriate the taxpayer's funds to the U.S. All of these methods, at some point, involve the opening of foreign bank accounts. Two examples are described below:

Example 1.

A bank account is opened in the tax haven country and a debit or credit card is issued from the account. These cards are used by the taxpayer in the U.S. to withdraw cash and to pay for everyday expenses. Since the cards are issued by banks located in tax haven countries, it is very difficult for the IRS to trace these transactions back to the taxpayer.

Example 2.

An International Business Corporation (IBC) is established. Funds are transferred from the foreign trusts to the IBC via foreign bank accounts. Fraudulent loans are set up from the IBC to taxpayers and funds are wired back to the taxpayers in the U.S. Because loans are generally not

taxable, the repatriation of funds is not reported on a U.S. tax return. In addition, because the ownership of IBCs is documented with bearer shares and IBCs are located in tax haven countries, it is very difficult for the IRS to prove that fraudulent loans are actually the taxpayer's income.

D. SPECIAL RULES FOR FOREIGN TRUSTS

If an arrangement involves a foreign trust, taxpayers should be aware that a number of special provisions apply to foreign trusts with U.S. grantors or U.S. beneficiaries. For example, a U.S. person who fails to report a transfer of property to a foreign trust or the receipt of a distribution from a foreign trust is subject to a tax penalty equal to 35 percent of the gross value of the transaction. Other examples of these provisions are the application of U.S. withholding taxes on payments to foreign trusts and the application of U.S. excise taxes to transfers of appreciated property to foreign trusts.

IV. Substance - Not Form - Controls Taxation

In analyzing the legitimacy of trusts, the United States Supreme Court has consistently stated that the substance rather than the form of a transaction is controlling for tax purposes. The federal courts have therefore consistently determined that abusive trust arrangements will be viewed as sham transactions and will thus be ignored for federal tax purposes.

A. A CLASSIC CASE

In ***Zmuda v. Commissioner***, 731 F.2d 1417 (9th Cir. 1984), the court held that the income and assets of the business trust, the equipment in the equipment trust, the residence in the family residence trust, and the assets in the foreign trust were all determined to belong directly to the owner. The moral of this case is that although a taxpayer may structure a transaction so that it satisfies the formal requirements of the Internal Revenue Code, the IRS may deny legal effect to a transaction if its sole purpose is to evade taxation. In that case the court also concluded that costs that were incurred to establish the trusts were not deductible as ordinary and necessary expenses.

The facts of the case are illuminating. American Law Association (ALA) seminars advertised that a taxpayer utilizing complicated business trusts organized in either the Turks and Caicos Islands, British West Indies, or the country of Belize (formerly British Honduras) could legally minimize or avoid the payment of federal taxes. In 1977, the Zmudas paid ALA a $10 membership fee and $8,000 for a seminar on tax avoidance. After receipt of forms and information on the establishment and use of business trusts, they flew to the Turks and Caicos Islands to set up a series of trusts.

The scheme required the cooperation of a local citizen to act as creator of the trusts. A notary public, Irene Roberts, and her brother, Lloyd, both previously unknown to the Zmudas, provided this cooperation. The Zmudas transferred $100 to Lloyd Roberts in exchange for 100 certificates of beneficial interest in Sunnyside Trust. Ownership of the certificates did not entitle the holder to any legal or equitable title in the trust property, nor to any right to manage the trusts, except in the event of their termination.

Lloyd then named the Zmudas as trustees of Sunnyside. As trustees, they had complete power to manage the trust and to distribute the income and corpus. Sunnyside, however, had no real assets. Its function was to act as trustee for the other two trusts, Buena and Medford.

The Zmudas transferred income-producing property, including real estate contracts and deeds of trust, into Buena Trust. In exchange they received 100 certificates of beneficial interest which they immediately sold to the third trust, Medford. These machinations produced a foreign trust, Buena, whose income was distributed to another foreign trust, Medford. Medford loaned money to the Zmudas in exchange for promissory notes. The notes were then delivered as gifts to the Zmudas, resulting in approximately $21,000 of allegedly tax-free income.

The IRS Commissioner issued a deficiency notice to the Zmudas on unreported income and on disallowed business deductions for the years 1976-78. He found that income received from the trusts was attributable to the Zmudas as gross income. He disallowed deductions for fees paid to the ALA and for other business expenses. The Tax Court affirmed in all respects.

The business purpose rule has historically been used to determine the validity of the formation of an entity. If the purpose of incorporation is a business activity, such as investment or profit, or if incorporation is followed by the conduct of business, then the corporation is a separate taxable entity.

The economic substance or economic effect rule focuses on transactions by a recognized entity. "Sham" transactions, having no economic effect other than the creation of income tax losses, cannot be recognized for tax purposes. The rule applies to loans and transfers of assets.

The business purpose rule may also be applied to individual transactions, the court in the Zmuda case concluded. A transfer of assets in a corporate reorganization that has no business purpose has been deemed a contrivance and disallowed for tax purposes. Similarly, the economic substance formula may be used to determine whether a family trust is valid, and whether a trust is a grantor trust for tax purposes.

The terminology of one rule may appear in the context of the other because they share the same rationale. Both rules elevate the substance of an action over its form. Although the taxpayer may structure a transaction so that it satisfies the formal requirements of the Internal Revenue Code, the Commissioner may deny legal effect to a transaction if its sole purpose is to evade taxation.

After reviewing the transactions involved in both the formation and subsequent activities of the entities here, the Tax Court found the trusts invalid. Although Lloyd Roberts is referred to as the creator of the trusts, he never held or contributed any of the property placed in them. The Zmudas as trustees had complete control over the income-producing property of the trusts. The Buena Trust engaged in no trade or business. These findings are not clearly erroneous and will not be disturbed. Whether termed lacking in business purpose or lacking in economic substance, the trusts were shams.

”The ALA plan was a sham from inception. A nominal transfer of $100 into a trust followed by the shuffling of fanciful certificates of beneficial interest created a serpentine conduit for income to the Zmudas. The income that they previously collected directly did not change its character through this phony diversion,” the court wrote. “The court properly considered the lack of alteration in economic relationships in finding the trusts invalid.”

B. TREATING GRANTOR AS OWNER OF TRUST ASSETS

Grantor trust rules provide that if the owner of property transferred to a trust retains an economic interest in or control over it, the owner is treated for income tax purposes as the owner of the trust property. Thus all transactions by the trust are treated as transactions of the owner.

In addition, a U.S. person who directly or indirectly transfers property to a foreign trust is treated as the owner of that property if there is a U.S. beneficiary of the trust. This means all expenses and income of the trust would belong to and must be reported by the owner, and tax deductions and losses arising from transactions between the owner and the trust would be ignored. Furthermore, there would be no "nontaxable exchange" of property with the trust, and the tax basis of property supposedly transferred to the trust would not be stepped up for depreciation purposes.

C. TAXATION OF NON-GRANTOR TRUSTS

If the trust is not a sham and is not a grantor trust, the trust's income (reduced by amounts distributed to beneficiaries) is taxable. The trust must obtain a taxpayer identification number and file annual returns reporting its income. The trust must report distributions to beneficiaries on Forms K-1 and the beneficiary must include the distributed income on the beneficiary's tax return.

D. TRANSFERS TO TRUSTS MAY BE SUBJECT TO ESTATE AND GIFT TAXES

Transfers to a trust may be recognized as completed gifts for federal gift tax purposes. Further, whether or not the gift tax applies, if the owner retains until the owner's death the use of, enjoyment of, or income from the property placed in a trust, the property will be subject to federal estate tax when the transferor dies.

E. PERSONAL EXPENSES GENERALLY NOT DEDUCTIBLE

Personal expenses such as those for home maintenance, education, and personal travel are not deductible unless expressly authorized by the tax laws. The courts have consistently held that non-deductible personal expenses cannot be transformed into deductible expenses by the use of trusts. Furthermore, the costs of creating these trusts are not deductible.

CHAPTER 12 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. What are the penalties associated with a fraudulent trust:

   a) they are civil only and can result in a fine of up to $25,000
   b) they are criminal only and can result in imprisonment of up to 20 years
   c) they are subject to state enforcement only
   d) they are subject to both criminal and civil sanctions at the federal level

2. The Internal Revenue Service has indicated that there has been a significant decrease in abusive trust tax evasion schemes than in prior years.

   a) true
   b) false

3. How is income from abusive foreign trusts treated in the U.S. for tax purposes:

   a) it is not taxed
   b) the U.S. will give deference to the laws of the nation where the trust was located
   c) the income is fully taxable
   d) the income is taxable but at a lower rate to encourage foreign investment

4. In analyzing the legitimacy of trusts, the U.S. Supreme Court has consistently stated that the substance rather than the form of a transaction is controlling for tax purposes.

   a) true
   b) false

CHAPTER 12 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The sanctions can be both criminal and civil and can result in a greater fine.

   B: Incorrect. The sanctions can be both criminal and civil but the criminal sanction is capped at five years in prison.

   C: Incorrect. The IRS has authority to prosecute violations of federal law involving fraudulent trusts.

   D: Correct. The sanctions can be both criminal and civil and lead to fines, imprisonment, or both.

   (See page 12-2 of the course material.)

2. A: True is incorrect. In the last few years, the Internal Revenue Service has detected a proliferation of abusive trust tax schemes.

   B: False is correct. There has been an increase, not a decrease, in these types of schemes. These promotions are targeted at wealthy individuals, small business owners, and professionals such as doctors and lawyers.

   (See page 12-2 of the course material.)

3. A: Incorrect. The income is indeed subject to federal income tax.

   B: Incorrect. The income is subject to American and not foreign laws when it is repatriated.

   C: Correct. There is no exclusion from taxation for this type of income.

   D: Incorrect. There is no such limitation in federal law.

   (See page 12-4 of the course material.)

4. **A: True is correct.** The federal courts have therefore consistently determined that abusive trust arrangements will be viewed as sham transactions and will thus be ignored for federal tax purposes.

   B: False is incorrect. A classic case supporting this statement is Zmuda v. Commissioner, where the court held that the income and assets of the business trust, the equipment in the equipment trust, the residence in the family residence trust, and the assets in the foreign trust were all determined to belong directly to the owner.

   (See page 12-6 of the course material.)

Chapter 13: Trust Alternatives: Conservatorship, Powers of Attorney and Life Insurance

As we discussed in Chapter 1, there are a number of reasons people consider the establishment of a trust. This chapter discusses some of the common alternatives to trusts. For example, an individual may want to ensure that children or grandchildren have funds to pay for education. Life insurance can fill this need without the need to establish a trust. Likewise, an individual who has an adult child who is unable to care for himself may consider the use of a conservatorship rather than the establishment of a trust. Any CPA or other financial professional should understand all of the circumstances of their client before recommending any specific vehicle to meet their short or long-term objectives.

I. Powers of Attorney

The average 40-year-old corporate executive probably does not spend a lot of time pondering what will happen if they became incapacitated and unable to make decisions on their own behalf. However, people at any age would be wise to consider how they would want their affairs to be handled if they became incapacitated. One option is the creation of a living trust that gives authority to a spouse to make decisions on behalf of that individual. Another option is the creation of a so-called power of attorney, which confers on the person appointed the power to act on behalf of the principal.

A. GENERAL POWER OF ATTORNEY

A power of attorney is a document in which the principal – or grantor – gives another person, the agent or attorney-in-fact, the authority to act on his or her behalf. It can be very limited or very broad, depending on the wishes of the principal. A power of attorney must be in writing and signed by the principal. Each state has its own specific rules governing the requirements for execution of a valid power of attorney. Commonly, a power of attorney is used for many purposes in both personal and business affairs.

> **Example.**
>
> *Jarred is planning to travel abroad in July, the same time his new home is scheduled to close. Rather than fly home from his vacation to sign the papers, he executes a power of attorney giving authority to his brother, Roger, to sign the papers on his behalf. This is a limited power of attorney that grants only those powers so specified and only for the duration so specified.*

A standard, nondurable power of attorney like the one used by Jarred, however, is useless as a vehicle for planning for incapacity. A nondurable power of attorney becomes invalid once the grantor becomes incapacitated. This is not true with a durable power of attorney. Having a durable power of attorney in place *before* a person becomes incapacitated will eliminate the need for the family to initiate a conservatorship or guardianship proceeding, in which a court is asked to give control of an incapacitated person's affairs to a friend or family member.

B. DURABLE POWER OF ATTORNEY

Simply put, a durable power of attorney is one that remains in effect if and when the principal becomes incapacitated. To be valid, it must be executed in accordance with the laws of the state of the principal *before* he becomes incapacitated (someone who lacks capacity cannot execute a valid power of attorney).

There are a number of advantages to using a durable power of attorney. The main advantage is that the principal gets to choose his own agent. In the event someone without a durable power of attorney becomes incapacitated, a court could appoint someone as conservator the individual would not have approved of. In addition, the existence of the durable power of attorney saves the time and expense of a court proceeding. It can also provide peace of mind to both the principal and his or her family.

Even married people can benefit from a durable power of attorney in the event of incapacitation. For example, if Spouse A becomes incapacitated when the couple is trying to sell their home, only Spouse B would be in a position to sign the necessary documents. If Spouse A had executed a durable power of attorney naming Spouse B as her agent, Spouse B would have authority to sign on behalf of both spouses.

1. Springing Power of Attorney

An individual might like the idea of a durable power of attorney, but may also want to retain active control of his or her affairs as long as he or she remains able to do so. The option in this situation is the so-called “springing” durable power of attorney, which becomes effective only upon the happening of a specified event. Often, the event is the incapacitation of the principal.

If so, the springing power of attorney must contain a method for determining if the principal is incapacitated so that third parties know they can rely upon their agent's authority. For example, a springing power of attorney may become effective only when an independent physician determines the principal is incompetent.

However, given the hesitation of some doctors to make such a determination, this type of power of attorney has limitations and must be carefully drafted. The definition of “incapacitated,” in particular must be carefully tailored. If the power of attorney does not provide a procedure for determining if the principal is incompetent, a springing power of attorney is effective when the agent swears in an affidavit that the principal is incompetent.

2. Scope of Powers

Like a general power of attorney, a durable power of attorney can be as broad or as limited as the principal would like. For example, a durable power of attorney may be limited to financial matters. However, since the durable power of attorney is most important in the event of incapacitation, it is generally important to have the powers broad.

Specific authority that might be included in a durable power of attorney includes the following:

- Paying for support and care of the principal;
- Borrowing money;
- Conducting banking transactions;
- Handling transactions involving real property;
- Defending and initiating legal claims;
- Accessing safe deposit boxes;
- Collecting insurance benefits;
- Preparing and filing tax returns;
- Exercising stockholder rights;
- Making gifts;
- Collecting social security and other benefits; and
- Contracting for services.

Some states limit the authority of an agent to dispose of certain assets or make changes to the principal's estate plans. If so, such authority should not be included in the durable power of attorney document. For example, in many states an agent lacks authority to create, modify or revoke a trust, make or revoke a gift, create or change survivorship interest in the principal's property or make or revoke a will.

3. Selecting an Agent

An agent named in a durable power of attorney can be a friend, relative, lawyer, financial professional or even a bank. It is a good idea to ask the person or institution ahead of time to ensure that they are willing to serve. Trustworthiness is obviously a key attribute in selecting an agent for a durable power of attorney.

A principal can name more than one agent. However, if multiple agents are named the document should clearly spell out whether both must agree on decisions, and, if so, what should happen in the event of a deadlock. It is also advisable to name a contingent or alternate agent who can act if the original agent himself becomes incapacitated or is no longer willing to act.

4. Obligations of the Agent

An agent appointed in a power of attorney – like the trustee of a trust – is a fiduciary, with strict standards of honesty, loyalty and candor to the principal. An agent must safeguard the principal's property, and keep it separate from the agent's personal property. For example, money should always be kept in a separate bank account for the benefit of the principal.

An agent should also keep detailed records showing the decisions he or she has made. Complete accounting should be provided showing how all funds were dispensed. The power of attorney document can also direct the agent to make periodic reports to an identified third party, such as the principal's CPA or attorney.

Agents who violate their obligations are legally liable to the principal for damages resulting therefrom. Agents are also prohibited in engaging in "self-dealing" when acting on behalf of their principal. They must put the interests of the principal ahead of their own.

Example.

Richard is the principal of a durable power of attorney in which his nephew, Wayne is named as his agent. Richard has recently suffered a stroke and has been moved to a convalescent hospital. Given his uncle's uncertain future and the need for funds to pay for his expensive medical care, Wayne decides to put Richard's house up for sale. It would violate his obligations as a fiduciary for Wayne to purchase the house for himself at a discounted price. Wayne should list the property with an experienced real estate agent and secure the best price possible for his uncle.

C. FORMALITIES OF EXECUTION

1. State Law Controls

There are not many formalities associated with executing a durable power of attorney. State law sets forth specific requirements for executing a valid power of attorney. California, for example, requires a power of attorney to include the date of its execution, to be signed by the principal and to be either witnessed by two adults or acknowledged before a notary public. If the power of attorney is witnessed, the witnesses must be adults and the agent may not be one of the witnesses. Some states, such as North Carolina, have requirements mandating the formal registration of a durable power of attorney with specified government agencies.

2. Copies

The agent should have certified copies available to third parties with whom he will be dealing. In some cases, a copy of the document must be filed with a third party. For example, when an agent is acting on behalf of the principal in a transaction involving real property, a copy of the document must be recorded with the applicable government agency along with the title documents. This is necessary to show the lawful transfer of title.

Banks and financial institutions also often require an original or a certified copy before allowing an agent to transact business on the principal's behalf. Banks also frequently provide customers with their own power of attorney forms.

D. TERMINATION AND MODIFICATION OF DURABLE POWER OF ATTORNEY

The principal of a durable power of attorney has the authority to modify or revoke the document so long as the principal is competent and as long as it is done in conformance with the provisions of the power of attorney. Like the power of attorney itself, the revocation should be in writing and delivered to any person or institution with knowledge of the power of attorney.

A durable power of attorney will automatically terminate under any of the following circumstances:

- Upon the death of the principal;
- In accordance with the terms of the power of attorney; or
- Removal or resignation of the agent.

In many states, a durable power of attorney that names the spouse as the agent automatically terminates in the event of divorce.

E. STATUTORY POWER OF ATTORNEY FORMS

To assist persons in planning for incapacity, many states have published so-called statutory durable powers of attorney forms to help individuals avoid the time and expense of having one drafted by an attorney. Like other forms, however, they have limitations. It may not contain the exact provisions desired. In such a case, a statutory form is not appropriate. A copy of the Texas statutory durable power of attorney is provided for reference at the end of this chapter.

II. Conservatorship: An Overview

When an adult becomes incapacitated and has not made other arrangements for his or her care or the management of his or her affairs, the family often considers conservatorship. This is a court process in which a family member or other interested person petitions the appropriate court (depending on the state in which the object of the motion resides) to have someone named conservator of the person. The person named conservator has the responsibility to make decisions concerning the personal well-being of the conservatee. The same person may or may not also be responsible for the conservatee's estate. This is sometimes used as an alternative to or in addition to the creation of a trust for the benefit of the impaired individual. This process, which in some states is referred to as "probate conservatorship," is reserved only for persons 18 years and older. When a minor is involved, the process is normally referred to as a "guardianship."

A. BASIS OF CONSERVATORSHIP

A court will only order a conservatorship when it is clear that absent one, the proposed conservatee will be unable to care for oneself. The specific requirements vary from state to state, but it must generally be shown that the individual is unable to satisfy his or her basic needs absent appointment of a conservator. In certain cases, an individual may

decide he or she would like another person to assume responsibility for the individual's care and/or their estate. This is referred to as a *voluntary conservatorship*.

B. APPOINTMENT OF CONSERVATOR

An application for conservatorship will set forth the reasons why a conservatorship should be ordered. The person making the application may or may not ask to serve as the conservator. Judges have a great amount of discretion in appointing a conservator. There is, however, a general preference to appoint someone with a close relationship to the conservatee, namely the following:

- A spouse;
- An adult child;
- A parent; or
- A sibling.

In appropriate cases, a judge will appoint someone else to act as conservator. Some states have a process for the appointment of a so-called "public conservator" who is a government official that acts on behalf of a number of conservatees. This is generally done when the conservatee does not have any family members who would be appropriate for the job.

When a court appoints a conservator of a person, that person may or may not also serve as conservator of the estate. The conservator of the estate is responsible for the management of the conservatee's assets while the conservator of the person is responsible for the day-to-day decisions regarding the personal care of the conservatee. The specific powers authorized by the court to any conservator are set forth in Letters of Conservatorship issued by the court ordering the conservatorship.

C. DECISIONS ON BEHALF OF CONSERVATEE

A conservator of the person must make a variety of decisions regarding the well-being of the conservatee. Powers regarding the care of the conservatee normally include the following:

- Making living arrangements for the conservatee;
- Ensuring that the conservatee has food;
- Providing for medical attention; and
- Providing for other basic needs such as transportation and recreation.

D. CONSERVATOR OF THE ESTATE

The conservator of the estate generally has the following obligations:

- Manage the conservatee's finances;

- Protect the conservatee's income and property;
- Take an inventory of the estate;
- Develop a plan to ensure that the needs of the conservatee are met;
- Ensure that bills are paid;
- Invest funds, if appropriate;
- Ensure that the conservatee is receiving all benefits, government and private, to which he or she is entitled;
- Make sure all taxes are paid in a timely fashion;
- Keep detailed and accurate financial records; and
- Make required financial reports to the court or other person as required.

1. Inventory of Estate Property

An individual chosen to be conservator of an estate must make and keep a list of what the estate owns. This includes doing the following:

- Locating property that is part of the estate;
- Ensuring that the estate property is put into the name of the conservator of the estate;
- Determining the value of estate property;
- Maintaining insurance as necessary for certain estate property; and
- Filing the inventory and appraisal with the court within the time prescribed by the applicable state law.

The last step is necessary since, unlike an agent designated through a power of attorney, a conservator is subject to the direction of the court that makes the appointment. This court appointment and oversight helps to ensure that the conservator is carrying out his or her duties and acting in the best interests of the conservatee.

2. Fiduciary Duty

Likewise, the conservator of the estate has a fiduciary obligation to act in the best interests of the conservatee. He is prohibited from self-dealing and may not commingle the funds or assets of the conservatee with his own or any other party. There are also specific restrictions, such as borrowing money from the estate or giving away any part of the estate.

3. Record Keeping and Accounting

A conservator must keep detailed and accurate records of all transactions relating to the estate, including funds received from social security, retirement plans, or other sources, payments made on real estate or for insurance, or any other expenses related to the estate. A detailed accounting is required, which includes all monies received and spent, the purpose for which they were received and spent, and the date and purpose of each transaction. The accounting must be filed with and approved by the court on a periodic basis as mandated by applicable state law.

E. CONSERVATEE'S RIGHTS

A conservatee retains certain rights regardless of his or her present incapacity. These are set out by each state in statute and normally include the following:

- Make or change a will (unless he or she lacks required testamentary capacity);
- Receive mail;
- Retain a lawyer;
- Petition the court to remove his or her conservator;
- Petition the court to end the conservatorship; and
- Make his or her own health-care decision (if competent to do so).

III. Guardianship

A guardianship is similar to a conservatorship; it is used when a person is in need of protection both for the person's physical and material well-being. It is usually used when the individual in need of care is a minor. As with conservatorships, the rules are mandated by state law. The minor is normally referred to as a "ward."

As with a conservatorship, any interested party can file a petition with the appropriate court (in most states, the probate court) asking for a guardian to be appointed. In some states, a minor above a certain age (i.e., 14 or older) can also file a petition asking for a guardian to be appointed. Before a formal hearing, the court will typically appoint someone (called a guardian ad litem) to meet with the ward and make an investigation for the court. A formal hearing will then be held to determine whether a guardian should be appointed, and if so, who should hold that position. In some states, minors above a certain age have the right to request the court to appoint someone other than the person stipulated in the will as guardian.

The guardianship generally lasts until the minor turns 18, unless the court determines that the guardianship is not in the minor's best interest.

If appointed, a guardian may be paid from the ward's estate, depending on all of the circumstances.

A. DEATH OF BOTH PARENTS

If both parents die, any minor children will obviously have to be placed in the care of a guardian. In the case of the death of both parents, the parent's will may have a provision naming a guardian. Even when nominated by a deceased parent, a court must still approve the selection of the guardian. Anything that can have an effect on the child's physical, intellectual, moral, or spiritual well-being is considered by the court in selecting a guardian. The presumption, however, is generally in favor of appointing the person or persons nominated in the parent's will. This is one of the many reasons it is so important that adults have a valid will in place. The importance magnifies when they marry and have children.

B. DEATH OF ONE PARENT

When the parents are married and one dies, the surviving spouse generally retains sole custody of any minor children without any court involvement. The only time the courts normally become involved in this situation is if someone challenges the guardianship and seeks custody of the child. In the absence of evidence that the surviving parent is unfit, the courts will rarely intervene.

Where parents are separated or divorced and the custodial parent dies, the surviving parent has custodial rights superior to those of any guardian named by the deceased parent. A natural parent's custody rights cannot be terminated by the death of the other parent. If the surviving natural parent is incompetent, unfit, missing, or unwilling to care for the child, the court can award custody to a guardian named by the deceased parent. Additionally, if a guardian named by the deceased parent has provided essential parenting for the child, he or she may have standing to challenge a competent, interested natural parent's rights. But the strong rights of the natural parent are very difficult to defeat.

C. POWERS OF GUARDIAN

A guardian of a minor may have some or all of the powers normally held by a parent. The two types of guardianships of minors are general guardianships and limited guardianships.

1. General Guardian

A general guardian is typically appointed when the minor has no living parents. A general guardian can also be appointed when the parents have abandoned the child and cannot be located. A general guardian has all the legal powers of a parent, but is not legally required to provide for the minor out of his or her own funds.

2. Limited Guardian

In a limited guardianship, the proposed guardian and the custodial parent decide what powers the guardian will exercise and both must sign a limited guardianship placement plan. This plan tells the court the reason for the guardianship, how long it will last, how the child will be supported, and how the parent will stay in contact with the child.

The placement plan must be approved by the court. If the parent does not keep the agreement made in the plan, the guardian or another person named by the court may ask the family division of the circuit court to terminate the parent's rights to the child and make the child available for adoption.

A parent must go to court to end a limited guardianship. In some cases, the court may decide that the parent is not ready to have the child back, and may set some conditions for the parent to meet before the child is returned. If a guardian is unable to keep the child, the guardian must petition the court to appoint someone else.

D. CONSERVATORSHIP OF MINOR'S ESTATE

Conservatorship provides for management and distribution of money and property left to children until they reach the age of 18. One person can serve as both the conservator and guardian, or different people can serve the two roles.

The need for a conservatorship can be avoided by not leaving large sums of money directly to children. For example, parents can choose to create a family trust to be used to care for the needs of their children in the event of their death.

For example, insurance proceeds can be paid into the trust if both parents die. Savings accounts in the parents' names can be directed to the trust. The parents select and name a trustee to manage the assets. They also prepare a trust agreement giving the trustee the power to manage the trust assets and use the income for the children's benefit. The trust agreement is effective upon the death of both parents. A trust can avoid the inflexibility of conservatorship that passes assets to the children at age 18, when the child may not be financially responsible enough to handle a large inheritance.

> **Example.**
>
> *Michelle and Martin Wilson have typical young-family estate-planning concerns. In their early 30s, Michelle and Martin have two children, ages 5 and 7. Michelle and Martin assume that if one of them died, the other would use family assets to provide for the children. They discussed the possibility that the survivor might remarry and have more children, and they still felt comfortable leaving everything to the survivor. They accomplished this by titling car, house, and investments in joint tenancies with rights of survivorship so that if either spouse dies, the property will pass to the survivor. They also have named each other as beneficiary on their life insurance policies. They know that when their assets increase in value and tax planning becomes an issue, this may no longer be an appropriate plan.*
>
> *Michelle and Martin also need a plan in case they both die when their children are minors. Their first idea was to prepare simple wills dividing their assets equally between the two children. However, they reconsidered this plan after learning that the court would appoint a conservator to manage property passing to the children while they are minors. Then, as each child turned 18, each would receive the property to manage, regardless of financial capability. Even though Michelle and*

Martin think their children are bright, they don't like the idea of their children managing $300,000 or $400,000 while so young.

Rather than leaving the assets to the children, Michelle and Martin followed the estate planner's suggestion to make wills leaving everything to the surviving spouse or, if there is no surviving spouse, to a testamentary trust for the children's benefit. The insurance proceeds also will be paid to the trust if both parents die. In establishing the testamentary trust, the parents selected the trustee and prepared a trust agreement giving the trustee the power to manage the trust and use the income for the children. The trust will avoid the inflexibility of conservatorship.

Michelle and Martin also nominated a guardian for the children in case both parents die. The guardian has the power and responsibility of a parent and makes decisions about the child's upbringing: schooling, religious training, and medical treatment. The mechanical aspects of nominating a guardian were easy; it was done in their wills. The difficult part for the Wilson's was deciding whom to nominate, but eventually they decided the best choice was Martin's brother, Mark, who lives nearby and has been very involved in the children's lives. They also nominated a good family friend as an alternate in case Mark cannot or does not want to be appointed when the time comes. Michelle and Martin talked at length with both Mark and the friend about their dreams and hopes for their children.

E. PROVIDING FOR A DISABLED CHILD

Parents of disabled children face special hurdles in estate planning. If the child will never be able to care for himself, the parents have to be concerned about both financial support and living arrangements.

One alternative is to leave everything to the other children, if any, and instruct them to care for the disabled child. Depending on the level of disability and the interests of the other children, however, this plan may not work.

Another alternative is to leave some assets outright to the non-disabled children and some assets in trust to provide income for the support of the disabled child. However, leaving too much money for the child might render them ineligible for certain government benefits, such as health coverage. The laws of the child's state of residence need to be consulted carefully. In some cases, a trust can be drafted to ensure that the child remains entitled to government benefits. This is one area where an experienced attorney can be helpful.

IV. <u>Life Insurance</u>

Life insurance can be a good estate-planning tool for a number of reasons, most notably the insured usually pays little up front for the policy and the proceeds of the policy pass directly to the beneficiaries without going through probate.

A life insurance policy is a contract. In the contract, the insurer promises to pay proceeds of the policy to the beneficiaries in the event the insured dies. The owner of the policy has the right to name the beneficiary and change the beneficiary as often as he or she likes unless the designation is made irrevocable.

The primary beneficiary is entitled to the proceeds only if he or she survives the insured. Contingent beneficiaries must likewise survive the insured. Thus, in cases of a class that has both surviving and deceased members, only those surviving will receive payment. Settlement options include both installment payments or payment at a future date. The owner of the policy can select the settlement option.

A. TYPES OF INSURANCE

There are basically two types of life insurance:

- Term or Pure insurance; and
- Whole life or Investment insurance.

Term insurance provides protection for a specified term of years. It is normally cheaper than whole insurance, particularly when the insured is relatively young. It has value only if the insured dies.

Whole insurance, on the other hand, has some cash value even if the insured does not die. It is normally more expensive than simple term insurance. Its utility as an estate planning or an investment tool is normally fairly limited.

B. TAX TREATMENT OF PROCEEDS

The proceeds from a decedent's life insurance policy paid by reason of his or her death generally are excluded from income. The exclusion applies to any beneficiary, whether a family member or other individual, a corporation, or a partnership.

1. <u>Veterans' Insurance Proceeds</u>

Veterans' insurance proceeds and dividends are not taxable either to the veteran or to the beneficiaries. Interest on dividends left on deposit with the Department of Veterans Affairs is not taxable.

2. <u>Life Insurance Proceeds</u>

Life insurance proceeds paid to a beneficiary because of the death of the insured (or because the insured is a member of the U.S. uniformed services who is missing in action) are not taxable unless the policy was turned over to a third party for a price. This

is true even if the proceeds are paid under an accident or health insurance policy or an endowment contract.

3. Accelerated Death Benefits

Income from accelerated death benefits received on the life of an insured individual can be excluded from income if certain requirements are met. Accelerated death benefits are amounts received under a life insurance contract before the death of the insured. These benefits also include amounts received on the sale or assignment of the contract to a viatical settlement provider. This exclusion applies only if the insured was a terminally ill individual or a chronically ill individual. This exclusion does not apply if the insured is a director, officer, employee, or has a financial interest, in any trade or business carried on by you.

a. Terminally ill individual.

A terminally ill individual is one who has been certified by a physician as having an illness or physical condition that reasonably can be expected to result in death in 24 months or less from the date of certification.

b. Chronically ill individual.

A chronically ill individual is one who has been certified as one of the following:

- An individual who, for at least 90 days, is unable to perform at least two activities of daily living without substantial assistance due to a loss of functional capacity.
- An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

A certification must have been made by a licensed health care practitioner within the previous 12 months.

c. Exclusion limited.

If the insured was a chronically ill individual, your exclusion of accelerated death benefits is limited to the cost you incurred in providing qualified long-term care services for the insured. In determining the cost incurred, do not include amounts paid or reimbursed by insurance or otherwise. Subject to certain limits, you can exclude payments received on a periodic basis without regard to your costs.

4. Insurance Received in Installments

If you receive life insurance proceeds in installments, you can exclude part of each installment from your income. To determine the part excluded, divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in your income as interest.

a. Specified number of installments.

If you will receive a specified number of installments under the insurance contract, figure the part of each installment you can exclude by dividing the amount held by the insurance company by the number of installments to which you are entitled. A secondary beneficiary, in case you die before you receive all of the installments, is entitled to the same exclusion.

Example.

As beneficiary, Elaine chooses to receive $40,000 of life insurance proceeds in 10 annual installments of $6,000. Each year, Elaine can exclude from her income $4,000 ($40,000 ÷ 10) as a return of principal. The balance of the installment, $2,000, is taxable as interest income.

b. Specified amount payable.

If each installment you receive under the insurance contract is a specific amount based on a guaranteed rate of interest, but the number of installments you will receive is uncertain, the part of each installment that you can exclude from income is the amount held by the insurance company divided by the number of installments necessary to use up the principal and guaranteed interest in the contract.

Example.

The face amount of the policy is $200,000, and as beneficiary you choose to receive annual installments of $12,000. The insurer's settlement option guarantees you this amount for 20 years based on a guaranteed rate of interest. It also provides that extra interest may be credited to the principal balance according to the insurer's earnings. The excludable part of each guaranteed installment is $10,000 ($200,000 ÷ 20 years). The balance of each guaranteed installment, $2,000, is interest income to you. The full amount of any additional payment for interest is income to you.

c. Installments for life.

If, as the beneficiary under an insurance contract, you are entitled to receive the proceeds in installments for the rest of your life without a refund or period-certain guarantee, you figure the excluded part of each installment by dividing the amount held by the insurance company by your life expectancy. If there is a refund or period-certain guarantee, the amount held by the insurance company for this purpose is reduced by the actuarial value of the guarantee.

Example.

As beneficiary, you choose to receive the $50,000 proceeds from a life insurance contract under a life-income-with-cash-refund option. You are guaranteed $2,700 a year for the rest of your life (which is estimated by use of mortality tables to be 25 years from the insured's death). The actuarial value of the refund feature is $9,000. The amount held by the insurance company, reduced by the value of the guarantee, is $41,000 ($50,000 - $9,000) and the excludable part of each installment representing a return of principal is $1,640 ($41,000 ÷ 25). The remaining $1,060 ($2,700 - $1,640) is interest income to you. If you should die before receiving the entire $50,000, the refund payable to the refund beneficiary is not taxable.

5. Interest Option on Insurance

If an insurance company pays you interest only on proceeds from life insurance left on deposit, the interest you are paid is taxable.

6. Flexible Premium Contracts

A life insurance contract (including any qualified additional benefits) is a flexible premium life insurance contract if it provides for the payment of one or more premiums that are not fixed by the insurer as to both timing and amount. For a flexible premium contract issued before January 1, 1985, the proceeds paid under the contract because of the death of the insured will be excluded from the recipient's income only if the contract meets the requirements explained under §101(f) of the Internal Revenue Code.

TEXAS STATUTORY DURABLE POWER OF ATTORNEY

STATUTORY DURABLE POWER OF ATTORNEY

NOTICE: THE POWERS GRANTED BY THIS DOCUMENT ARE BROAD AND SWEEPING. THEY ARE EXPLAINED IN THE DURABLE POWER OF ATTORNEY ACT, CHAPTER XII, TEXAS PROBATE CODE. IF YOU HAVE ANY QUESTIONS ABOUT THESE POWERS, OBTAIN COMPETENT LEGAL ADVICE. THIS DOCUMENT DOES NOT AUTHORIZE ANYONE TO MAKE MEDICAL AND OTHER HEALTH-CARE DECISIONS FOR YOU. YOU MAY REVOKE THIS POWER OF ATTORNEY IF YOU LATER WISH TO DO SO.

I, ____ (insert your name and address),

appoint____ (insert the name and address of the person appointed) as my agent (attorney-in-fact) to act for me in any lawful way with respect to all of the following powers except for a power that I have crossed out below.

TO WITHHOLD A POWER, YOU MUST CROSS OUT EACH POWER WITHHELD.

Real property transactions;

Tangible personal property transactions;

Stock and bond transactions;

Commodity and option transactions;

Banking and other financial institution transactions;

Business operating transactions;
Insurance and annuity transactions;

Estate, trust, and other beneficiary transactions;

Claims and litigation;

Personal and family maintenance;

Benefits from social security, Medicare, Medicaid, or other governmental programs or civil or military service;

Retirement plan transactions;

Tax matters.

IF NO POWER LISTED ABOVE IS CROSSED OUT, THIS DOCUMENT SHALL BE CONSTRUED AND INTERPRETED AS A GENERAL POWER OF ATTORNEY AND MY AGENT (ATTORNEY IN FACT) SHALL HAVE THE POWER AND AUTHORITY TO PERFORM OR UNDERTAKE ANY ACTION I COULD PERFORM OR UNDERTAKE IF I WERE PERSONALLY PRESENT.
SPECIAL INSTRUCTIONS:

Special instructions applicable to gifts (initial in front of the following sentence to have it apply):

I grant my agent (attorney in fact) the power to apply my property to make gifts, except that the amount of a gift to an individual may not exceed the amount of annual exclusions allowed from the federal gift tax for the calendar year of the gift.

ON THE FOLLOWING LINES YOU MAY GIVE SPECIAL INSTRUCTIONS LIMITING OR EXTENDING THE POWERS GRANTED TO YOUR AGENT.

____
____
____
____

UNLESS YOU DIRECT OTHERWISE ABOVE, THIS POWER OF ATTORNEY IS EFFECTIVE IMMEDIATELY AND WILL CONTINUE UNTIL IT IS REVOKED.
CHOOSE ONE OF THE FOLLOWING ALTERNATIVES BY CROSSING OUT THE ALTERNATIVE NOT CHOSEN:

(A) This power of attorney is not affected by my subsequent disability or incapacity.

(B) This power of attorney becomes effective upon my disability or incapacity.

YOU SHOULD CHOOSE ALTERNATIVE (A) IF THIS POWER OF ATTORNEY IS TO BECOME EFFECTIVE ON THE DATE IT IS EXECUTED.

IF NEITHER (A) NOR (B) IS CROSSED OUT, IT WILL BE ASSUMED THAT YOU CHOSE ALTERNATIVE (A).

If Alternative (B) is chosen and a definition of my disability or incapacity is not contained in this power of attorney, I shall be considered disabled or incapacitated for purposes of this power of attorney if a physician certifies in writing at a date later than the date this power of attorney is executed that, based on the physician's medical examination of me, I am mentally incapable of managing my financial affairs. I authorize the physician who examines me for this purpose to disclose my physical or mental condition to another person for purposes of this power of attorney. A third party who accepts this power of attorney is fully protected from any action taken under this power of attorney that is based on the determination made by a physician of my disability or incapacity.

I agree that any third party who receives a copy of this document may act under it. Revocation of the durable power of attorney is not effective as to a third party until the third party receives actual notice of the revocation. I agree to indemnify the third party for any claims that arise against the third party because of reliance on this power of attorney.

If any agent named by me dies, becomes legally disabled, resigns, or refuses to act, I name the following (each to act alone and successively, in the order named) as successor(s) to that agent:

____.

Signed this ______ day of __________, 20___.

____
(your signature)
State of _______________________
County of ______________________
This document was acknowledged before me on
__________________________(date) by _______________________________ (name of principal).
____
(signature of notarial officer)
(Seal, if any, of notary)
____
(printed name)
My commission expires: _______________

THE ATTORNEY IN FACT OR AGENT, BY ACCEPTING OR ACTING UNDER THE APPOINTMENT, ASSUMES THE FIDUCIARY AND OTHER LEGAL RESPONSIBILITIES OF AN AGENT.

CHAPTER 13 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. To be effective, a power of attorney must be which of the following:

   a) in writing
   b) approved by a court of law
   c) executed by someone lacking mental competence
   d) limited in scope and duration

2. A disadvantage of a durable power of attorney is that the principal incurs an increased amount of time and expense if it should ever have to be put into effect.

   a) true
   b) false

3. Who is eligible to act as agent through a durable power of attorney:

   a) as the name suggests, only a licensed attorney
   b) only a blood relative
   c) only someone approved by a court of law
   d) a friend, relative, lawyer or other person so designated in the document

4. Once a durable power of attorney has been signed, it cannot be modified or revoked.

   a) true
   b) false

5. In which of the following situations might a family consider appointment of a conservator:

   a) when a wild teenager inherits a large sum of money
   b) when a child is severely injured in a car accident
   c) when an adult who suffers a traumatic brain injury is no longer able to care for himself
   d) any of the above

6. The conservator of an estate has a fiduciary obligation to act in the best interests of the conservatee.

   a) true
   b) false

7. When a guardian is nominated in a parent's will, the courts do not have to approve the selection.

   a) true
   b) false

8. Why is life insurance often a good estate planning tool:

   a) the government taxes only half of the proceeds
   b) proceeds are distributed directly to beneficiaries without the necessity of probate
   c) insurance is usually available at a fairly low cost
   d) both b and c above

9. Accelerated death benefits are amounts received under a life insurance contract before the death of the insured.

   a) true
   b) false

CHAPTER 13 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** A general power of attorney is not effective unless made in writing and signed by the principal.

   B: Incorrect. No such court approval is required.

   C: Incorrect. To the contrary, an individual must be competent before the power of attorney can be executed, although it generally only takes affect after the person loses competency.

   D: Incorrect. Powers of attorney can be broad and long in duration.

   (See page 13-1 of the course material.)

2. A: True is incorrect. The existence of a durable power of attorney saves the time and expense of a court proceeding.

   B: False is correct. Actually, time and expense is saved through the use of a durable power of attorney.

   (See page 13-2 of the course material.)

3. A: Incorrect. The agent can, but need not be, a licensed attorney.

   B: Incorrect. The agent can, but need not be, a blood relative.

   C: Incorrect. No such requirement exists.

   D: Correct. The person can be any of those types of people or even a bank.

   (See page 13-3 of the course material.)

4. A: True is incorrect. The principal of a durable power of attorney has the authority to modify or revoke the document so long as he or she is competent, and as long as it is done in conformance with the provisions of the power of attorney.

   B: False is correct. A revocation should be in writing and delivered to any person or institution with knowledge of the power of attorney. A durable power of attorney will automatically terminate upon the death of the principal, in accordance with the terms of the power of attorney, or the removal or resignation of the agent.

   (See page 13-5 of the course material.)

5. A: Incorrect. A conservatorship is used to manage the affairs of an incompetent adult.

   B: Incorrect. A conservatorship is used to manage the affairs of an incompetent adult.

   C: Correct. An incapacitated adult is the typical subject of a conservatorship.

   D: Incorrect. Only one response is a suitable candidate for a conservatorship.

   (See page 13-5 of the course material.)

6. **A: True is correct.** The conservator is prohibited from self-dealing and may not commingle the funds or assets of the conservatee with his own or any other party.

   B: False is incorrect. The conservator must also keep detailed and accurate records of all transactions relating to the estate, including funds received from social security, retirement plans, or other sources, payments made on real estate or for insurance, or any other expenses related to the estate.

   (See page 13-7 of the course material.)

7. A: True is incorrect. Even when nominated by a deceased parent, a court must still approve the selection of the guardian.

   B: False is correct. Anything that can have an effect on the child's physical, intellectual, moral, or spiritual well-being is considered by the court in selecting a guardian. The presumption, however, is generally in favor of appointing the person or persons nominated in the parent's will.

   (See page 13-9 of the course material.)

8. A: Incorrect. Proceeds are actually not subject to tax by the recipient.

   B: Incorrect. This is correct, but it is not the best answer.

   C: Incorrect. This is correct, but it is not the best answer.

   D: Correct. The proceeds pass directly to the designated beneficiary without probate. In addition, the insured probably paid little up front for the insurance.

   (See page 13-12 of the course material.)

9. **A: True is correct.** Income from accelerated death benefits received on the life of an insured individual can be excluded from income if certain requirements are met.

   B: False is incorrect. These benefits also include amounts received on the sale or assignment of the contract to a viatical settlement provider.

   (See page 13-13 of the course material.)

Glossary

A

A/B Trust: A type of Living Revocable Trust used by married couples. In this type of living trust, two trusts (trust A and trust B) are created at the time the first spouse dies. By dividing the couple's estate into two trusts at the first death, each spouse can pass the maximum amount of property allowed to avoid federal estate taxes. One trust, usually trust A, is often referred to as the marital deduction trust and the other trust, usually trust B, is often referred to as the shelter trust.

Administrator: The person appointed by the court to manage your estate when you die without leaving a will. Since the administrator is court appointed, he or she is required to post a bond as security. He or she has the same duties as an executor. In some states, the position is called "personal representative."

Annual Exclusion: The amount of property the IRS allows a person to gift to another person during a calendar year before a gift tax is assessed and/ or a gift tax return must be filed. The amount is increased periodically.

B

Beneficiary: An individual, institution, trustee or other entity designated in a will or trust to receive something of value.

C

Charitable Lead Annuity Trust: A charitable lead annuity trust is a charitable lead trust paying a fixed percentage of the initial value of the trust assets to the charity for the charitable term.

Charitable Lead Trust: A charitable lead trust pays an annuity or unitrust interest to a designated charity for a specified term of years (the "charitable term") with the remainder ultimately distributed to non-charitable beneficiaries. There is no specified limit for the charitable term. The donor receives a charitable deduction for the value of the interest received by the charity. The value of the non-charitable beneficiary's remainder interest is a taxable gift by the grantor.

Charitable Lead Unitrust: A charitable lead unitrust is a charitable lead trust paying a percentage of the value of its assets, determined annually, to a charity for the charitable term.

Charitable Remainder Trust: A trust used to make large donations of property or money to a charity so the person making the gift or donation can obtain a tax advantage. In a charitable remainder trust, the donor reserves the right to use the trust property during his life or some other specified time period, and when the agreed period is over the property goes to the charity.

Conservator: An individual appointed by a court to manage the affairs of an adult who is no longer competent. Also a person appointed by a court to manage the assets of a minor.

Conservatorship: A court controlled program where a conservator is appointed by the court to manage the monetary affairs of a person(s) who is unable to manage his/her own affairs.

Contingent Beneficiary: Beneficiary of a life insurance policy who is entitled to receive the policy proceeds on the insured's death if the primary beneficiary dies before the insured; or the beneficiary who receives the remaining payments if the primary beneficiary dies before receiving the guaranteed number of payments.

Corpus of a Trust: Literally "the body" of the trust. Used to refer to the money or property placed in a trust. Distinguished from the income produced by the trust.

***Crummey* Trust:** An irrevocable trust in which a beneficiary possesses a right to withdraw some or all of the property contributed for a period of time (usually 30 days), after which time the power lapses and the property is governed by the terms of the trust document; the beneficiary's right to withdraw is considered a gift of a present interest for gift tax purposes, thereby qualifying contributions for the gift tax annual exclusion; irrevocable life insurance trusts (see below) are usually Crummey trusts.

D

Decedent: An individual who has died.

Delaware Business Trust or Alaska Business Trust: A trust established to hold and invest assets with greater flexibility than allowed by most trusts. Permits limited liability, creditor protection, and valuation discounts. These trusts are a creation of the Delaware and Alaska legislatures and have no impact on taxation of trusts for federal purposes. These "business trusts" have no special distinction in the Internal Revenue Code and would be a simple, complex, or grantor trust depending on the terms of trust instrument. The regulations require that trusts operating a trade or business be treated as a corporation, partnership, or sole proprietorship, if the grantor, beneficiary or fiduciary materially participates in the operations or daily management of the business. Filing requirements would depend on this classification.

Direct Skip: An outright generation-skipping transfer, either by gift or at death, to a recipient, known as a "skip person," who is two or more generation levels below the transferor. This type of property transfer prompts the generation-skipping transfer tax.

Domicile: The location of a person's home or principal residence although he may also have living quarters in another location.

Donee: One who receives a gift.

Donor: An individual who makes a gift. Also referred to as trustor, grantor or settlor in certain circumstances.

Durable Power of Attorney: A written legal document that lets an individual designate another person to act on his or her behalf, even in the event the individual becomes disabled or incapacitated.

E

Estate: The assets owned by a decedent at the time of his or her death.

Estate Planning: The process by which an individual determines how to divide his or her assets upon death or during their lifetime in anticipation of death.

Estate Taxes: Taxes imposed on the "privilege" of transferring property by reason of death. Estate tax is most commonly used in reference to the tax imposed by the Federal Government rather than the state government. Estate taxes are intended to raise revenue for the government and break up a family's wealth, so that the nation's wealth does not concentrate in the hands of a few families.

Executor/ Executrix: The person (male/female) named in a will to manage a decedent's estate. The more modern term is a "personal representative," which removes any reference to the sex of the person.

F

Fee Simple Ownership: Outright ownership of property with absolute rights to dispose of or gift it to anyone.

Fiduciary: A person with the legal duty to act primarily for another's benefit in a position of trust, good faith, candor and responsibility. "Fiduciary" is often used as an alternative term for "trustee."

Fiduciary Duty: The duty of a fiduciary to act in a position of trust, good faith, candor and responsibility, on behalf of another. The duty is one of the best defined responsibilities under the law and is very strictly enforced by the courts.

G

General Power of Appointment: A power of the donee (the one who is given the power) to pass on an interest in property to whomever he pleases, including himself or his estate.

General Power of Attorney: A legal document that gives one person (the agent) the legal authority to act on behalf of the other (the principal). The scope of the document can be as broad or narrow as the principal desired. A general power of attorney becomes invalid when the principal dies or becomes incompetent.

Generation Skipping Transfer (GST): A transfer of property, usually in trust, that is designed to provide benefits for beneficiaries who are two or more generations younger than the generation of the grantor.

Generation Skipping Transfer Tax (GSTT): A transfer tax generally assessed on transfers to grandchildren, great grandchildren and others who are at least two generations younger than the donor.

Generation Skipping Transfer Tax Exemption: An exemption from generation-skipping tax for transfers by an individual either during life or at death.

Generation Skipping Trust: Any trust having beneficiaries who belong to two or more generations younger than the grantor.

Gift: Literally a gratuitous transfer of something of value from the owner to another person. To be a valid gift there must be intent, actual transfer to the donee or recipient of the gift and acceptance.

Grantor: Another name for trustor or settlor.

Gross Estate: The total value of all property owned by a decedent at the time of his or her death.

Guardian: A person appointed by a court to care for a minor. The guardian may or may not also serve as conservator of the minor's estate.

H

Heirs: Those persons who are entitled under the statutes of intestate succession to the property of a decedent. Also used to refer generally to beneficiaries of a will. Also known as "next of kin."

I

Illinois Land Trust: In Illinois, and in five other states, legislation has been enacted that creates a special type of trust, commonly referred to as an "Illinois Land Trust". These trusts are designed to house real estate within a grantor trust and provide limited access to grantor or beneficiary information contained in the trust instrument or known to the trustee.

Income Beneficiary: A beneficiary whose interest is limited to income earned.

Inherit: To receive property from a deceased person.

Insurance Trust: Allows the placement of life insurance policies into a trust without gift tax or estate tax consequences. Unlike a Living Trust, it is irrevocable. The Trust is the owner and beneficiary of the life insurance policies. Very specific administrative procedures must be followed to take advantage of the tax benefit.

Inter Vivos: Literally means during life. Refers to transactions, such as gifts, made during a person's lifetime.

Inter Vivos Trust: Legal name for a living trust. The trust is set up by the grantor during his or her lifetime.

Intestate: A person who dies without having made and left a valid will.

Intestate Succession: The distribution of property to heirs according to the statutes of the state of residency upon the death of a person who owned the property but did not leave a valid will.

Irrevocable Trust: A trust that cannot be changed or terminated after it is established.

J

Joint Tenancy: A form of property ownership in which two people co-own property with an automatic right of survivorship. If one of the owners dies, the surviving owner automatically receives the deceased's owner's interest. This allows real property to pass without going through probate.

L

Life Estate: An estate or interest that someone has in property which lasts only during his lifetime, or the lifetime of some other person or persons. The life tenant has no ownership rights to transfer the interests after the life estate runs out.

Life Insurance Trust: A type of irrevocable trust used to hold life insurance. When a life insurance policy is held in an insurance trust, it is protected from estate taxes when the insured dies, provided the trust is established properly, managed properly, and the insured does not retain any "incidents of ownership."

Living Trust: A trust created and in effect during the lifetime of the maker.

M

Marital Deduction: The unlimited deduction allowed under federal estate tax law for all qualifying property passing from the estate of the deceased spouse to the surviving spouse. The value of the property passing to the surviving spouse under the marital deduction is "deducted" from the deceased spouse's estate before federal estate taxes are calculated on the estate. Proper planning and use of the deduction allows more property to pass estate tax free to the family.

P

Pay-on-Death Account: A bank account that is designed to avoid probate. It is a contract between the bank and the account holder guaranteeing that, upon the account holder's death, the bank will pay the balance of the account to whomever is designated to receive the account.

Per Stirpes: The most common way of distributing an estate such that if one of the children is dead. It describes generally the way a bequest is to be divided among a person's descendents. Most people want bequests to their children to be divided equally among the children. A per stirpes distribution does this, and it also governs what happens if any child has died. If a child has died, his (or her) share is divided among his issue if he has any issue.

Pour Over Trust: One which exists separately and independently of the will and is designated to serve as a custodian of property which it receives from the will.

Pour Over Will: This is a Will used to transfer (pour over) into a trust any property that is left in a person's estate after death.

Power of Appointment: A right given to another in a written instrument, such as a will or trust that allows the other to decide how to distribute your property. The power of appointment is "general" if it places no restrictions on who the distributees may be. A power is "limited" or "special" if it limits the eventual distributee.

Power of Attorney: A document established by an individual (the principal) granting another person (the agent) the right and authority to handle the financial affairs for the principal. A power of attorney becomes invalid at the death or incompetency of the principal, unless the power of attorney is a "durable power of attorney" which remains in effect after the principal becomes incompetent.

Probate: A court procedure for settling the personal affairs of a decedent by formally proving the validity of a will and establishing the legal transfer of property to beneficiaries, or appointing an administrator and supervising the legal transfer of property to heirs if there is no valid will.

Probate Fees: The fees, often a percentage of the estate, paid to the attorney and others who handle the probate proceeding.

Q

Qualified Terminable Interest Property: Property which passes to the surviving spouse who is entitled to all the income during life but whose interest terminates at death. This property qualifies for the marital deduction and is taxable in the estate of the surviving spouse.

QTIP Trust: An irrevocable trust for the benefit of the grantor’s spouse which qualifies for the gift and/or estate tax marital deduction; must provide that spouse receives all of the trust accounting income at least as often as annually for life (e.g., cannot provide for reduction or cessation of income interest in the event of spouse’s remarriage) and that no other person has any interest in the trust while the spouse is alive; principal benefit is that the grantor can control the disposition of the trust property at the spouse’s death and still obtain the gift and/or estate tax marital deduction.

R

Remainderman: One entitled to the remainder of an estate after a particular reserved right or interest has expired.

Revocable: A trust in which the trustor (maker of the trust) has, by the terms of the trust agreement, reserved the power to alter, amend or terminate the trust and to receive the property back from the trustee.

Revocable Living Trust: A living trust or inter vivos trust that can be amended and revoked, usually by the person who established the trust. This trust may become irrevocable and unamendable when the only person who can amend or revoke the trust dies or becomes incompetent.

Rule Against Perpetuities: A rule of common law that makes void any estate or interest in property so limited that it will not take effect or vest within a period measured by a life or lives in being at the time of the creation of the estate plus 21 years and the period of gestation. In many states the rule has been modified by statute. Sometimes it is known as the rule against remoteness of vesting.

S

Settlor: A person who establishes a trust. The term settlor is used interchangeably with the terms "trustor" and "grantor."

Spendthrift: A provision which protects the beneficiaries against claims of creditors and prevents the beneficiaries from selling, assigning, or transferring their interest in the trust.

Spouse: Legal term for a married person, either a husband or wife.

Successor Trustee: The trustee who takes over when the initial trustee can no longer function.

Surviving Spouse: The husband or wife that lives after the death of his or her spouse.

T

Tenants In Common: A form of asset ownership in which two or more persons have an undivided interest in the asset and the ownership shares are not required to be equal.

Testamentary Trust: A trust established after the death of the grantor under the provisions of the trustor's will.

Testate: An individual who has executed a valid will is said to be testate.

Testator: An individual who executes a will.

Totten Trust: A bank account that is designed to get around probate. The account is created by a person in his or her own name as the trustee for another person. It is a type of revocable trust until the creator dies; then it is paid out to the designated beneficiary(ies).

Trust: A legal document by which one person, called the trustor, donor, grantor or settlor, places property in the title of the trust for the benefit of himself or another. Normally involves trustor, trustee, who is charged with managing the trust, and beneficiary, in whose behalf the trust is established.

Trust Instrument: Refers to the document created by a grantor to establish the trust. It provides the governing guidelines, identifies the trustor(s), identifies the beneficiaries, and identifies the powers of the trustees and others involved with the trust. It should also include a listing of the assets that were transferred to the trust and constitute the corpus of the trust.

Trustee: The person or institution that manages trust property under the terms of the trust. The trustee becomes the legal owner of the corpus of the trust. The duties and obligations of the trustee are laid out in the trust instrument and imposed by law.

Trustor: A person who establishes a trust. The term trustor is used interchangeably with the "settlor" and "grantor" or “donor.”

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