IRREVOCABLE TRUSTS

Shifting Income and Wealth Using Irrevocable Trusts

A. Irrevocable Trusts - Generally: There are several types of irrevocable trusts that can be used to make gifts to other persons with the assets under the control and management of a trustee.

A.1 Purposes. Gifts to an irrevocable trust are sometimes motivated by a desire to minimize taxes or to shelter assets from the claims of future creditors and other claimants (including spouses in divorce cases and plaintiffs in civil lawsuits).

(a) *Creditor Protection*. Assets placed in an irrevocable trust are not available to the creditors of the settlor[1] except for creditors (i.e., claimants) whose claims existed before property is transferred to the trust. Assets placed in an irrevocable trust are not available to the creditors of any beneficiary, regardless of when a claim arose against the beneficiary. This can be particularly important for business interests that are intended to benefit the family for generations to come.

(b) *Estate Tax*. It is common for people to make gifts to an irrevocable trust when their estates exceed the applicable exclusion for federal estate tax purposes[2] because once the exclusion is exhausted, the estate-tax rate is 40%.[3] By giving away appreciating assets, the appreciation is shifted to others.

(c) *Income Tax*. Giving away income-producing assets is appropriate to shift the income to the beneficiaries of an irrevocable trust when the s

A.2 Limitations. To be effective for estate-reduction purposes, the trust must be irrevocable, and the trust's settlor should not be a beneficiary of the trust. It is also best if the settlor is not a trustee, either.

A.3 Annual "Crummey" Withdrawal Right. In order to qualify for the annual exclusion for gift-tax purposes ($15,000 in 2019), irrevocable trusts usually contain a provision giving the trust's beneficiaries a temporary right to withdraw annual contributions, at least in part. This withdrawal right is often called a "Crummey power" in reference to a Ninth Circuit Federal Court case involving a family with the "Crummey" surname.

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1 "Settlor" refers to the creator of a trust. Other synonyms include "grantor", "trustor", and "trust maker".

2 Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. Subject to legislative changes, the applicable exclusion is $11,400,000 in 2019. In 2026, this will revert to $5 million plus cost of living adjustments from 2011, which may be around $6,200,000. For the applicable exclusion in prior years, see https://rushforthfirm.info/advintro.html#ae.

3 Subject to legislative changes, the maximum rate imposed for federal estate tax purposes is 40%. For the rates in prior years, see https://rushforthfirm.info/advintro.html#ae.

A.4 Different Types of Trusts. This memo mentions several types of trusts, but the types can be overlapping and/or combined. The uses of irrevocable trusts for unique situations is virtually unlimited.

B. Bypass and Spendthrift Trusts: A "bypass trust" is a trust that benefits one or more beneficiaries without being considered assets of those beneficiaries for estate and gift tax purposes. Under state law, a bypass trust can be designed to also qualify as a "spendthrift trust", which cannot be attacked by a beneficiary's creditors. In short, this type of trust can reduce the beneficiaries' estate taxes and protect trust assets from creditors' claims at the same time.

B.1 Uses**.** The most well-known use of the “bypass trust” is in a revocable trust (or an irrevocable self-settled spendthrift trust[4]) established by a couple that divides into multiple trusts when the first spouse or partner dies. At that first death, it is common to place some of the trust’s assets into an irrevocable bypass trust — sometimes referred to as a “credit-shelter trust” — that is to be preserved against the claims of creditors and sheltered from federal transfer taxes. The bypass trust is also used in generation-skipping trusts, as discussed below.

B.2 Permitted Benefits. A beneficiary may have the following rights and privileges (or any combination thereof) without having the trust's assets included in their estates and, at least under Nevada law, without having their interest in the trust subjected to the claims of their creditors:

(a) *Income*. The beneficiary may receive all trust income.

(b) *Principal*. The beneficiary may receive trust distributions in the trustee's discretion.

(c) "*5 or 5 Power*". The beneficiary may have the noncumulative right to withdraw up to 5% (or $5,000, if greater) of the trust each year. This power is not usually included if the beneficiary has a taxable estate because if the beneficiary dies holding this power, the amount over which the power could have been exercised will be included in the beneficiary's taxable estate.

(d) *Power of Appointment*. The beneficiary may have the power to direct distributions from the trust either during life or at death or both so long as the beneficiary cannot exercise the power in favor of him/herself, his/her creditors, his/her estate, or the creditors of his/her estate.

(e) *Trustee*. The beneficiary can be the trustee so long as the trustee's discretion to make distribution is limited to amounts appropriate for the beneficiary's "health, education, support, and maintenance."

C. Supplemental Needs Trusts: If an intended beneficiary is a recipient of Medicaid, SSI, or other governmental assistance programs, an outright gift or a gift in trust may disqualify the beneficiary from continuing to receive such assistance. Trusts can be designed so that

[4] “Self-settled spendthrift trusts” are also known as “asset-protection trusts”. For more information on asset-protection trusts, see https://rushforthfirm.info/assetpro.html.

distributions are made only to "supplement" the benefits already being received. So long as distributions made by the trustee are discretionary and not mandatory, the trust assets and trust distributions are not, under most programs, considered disqualifying resources. Supplemental needs trusts are another form of a spendthrift trust specifically designed so that the trust assets are not counted as the beneficiary's assets for purposes of determining eligibility for benefits under assistance programs.

D. Alphabet Soup of Irrevocable Trusts: Irrevocable trusts can be designed in an infinite number of ways. There are some very special types of irrevocable trusts that have evolved over the years as well-recognized estate planning tools, including the irrevocable life insurance trust (ILIT), the charitable remainder trust (CRT), the charitable lead trust (CLT), qualified personal residence trust (QPRT), and others. New types of irrevocable trusts are created regularly by creative planners.

E. The Irrevocable Life Insurance Trust (ILIT): An irrevocable life insurance trust is created primarily to avoid estate tax proceeds from life insurance policies.

E.1 General Rule. Generally, the proceeds of life insurance policies are included in the insured's taxable estate at his or her death if the insured had "an incident of ownership" in the policy within three years of death. Estate taxation can be escaped by having someone other than the deceased own the policy and all of its attendant rights.

E.2 Ownership by Spouse: Making the spouse the owner and beneficiary can defer the estate tax if the insured’s spouse dies first. Tax avoidance is possible if the insurance, together with the spouse’s own estate, does not exceed the applicable estate-tax exclusion. Because this technique requires the spouse to survive, it is a gamble to use this technique.

E.3 Ownership by Children: Ownership by children or other family members can eliminate the estate tax, but it may also defeat some nontax objectives (such as spendthrift protection) and some tax objectives (such as generation-skipping). The primary problem is loss of control with respect to the use and application of the insurance proceeds. Untimely deaths, creditors' claims and lawsuits, and even divorces can divert the insurance proceeds from their intended purposes.

E.4 Using an ILIT. An irrevocable trust can be made the owner and beneficiary of all life insurance, removing the proceeds from the estate of the insured and the insured's spouse.

(a) The trust must be the owner AND beneficiary of the insurance, and the Settlor cannot retain any rights in the insurance policy.

(b) The trust must be irrevocable, and neither the Settlor nor the Settlor’s spouse should be a trustee or a beneficiary unless the trust is designed as a Nevada self-settled spendthrift trust (“SSST” or “asset-protection trust”).

(c) The insured's spouse can be a beneficiary of the trust so long as contributions to the trust come from the insured's separate property and other strict formalities are followed.

(d) If an existing insurance policy is contributed to the trust, the transfer will constitute a taxable gift of the policy's value, which is approximately the cash value (not surrender value) plus unearned premiums. If the value contributed by a donor exceeds the annual gift-tax exclusion[5] for the trust's beneficiaries, a gift-tax return will be required, and the donor's "applicable exclusion"[6] for gift- and estate-tax purposes will be used to negate the tax. Also, if the insured makes a gift of an existing policy and dies within three years, the policy proceeds will be included in the insured's estate for federal estate-tax purposes despite the existence of the trust.

(e) At least some of the gifts made to the trust to allow the trustee to pay policy premiums will be covered by the $15,000 annual exclusion for gift-tax purposes if the exclusion has not been applied to other gifts and the insurance trust contains the appropriate provision giving the trust's beneficiaries a "Crummey power", which is a right to withdraw trust contributions for a brief period of time, usually 30 days.

(f) The trustee cannot be required or permitted to pay any estate tax, but the trustee should be authorized to make loans to — or to purchase assets from — the insured's estate or revocable trust to provide the needed cash to pay the estate tax.

(g) Since the policy will mushroom in value at death, the irrevocable insurance trust will exclude much more value from the taxable estate than the cumulative value of the gifts made to maintain the insurance.

F. Generation-Skipping Trusts

F.1 Multiple Generations. Trusts are created to provide for the management of trust assets until those assets are distributed. Trusts inherently involve a deferral of distributions, usually until the death of the trust's settlor (creator), until a beneficiary reaches a particular age, or until some other identifiable event occurs. A "generation-skipping trust" is a trust that continues more than one generation. It is usually designed as a "bypass trust" for estate tax purposes so that the taxation of assets skips a generation.

F.2 Generation-Skipping Transfer Tax. Years ago, Congress decided that generation skipping was reducing the amount of estate tax collected, and it imposed the federal generation-

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[5] During each calendar year, each taxpayer can exclude certain gifts from the imposition of the gift tax. There is an "annual exclusion" applicable to gifts made to each donee (recipient) during each calendar year. This amount is $15,000 for gifts in 2018 and 2019 (and subject to a cost-of-living increase in future years). Other exclusions that have no dollar limit include: (1) tuition you pay directly to the educational institution for someone else; (2) medical expenses you pay directly to the health-care institution for someone else; (3) gifts to your spouse; and (4) gifts to a qualified charity. The "applicable exclusion" that is available for taxable transfers during life and at death will not be affected except as to gifts that exceed these exclusions. Gifts that exceed the annual exclusions and the lifetime "applicable exclusion" will trigger a gift tax.

[6] Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. Subject to legislative changes, the applicable exclusion was $11,180,000 in 2018 and is $11,400,000 in 2019. In 2026, this will revert to $5 million plus cost of living adjustments from 2011, which may be around $6,200,000. For the applicable exclusion in prior years, see https://rushforthfirm.info/advintro.html#ae.

skipping transfer tax ("GST Tax").[7] Unlike other transfer taxes, for the GST Tax, there is not a range of graduated tax brackets. The GST Tax is imposed at the highest estate tax bracket.5

(a) The GST Tax is imposed on transfers to grandchildren and lower generations, who are referred to in the law as "skip persons".

(b) Gifts (other than gifts in trust) that qualify for the $15,000 annual gift tax exclusion are also excluded for GST Tax purposes.

(c) There is a "GST exemption" that each transferor has.[8] Like the "unified credit" for gift and estate tax purposes, the GST exemption can be applied either during life or at death. The "applicable exclusion" for gift tax purposes is the same as for the estate tax.

(d) Once the exemption has been exhausted, the GST Tax applies in addition to any applicable gift or estate tax.

F.3 <u>Bypass Trusts</u>. The GST exemption amount can be placed in a "bypass trust" (as discussed in section of this memo) that allows beneficiaries from the children's generation to receive the income from and use of trust assets without having those assets included in their estates.

F.4 <u>Dynasty Trusts</u>. Many generation-skipping trusts are designed to primarily benefit the settlor's grandchildren, but some generation-skipping trusts are designed to last for several generations. The laws of most states require that a trust terminate at the end of 90 years or 21 years after the death of all those living at the time the trust became irrevocable. That maximum period is imposed by the "rule against perpetuities", which is a law that has existed for centuries to prevent perpetual trusts. Nevada law now permits 365-year trusts, and other states permit trusts that can theoretically last for centuries. Some states have abolished the rule against perpetuities, and in those states, trusts can theoretically last forever. It its regulations relating to the GST Tax, the IRS has indicated that it will not be bound by the states' rule-against-perpetuities laws, and that a transfer after the "perpetuities period" (as defined by the IRS) will trigger the imposition of the GST Tax.

(a) A dynasty trust can allow trust assets to be managed for the benefit of the settlor's family for approximately three generations. If the trust is drafted appropriately AND the settlor allocates his or her GST exemption to transfers to the trust, there can be no estate, gift, or generation-skipping transfer tax imposed as long as the trust lasts.

(b) A dynasty trust will usually discourage the expenditure of trust principal, but it will allow beneficiaries to use trust assets. For example, a shared family mountain

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[7] The federal generation-skipping transfer tax ("GST tax") is imposed at the highest rate imposed for federal estate tax purposes, which is mentioned in note 2. For 2011 and beyond, the GST exemption has been the same as the applicable exclusion for estate tax. (See note 2.)

[8] See note 2.

cabin or condominium or other vacation property could be held in this trust for several generations.

(c) Because a dynasty is an irrevocable trust, it also can be a spendthrift trust that is exempt from the claims of the beneficiaries' creditors.

F.5 Grantor Trusts: "Grantor Trusts" are not so much a type of trust as they are an income tax classification. A trust is considered a "grantor trust" if the Settlor (grantor, trustor, trust creator) has certain powers over the trust or if others have too many powers over the trust that might be exercised in favor of the Settlor. All taxable income that is paid to a grantor trust will be taxed to the trust's Settlor as if the Settlor owned the income-producing assets.

(a) *Revocable Trusts*: Revocable trusts are always grantor trusts, but irrevocable trusts are usually designed not to be grantor trusts.

(b) *Irrevocable Trusts*: Because an irrevocable trust is usually designed not to be a grantor trust for income tax purposes, an irrevocable trust that is a grantor trust is sometimes thought to be "defective", and so it is sometimes called a "defective grantor trust" ("DGT") or an "intentionally defective grantor trust" ("IDGT"). Because of the benefits discussed below, some irrevocable trusts are designed to be grantor trusts, which makes them "intentionally defective". Such trusts are designed to be grantor trusts for income tax purposes but excluded from the grantor's estate for estate tax purposes. A trust can also be designed to be a "grantor trust" as to a beneficiary. This type of trust is referred to as a "beneficiary-grantor trust" or as a "beneficiary defective inheritors trust" ("BDIT").

F.6 Paying the Tax: For many irrevocable trusts, the main purpose is to make a gift of property to the trust's beneficiaries in order to shift the income, appreciation, and value of the property away from the trust's settlor in order to reduce the settlor's estate tax liability at his or her death. A grantor trust requires that the grantor pay all of the trust's tax, which is yet another way of reducing the settlor's estate. Because the payment of the tax is required by law, it is not considered a gift. Thus, some estate planning practitioners design their trusts as grantor trusts to take advantage of this ability to give the trust's beneficiaries yet another benefit. Most grantor trusts are designed so that the trustee's powers and the trust's administrative provisions that cause the trust to be a grantor trust can be cancelled. Many grantor trusts include a provision that permits (but does not require) the trustee to reimburse the settlor for the taxes the settlor pays on trust income, but that can trigger unintended, undesirable consequences.

F.7 Transactions with a Grantor Trust: Any transaction between the grantor trust and the grantor is treated for income tax purposes as having no tax consequences. One use of that trust is for business-succession planning, which is discussed in the article on business entities.

G. S Corporation Stock: An irrevocable trust can be designed to hold S corporation[9] stock in one of three ways: (a) as a grantor trust; (b) as a qualified subchapter S trust ("QSST"); or (c) as an electing small business trust ("ESBT"). While the trust's settlor (creator) is alive, the easiest method is usually to have the trust qualify as a grantor trust. Even if an irrevocable trust is originally designed to hold assets other than stock in an S corporation, it is wise to give the trustee authority (and perhaps the directive) to make the trust qualify as either a QSST or an ESBT.

H. Other Irrevocable Trusts: Other types of irrevocable trusts are discussed on our informational website (https://www.rushforthfirm.info).

H.1 For charitable trusts, see https://rushforthfirm.info/pdf/charitable.pdf.

H.2 For grantor-retained income trusts (GRITs), such as the grantor-retained annuity trust (GRAT) and the qualified personal residence trust (QPRT), see https://rushforthfirm.info/advfreez.html and https://rushforthfirm.info/pdf/qprt-grat.pdf.

H.3 For asset-protection trusts--including offshore trusts and "Nevada incomplete-gift, non-grantor" trusts, also known as "NINGs," see https://rushforthfirm.info/pdf/ap.pdf.

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[9] An "S corporation" is a domestic corporation that has filed a special tax election with the Internal Revenue Service to be tax under "Subchapter S" of the income tax laws. An S corporation usually pays no tax, and its shareholders are taxed somewhat like partners. In the absence of an election to be an S corporation, corporations are taxed under Subchapter C, so corporations that are not S corporations are sometimes called "C corporations", although you will not find that term in the Internal Revenue Code.