PRACTICAL TAX STRATEGIES

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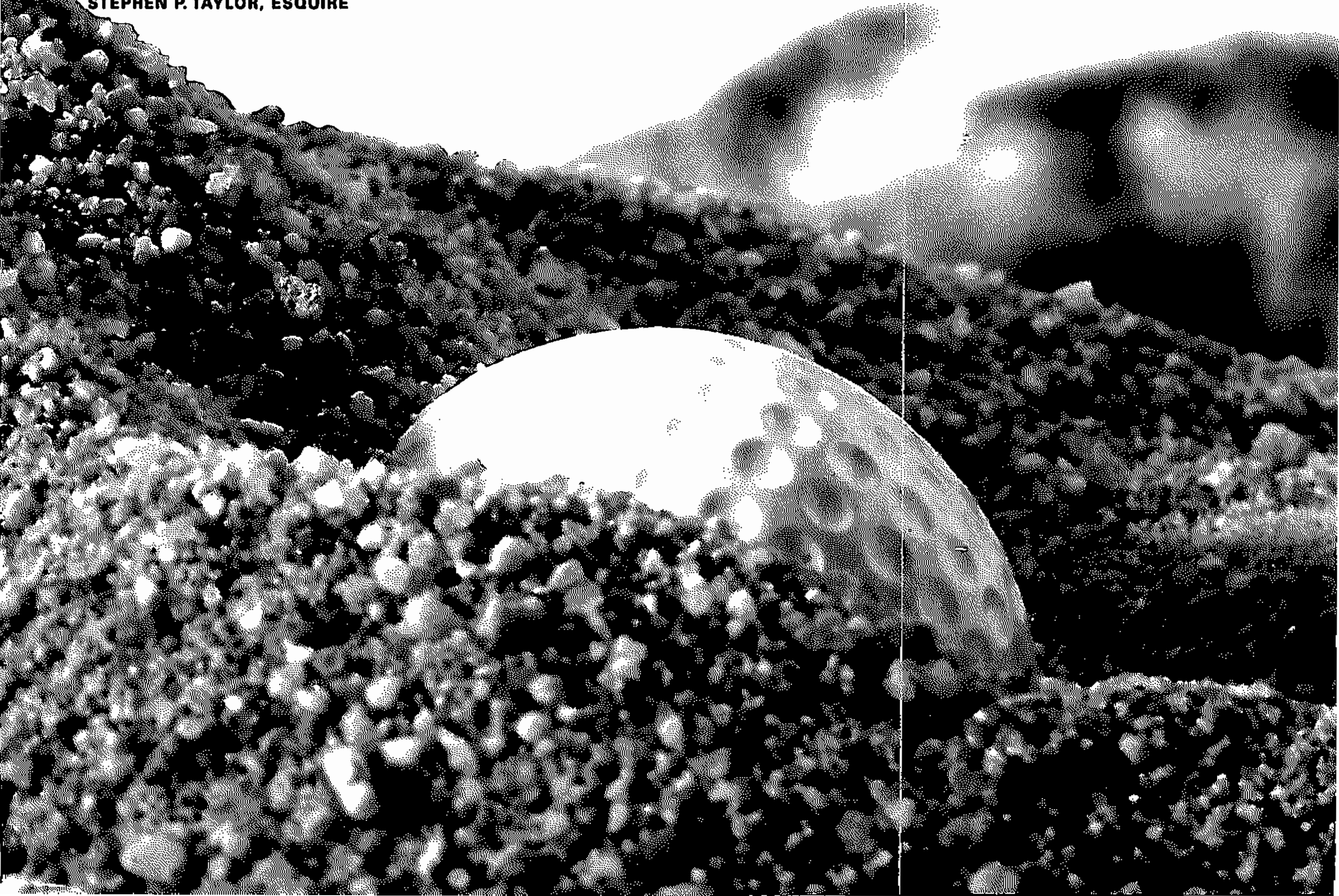
USING TRUSTS TO MAXIMIZE FAMILY PROTECTION AND MINIMIZE ESTATE TAXES

JOSEPH R. POZZUOLO, ESQUIRE
JEFFREY S. POZZUOLO, ESQIURE
STEPHEN P. TAYLOR, ESQUIRE



USING TRUSTS TO MAXIMIZE FAMILY PROTECTION AND MINIMIZE ESTATE TAXES

JOSEPH R. POZZUOLO, ESQUIRE, JEFFREY S. POZZUOLO, ESQUIRE AND STEPHEN P. TAYLOR, ESQUIRE

Practitioners can take advantage of this primer on the tax benefits of transferring assets to a trust.

Your client Abe finally decides to transfer assets out of his estate to provide for his and his family's continued health, welfare, and security. At the same time, Abe hopes to avoid estate taxes as much as possible. However, he may have concerns about relinquishing control of his assets for such tax savings. He may be concerned that members of his family cannot responsibly manage the assets or that his children are minors or have special needs. Abe may be worried about who will manage his property if he becomes incompetent or disabled and who will make payments for his hospital, nursing, or overall medical care in such a situation. He also thinks about who will manage his investments and increase their value. Whatever Abe's concerns, he mostly just wants to provide for the ongoing support of himself and his family after he transfers his assets.

Putting Abe's investment assets in trust may be the solution to these problems. A trust allows his assets to be managed even after they have left his control or when he becomes unable to directly manage the assets himself. Within a trust document, he may set restrictions on how assets may be used and proscribe various ages and events at which a beneficiary can receive funds. He appoints a trustee or co-trustees, who may be a trusted friend or a professional corporate trustee, to manage the assets and ensure they are used as he would desire according to the terms of the document. In the event of Abe's death or incapacity, the trust provisions essentially control his assets indirectly to ensure the wealth he acquired can provide his family a base level of support for years to come and not be dissipated frivolously.

This article is geared to practitioners, their clients, or sophisticated individuals who want an inclusive, background article on trusts. This article will go through the many decisions a creator of a trust faces when drafting a trust. First, it discusses what a trust is and how it compares to other entities. Second, it examines the various trust options to help the creator of a trust determine the most desirable type, especially in regards to their tax consequences. Third, it considers various trust provisions pertaining to distributions of assets and beneficiaries' ability to assert their rights. Fourth, it explores the possible choices of trustees and details provisions to safeguard against improper acts by trustees. Lastly, it discusses various schemes to fund the trust effectively in

JOSEPH R. POZZUOLO, J.D., is the senior shareholder of Pozzuolo Rodden, P.C. Counselors at Law in Philadelphia, Pennsylvania, and a member of the American Bar Association's Committee on Taxation and the Philadelphia Bar Association on Corporation and Business Law. JEFFREY S. POZZUOLO, J.D., M.B.A., and STEPHEN P. TAYLOR, LL.M. are associates at Pozzuolo Rodden, P.C.

order to save estate and gift taxes or meet charitable purposes or other endeavors.

What is a trust?

A trust is an entity created by a transferor, grantor, or settlor (all synonymous). The grantor transfers property, the res, to a person called a trustee to hold for the benefit of the beneficiaries, who ultimately receive the property. The trustee, who may be an individual or a trust company, has *legal title* to the property, whereas the beneficiaries have *equitable title*. The trustee legally holds, manages, and uses the property for the benefit of the beneficiaries as specified in the trust. The beneficiaries hold only equitable title because they do not have direct control over the assets but, ultimately, are the owners of an equitable interest in the property held under trust.

A trust is generally created when a grantor designates a trustee to hold property in trust for the trust beneficiaries and the property is actually transferred to the trust. Generally, no magic words are necessary for a trust to be created, but, at a minimum, it is best to have wording to the effect of "I give [such property] to [trustee] to hold in trust for the benefit of [the beneficiaries]." It is important to show clear and convincing evidence of an intent to create a trust arrangement.

How does a trust compare to other entities?

A trust is an entity separate and distinct from the grantor and the beneficiaries. In this way, trusts are similar to partnerships, limited liability companies (LLCs), and corporations, which are entities separate and distinct from their partners, members, and shareholders, respectively. A trust also pays its own taxes and acts through the trustee. However, trust beneficiaries generally do not have the power to control the trust that partners of partnerships, members of LLCs, and shareholders of corporations may have.

Similar to partnerships, trusts have the benefit of being relatively simple to establish and simple to manage. They do not require formal registration with the state as required by partnerships or corporations. Generally, the trust is created and the trustee simply acts under the terms of the trust.

On the other side, trusts do not have the same types of protection that partnerships, LLCs, and corporations may have. A partner, member, or shareholder may vote and change the management if he or she sees, or even suspects, foul play. If a trust beneficiary sees foul play, the beneficiary may have to request a formal accounting and may be able to remove the trustee only if the beneficiary can show mismanagement or a breach of the trustee's duties. It is possible, however, to include provisions that allow a beneficiary or an independent person to replace a trustee.

Types of trusts

Generally, trusts may be inter vivos or testamentary, and revocable or irrevocable. They may have special status such as charitable trusts, special needs trusts, or the ability to hold S corporation stock.[1] These different configurations have different tax and dispositive effects.

Inter vivos trusts versus testamentary trusts. A trust may either be an inter vivos trust or a testamentary trust. An inter vivos trust is one created during the grantor's lifetime. A grantor establishes an inter vivos trust by properly executing and funding a trust agreement with a trustee during his or her lifetime.

On the other hand, a testamentary trust is established or created by will, which becomes effective after the grantor's death. A testamentary trust is usually a trust embedded within the will document itself. For it to be valid, the will must be formally executed according to the laws of the particular state.[2]

Revocable versus irrevocable. An inter vivos trust may either be revocable or irrevocable. A revocable trust may be amended or revoked by the grantor. An irrevocable trust may not be amended or revoked by the grantor. Revocability will affect taxes, the disposition, and the administration of a trust.

By default, only an inter vivos trust may be revocable because once the grantor dies, he or she cannot amend or revoke a testamentary trust anymore. The lack of revocability associated with an irrevocable trust prevents the grantor from changing beneficiaries, trustees, the timing of dispositions, or from pulling the assets back into his or her estate. Generally, re-

[1] Typically, trusts may not hold S corporation stock.

[2] In some states, this requires the testator (the person for whom the will is for) signing in front of two witnesses and a notary public, the witnesses signing in everyone's presence, after which the notary signs while the non-signing parties look at the signature. Wills have been cast aside if a witness was in the same room, but not looking directly at the signing or if the witnesses signed before the testator.

vocability is a trade-off between retaining control over the assets within the trust versus tax savings by completely removing assets from the grantor's estate and control.

Disposition and administration. There are various disposition benefits among the various trust types. Generally, inter vivos trusts provide the following benefits: immediate asset management, avoidance of probate, and, potentially, protection from creditors. Revocable inter vivos trusts allow the grantor to be able to maintain actual control of the assets. Irrevocable inter vivos trusts may be used to remove assets and all future appreciation of such assets from the grantor's estate, which may be an extremely powerful estate planning tool.

On the other hand, with testamentary trusts, a decedent's assets are not transferred until his or her death. Thus, the grantor controls the assets through his or her life. Again, there is a balance of maintaining control versus receiving tax and disposition benefits of an inter vivos trust. However, with all trusts, the grantor retains the benefits of de facto control of assets and central management after his or her death because the terms of the trust express the grantor's wishes as to how his or her assets are to be managed and disposed.

Asset management. Trusts act as central vehicles for asset management. Assets may be pooled together and managed within a single trust rather than separately managed. The pooling of assets creates cost efficiencies through economies of scale and greater access to investments. For example, some professional trust and investment management companies require minimum investments. By pooling together his or her assets into a trust, a grantor may be able to access the professional management and diversity as he or she desires, thereby assuring smoother, professional trust administration. This may also be used as a way to keep individual beneficiaries from mismanaging their share of the assets and losing their potential benefits.

Both inter vivos and testamentary trusts have the benefits of such management, but inter vivos trusts allow this management during grantor's life and/or incompetency. By using an inter vivos trust, a grantor can enjoy life, family, and friends, rather than having to manage his or her money and affairs. In the event of a grantor's incompetency, the trustee will manage the grantor's assets and pay for the grantor's affairs such as nursing homes, medical bills, and other support expenses.

Post-transfer control of assets. A grantor may indirectly control the use and distribution of assets after transferring them to a trust. The grantor does this by writing restrictions into the trust document on how assets may be used. The grantor may dictate that certain events must occur to trigger distributions of assets to beneficiaries. For instance, the grantor may state that a payment to his or her child for college is contingent on the child's pursuit of an undergraduate degree.

The grantor may appoint a close, personal friend as co-trustee with a trust company because that friend knows the grantor's wishes. The grantor could give the individual co-trustee wide discretion over the circumstances under which payments are to be made to beneficiaries. If the trust is an inter vivos trust, and the grantor is alive and competent, the friend will likely respect the grantor's wishes. If the trust is testamentary, the close friend will know what types of distributions the grantor would have granted and will make similar decisions. For example, a close, personal friend most likely will be aware of the grantor's family dynamic.

Whether a trust is revocable will have an effect on how it is taxed.

Avoiding probate. A grantor may avoid probate by transferring assets to a trust. Only those assets transferred to an inter vivos trust avoid probate. Probate is the first step in the administration of a decedent's estate and is the formal process in which the decedent's local county judicial authority approves the will and documents the assets that pass through the decedent's will. Due to the formalities required in some states, a will may not be admitted if it was not executed according to state law. If the will is not admitted, the property is distributed according to the state's intestate laws. Generally, the state's intestate laws dictate that the decedent's property passes to the spouse or to the children. When the decedent dies leaving no surviving spouse or children, his property may pass to his or her parents or more distant relatives. A potential problem arises when the will submitted to probate is rejected but an older version is admitted. In this case, the decedent's property may pass to beneficiaries named in the prior version who are no longer associated with the decedent or have no need for the inheritance.

Further, assets that pass by trust conditioned on the grantor's death pass automatically at the grantor's death. These assets may avoid probate fees, creating some financial savings for the grantor's estate. Whether or not assets pass on death under a will or a revocable trust, however, administering any estate involves appraisals, preparation of federal and state estate tax and inheritance tax returns, fiduciary income tax returns, and legal fees in selling and disposing of assets. There also may be executors' and/or trustees' commissions and the expense of an accounting. Fees could be substantial if there is litigation or difficulty in proving heirship, which could occur whether assets pass by revocable trust or by will.

Protection from creditors. Assets may be protected from the reach of creditors if they are placed into trust. Whether and to what extent the assets may be protected from creditors depends on state law. Generally, absent intent to defraud creditors, assets transferred to an (inter vivos) irrevocable trust are protected from creditors. Thus, a grantor may be able to guarantee that he or she will have assets to provide for his or her family no matter how large the grantor's future debts and liabilities become. However, most states subject "self settled trusts," in which a trustee has the discretion to make payments to the trust's creator, to the claims of the grantor's creditors to the extent the trustee's discretion may be exercised.

Disposition effects of revocability. Because revocable trusts are revocable and amendable, and because they also are always inter vivos trusts, a grantor may manage his or her assets in a revocable trust almost as though the grantor had not even transferred them to a trust. The grantor may amend or revoke the trust, taking back whatever assets or funds were initially transferred. The grantor may decide to change the distribution policies so that beneficiaries receive money at different times. Perhaps, the grantor divorced and now wants to remove an ex-spouse or his or her children from the trust. All of these options and more are possible with a revocable trust. A revocable trust is the proper type if a grantor wants to manage the trust and, at the same time, may not want to completely part with assets.

On the other hand, although irrevocable trusts do not have the benefit of being revocable, they do have other benefits. Irrevocable trusts are excellent vehicles for removing assets from the grantor's estate, including any future appreciation on the value of the assets placed in trust. Additionally, whereas a grantor is usually responsible for paying taxes generated by the assets within a revocable trust, a grantor can achieve certain tax benefits by placing assets into an irrevocable trust.

Tax treatment of trusts. Trusts generally face two types of taxes: (1) income taxes; and, (2) transfer taxes related to wealth transfer. The tax treatment depends on whether the trust is revocable or irrevocable, and on the timing of when the trust becomes irrevocable. The rules related to taxation of trusts are generally located under Sections 2001 *et al* (estate taxes) and Sections 641 *et al* (income taxes).

Income taxes. A trust that is not attributed to any particular person (i.e. an irrevocable trust) is treated, for tax purposes, similar to a mix of a partnership and also like a corporation. Such a trust receives partnership-like tax treatment in that it has single, flow-through taxation. Beneficiaries recognize a portion of the trust's income on their Forms 1040 to the extent income is distributable to them. The trust receives a deduction for the amount taxed to the beneficiaries. Thus, the beneficiary is personally responsible for income distributable and the trust is responsible for income not distributable.

Such a trust receives corporation-like tax treatment in that it has its own separate taxation; it is treated as an individual taxpayer with certain modifications and with narrower tax brackets. Thus, beneficiaries generally will not have a tax consequence on their personal Forms 1040 if no distributions are made, which is similar to how a corporation that makes no distributions to the stockholders is treated. Further, a beneficiary entitled to trust income is taxed on that amount, whether or not it is actually distributed.

Wealth transfer tax system. The wealth transfer tax system comprises three transfer taxes: (1) the gift tax;[3] (2) the estate tax;[4] and (3) the generation skipping transfer tax.[5] For each, an individual is given various unified credits, exemptions, and exclusions.

1. *Gift tax.* The gift tax is a tax on lifetime transfers. However, the gift tax applies only to transfers made in excess of the annual exclusion amount. This means that each year, a person may transfer a set amount to any number of persons free of gift tax. The annual exclusion amount is indexed for inflation ($13,000 for

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[3] Section 2501 *et al.*

[4] Section 2001 *et al.*

[5] Section 2601 *et al.*

[6] Section 2505.

[7] The maximum rate is 60%, including the 5% recapture for estate over $10 million.

[8] This tax was enacted to counter schemes of transferring assets to grandchildren or great grandchildren to avoid layers of the estate tax. Without a direct transfer, there would traditionally be a tax at the parent's death from parent to child, and then another tax at the child's death from child to grandchild. Parents would transfer directly from parent to grandchild, resulting in only one tax by avoiding the child to grandchild tax. This tax is to ensure that the second layer from child to grandchild is not avoided in direct transfers.

2012 and $14,000 for 2013). There is also a lifetime exemption amount.[6] If a person makes a gift in an amount in excess of the annual exclusion amount, the excess amount will reduce that person's lifetime exemption (currently, $5,120,000 for 2012 going down to $1,000,000 for 2013 unless Congress and the President act). After the lifetime exemption is exhausted, gifts of amounts above the annual exclusion are taxed at up to 35% in 2012 (going up to 55% in 2013 unless Congress and the President act) of the value transferred for federal gift tax. The benefit of gift giving is that once an asset is a "completed gift," the income and appreciation are outside of the transferor's estate, barring claw-back treatment discussed below.

2. *Estate tax.* The estate tax is a tax on the transfer of assets that occurs when a person dies. The tax is based on the fair market value of the assets transferred at death, plus certain assets previously give as gifts that are clawed back into the decedent's estate under Sections 2035-2041. The taxable amount is reduced by a credit based on the estate tax exemption ($5,120,000 for 2012 and $1,000,000 for 2013 pending action from Congress). Like the gift tax, the current top estate tax rate is 35%, which will go up to 55% pending action by Congress and the President.[7] A "tentative tax" based on the graduated rate table is first computed on the total of the taxable estate and "Adjusted Taxable Gifts," i.e., the total of gifts (at gift tax values) above annual exclusion amounts. The taxable estate is determined by deducting state death taxes, along with debts, funeral expenses, and administrative expenses. The total is reduced by the gift tax (if any) that would be imposed at current rates on adjusted taxable gifts and by a "unified credit" based on an exempt amount that is currently $5,120,000 in 2012. Although the unified credit is based on $5,120,000, the credit itself, which is the tentative tax on $5,120,000, is $1,772,800.

3. *Generation skipping transfer tax.* The generation skipping transfer tax (GST) applies to transfers made, whether by gift or at death, to grandchildren, more remote descendants, or other persons more than 37.5 years younger than the transferor (called "skip person(s)").[8] An individual is given a GST exemption ($5,120,000 for 2012 and $1,000,000 for 2013 pending action from Congress), and can allocate such amounts

HOW WOULD YOU RULE?

On 9/10/07, the IRS sent a notice of deficiency to Sylvia that increased her 2005 income tax liability by $20,000. A month later, Sylvia filed for bankruptcy under Chapter 13 and listed the $20,000 IRS claim. As part of the bankruptcy proceeding, the IRS filed a proof of claim for an unsecured priority claim of $16,000, which was $4,000 less than the amount in the deficiency notice. Sylvia's Chapter 13 bankruptcy plan was confirmed, and the Service was paid the entire amount of its claim of $16,000. Sylvia's unsecured creditors were also paid $10,000. Sylvia later converted her Chapter 13 bankruptcy to Chapter 7. She believed that all of the Service's claims had been fully paid. Can the Service subsequently collect the $4,000 it asserted was the unpaid balance of Sylvia's 2005 taxes?

Solution: No. *Moore*, TC Summary Opinion 2012-116.

Sylvia fulfilled her obligation to the Service under the confirmed Chapter 13 plan. The IRS received everything it asked for in the bankruptcy proceeding. Attempting to collect an additional amount from Sylvia violated the implicit bargain it made in the bankruptcy proceeding to refrain from collecting more. Sylvia listed the correct amount of her tax liability, and the Service's mistake was solely its responsibility.

The IRS argued that the additional tax liability it was trying to collect was not dischargeable in a Chapter 7 case, so it should not be prevented from collecting it. The IRS, however, was paid everything it asked for in the Chapter 13 case, and the conversion to Chapter 7 did not have a negative impact on its claim. There was no reason the Service should be able to collect additional money from Sylvia as a result of the conversion after its claim was paid in full.

to trusts or transfers.[9] The amount allocated is used to determine what is called the "inclusion ratio," which is a percent determined as one minus the fraction of the amount allocated over the amount transferred (1 – (amount allocated/amount transferred)). When a GST taxable event takes place, the fair market value multiplied by the inclusion ratio is taxable at the highest estate tax rate and the other portion is not. Improper planning with respect to skip persons can lead to a total tax between gift taxes, estate taxes, and the GST that is in excess of the amount transferred.

Tax effects of revocability. Whether a trust is revocable will have an effect on how it is taxed. A trust's revocability determines who is responsible for paying income taxes and whether the assets in the trust will be included in, and taxed to, the grantor's estate.

Revocability also affects the estate tax treatment of the assets within a trust. When assets are transferred to an irrevocable trust, generally, any appreciation gained on those assets or any income earned by those assets accrues outside of the grantor's estate when they are in the grantor's estate for a revocable trust. This creates a significant tax benefit. Thus, timing can be everything. If assets are placed into an irrevocable trust when their value is low, and then their value appreciates significantly, all of that appreciated value may be transferred gift and estate tax-free.

If the trust is revocable, the grantor will be responsible for paying the income taxes because the grantor is treated as still owning the assets. If the trust is irrevocable, the beneficiaries will be responsible for paying income taxes to the extent income is required to be distributed, and thereafter, to the extent of other distributions, up to the extent of the trust's income. The trust's capital gains are generally taxed to the trust rather than to then beneficiaries.

Claw-back provisions. The Code contains "claw-back" provisions that nullify a transfer and bring assets back into the grantor's estate. The provisions apply when the grantor maintains certain "strings" of control or enjoyment over the assets transferred. If the claw-back provisions of Sections 2035-2042 apply, assets transferred by gift will be included in the grantor's taxable estate and taxed at fair market value at death rather than gift tax value.

The following is a list of circumstances that will cause the re-inclusion of transferred assets into the grantor's estate:

- The grantor relinquished an interest in a property or a power over the property described in Sections 2036, 2037, 2038, or 2042 within three years of death.[10]
- The grantor retained the right to possess or enjoy the property; the right to determine who could possess and enjoy the property; or the right to retain the right to vote in shares transferred.[11]
- The beneficiary can obtain the property only by surviving the grantor, and the value of the grantor's reversionary interest is greater than 5% of the value of the property transferred or the grantor can control the disposition of that amount.[12]
- The grantor has the power over the property to alter, amend, revoke, or terminate the gift or trust, or relinquished such right within three years before death.[13]
- A beneficiary has a right to an annuity or other payment by reason of surviving the decedent when the decedent retained the right to pay an annuity for his or her life, or for a period ascer

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[9] As a note for practitioners, there is an automatic allocation for GST transactions as of 2001 and later; however, this should be opted out of and manually allocated to avoid the complex automatic allocation rules and potential misallocations.

[10] Section 2035.

[11] Section 2036.

[12] Section 2037.

[13] Section 2038.

[14] Section 2039.

[15] Section 2040.

[16] A general power of appointment is the right to appoint property to oneself, his or her estate, or the creditors of himself or herself or his or her estate.

[17] Section 2041.

[18] Section 2042.

[19] See Section 672(e).

[20] An adverse party means a person with a substantial beneficial interest in the trust who would be adversely affected by the exercise or non-exercise of a power held with respect to the trust. A non-adverse party is a person that is not an adverse party. Note that related and subordinate parties such as the grantor's spouse if living with the grantor, and a grandparent, parent, issue, sibling, an employee of the grantor, a corporation or employee of a corporation in which the stock holdings of grantor and the trust are significant in terms of voting control, and a subordinate employee of a corporation in which the grantor is an executive are treated as non-adverse parties unless it can be shown otherwise by the preponderance of the evidence. Sections 672(a)-(c).

[21] Section 673.

[22] Section 674.

[23] Section 675.

[24] Section 676.

[25] Section 677.

tained by reference to his or her death.[14]

- The value of property owned jointly by the grantor except to the extent it can be proven that other owners contributed to the value of the jointly held property.[15]
- To the extent a grantor holds a general power of appointment[16] or released such power and retained a power includable under Section 2036 to 2038.[17]
- Life insurance on the grantor that is payable to the grantor or her estate.[18]

Grantor trust rules. When it comes to income taxes, the general rule is that irrevocable trusts are taxed as separate entities and pay their own taxes. "Grantor trusts," however, do not fall under the general rule. Grantor trusts are treated as revocable trusts for income tax purposes. A grantor trust is disregarded for tax purposes and the income must be reported on the grantor's personal income tax return. An irrevocable trust will be deemed a grantor trust if the grantor retains certain incidences of ownership. Note, that if a grantor's spouse holds these powers, the grantor is deemed to hold them.[19] Also note that if a non-adverse party, as opposed to an adverse party, holds the powers in mentioned in Section 674, 675, or 676, these powers will also be considered held by the grantor.[20] These powers include:

- The grantor retains a right to receive an interest worth 5% of the trust or greater.[21]
- The grantor or a non-adverse party retains the power of disposition of the beneficial enjoyment of the trust assets or the income from the assets without the consent of an adverse party.[22]
- (1) The grantor or a non-adverse party retains powers to deal for the trust to transfer assets for less than adequate consideration; (2) the grantor or a non-adverse party may permit the grantor, directly or indirectly, to borrow without adequate interest or security; (3) the grantor borrows and does not return the funds by the end of the tax year, and the loan was not made by a trustee other than the grantor or a related and subordinated party for adequate interest and security; and (4) the power of administration is exercisable by anyone without a fiduciary duty.[23]
- The grantor or a non-adverse party retains a power to revoke the trust and re-vest the grantor with title.[24]
- The grantor or a non-adverse party retains the right to approve, request, or consent to income of the trust being distributed to the grantor or the grantor's spouse, to be held for the grantor or the grantor's spouse in the future, or applied for premiums on insurance policies on the life of the grantor or the grantor's spouse.[25]

One type of trust, called an intentionally defective grantor trust, actually seeks to have this tax effect. If the grantor pays the income taxes, but the trust itself is not included in the grantor's estate, the payment of taxes is essentially a tax-free transfer of additional value. It is tax free because the trust does not have to use trust assets to pay the taxes itself, leaving more assets available to the beneficiaries. Here, the grantor pays the taxes and the value of the assets remains the same. However, the grantor must make certain that he or she will be able to actually pay the taxes. For example, if the grantor has transferred too many assets to an irrevocable trust, he or she may have no money left to pay the taxes.

Trust provisions relating to distributions and beneficiary rights

A grantor may draft a trust document that prescribes distributions to beneficiaries and their ability to assert their rights. The grantor will dictate how the assets are to be split up, the distribution mechanism, limitations on distributions, and the dispute resolution limits and procedures. Different provisions should be tailored to different situations based on the grantor's preferences and each beneficiary's situations. Some grantors desire more protection than others do, and some beneficiaries need more restriction than others do.

Automatic payments, discretionary distributions, and withdrawal rights. After determining who will be the beneficiaries and what they are to receive, a grantor must determine the distribution schemes or methods, or how to make payouts. A grantor may set up or provide: (1) automatic payments, (2) discretionary distributions, and/or (3) beneficiary withdrawal rights.

Automatic payments are exactly that—payments made automatically to a beneficiary in a specified amount on a specified schedule or on the occurrence of a specified event. For example, an automatic payment provision could provide that a beneficiary receives all net income from the trust on a monthly, quarterly, or annual basis or 1/3 of the principal on his or her 35th birthday. Discretionary payments are not automatic. They are payments made at the trustee's discretion. The trustee may decide how much should be paid or when the payment should be made. This is a case in which a trustee familiar with the grantor is important in order to know what types of payment the grantor would desire.

A grantor should consider the characteristics of each beneficiary when choosing a distribution method. Generally, automatic payment provisions are good for beneficiaries who are more responsible with funds. In the case of automatic payments, beneficiaries receive the payments regardless of need or future use, so they should be trusted to not spend any excess funds frivolously. Discretionary distributions are more suited for beneficiaries who are irresponsible with their funds or whose funds need protection. For example, a beneficiary may take the $5,000 she receives automatically each month and spend $3,000 on living expenses and $2,000 on drugs or an industrial griddle for her small apartment. If the payments were discretionary, the beneficiary would have $3,000 distributed for rent, food, car payments, and other expenses, but she will be denied the last $2,000.

Another method is to grant a beneficiary withdrawal rights. Withdrawal rights are rights a beneficiary has to withdraw from the principal of the trust fund. With withdrawal rights, a beneficiary possesses an option to demand that the trustee make payments to him or her. Usually withdrawal rights are set according to a schedule, so that, for example, a beneficiary may withdraw 30% of trust fund principal on her 30th birthday.

Withdrawal rights may be cumulative or non-cumulative. If the rights are cumulative, the beneficiary may carry over the amounts not withdrawn to subsequent periods. Non-cumulative rights may not be carried over.[26] With cumulative withdrawal rights, if the beneficiary does not withdraw principal, the funds continue to remain in the trust and receive management and investment. Non-cumulative withdrawal rights permit beneficiaries to withdraw certain amounts within any period for certain predetermined reasons, such as for health, education, maintenance, and support, or for emergencies, but do not allow for an ever increasing withdrawal amount.

Generally, as to funds that remain in the trust, the beneficiary will be deemed to have received the full withdrawal by constructive receipt and then contributed the amount back to the trust. In this situation, the beneficiary will be treated as the grantor of the non-withdrawn amount.[27] The beneficiary will be responsible for the taxes on that portion and such amounts may be included in the beneficiary's estate at death. Therefore, except for large principal withdrawals or when it is preferred that the funds remain in the trust, the grantor may be well advised to incorporate automatic payment provisions rather than withdrawal rights.

Payments 'to the beneficiary' versus 'for the beneficiary's benefit.' Another twist on payments is paying "to the beneficiary" or paying "for the beneficiary's benefit." If a provision provides that payments are made directly "to the beneficiary," the beneficiary will receive the payment outright. What the beneficiary does with the money after that is his or her decision. Making direct payments to a beneficiary is considered only if the beneficiary is responsible with money and not a spendthrift. If the trust states that payments are to be made "for the beneficiary's benefit," the trustee will pay a payee directly on behalf of the beneficiary rather than make outright distributions to the beneficiary. This situation is best for beneficiaries who are spendthrifts, who may have substance abuse or gambling issues, or, who are simply not trusted to use such funds to pay for the intended purposes, such as health insurance.

Limits on distributions. Another control mechanism is to limit the amount that can be distributed to a beneficiary. This may be either an absolute amount, such as all income up to $50,000 annually, or a fluid amount, such as 4% of the year-end principal amount annually. A grantor sets absolute limits if he or she does not want the beneficiary to receive too much, while fluid limits are set so that the beneficiary may limit distributions to investment income and not draw on principal, thus depleting the trust too early.

Limits may also be used as incentives to ensure that beneficiaries do not become compla-

[26] For example, if a beneficiary has a withdrawal right of $10,000 per quarter, but withdraws only $5,000 in each of the first two quarters, in the third quarter the beneficiary may withdraw $20,000, which is $10,000 permitted in the third quarter plus an additional $10,000 (the amounts not withdrawn in the first two quarters—$5,000 each quarter). A non-cumulative benefit would be limited to $10,000 in the third quarter because a beneficiary's withdrawal right is limited to only the amount in each quarter and the amounts not withdrawn may not be carried over.

[27] Except for Crummey powers described below.

[28] See Fl. Stat. §72.517 (wills); Fl. Stat. §736.1108 (trusts); Ind. Code §29-1-6-2 (wills); Ind. Code §304-2.1-3 (trusts).

[29] Challis and Zaritsky, "State Laws: No-Contest Clauses," American College of Trust and Estate Counsel (3/24/12) www.actec.org/public/Documents/Studies/State_Laws_No_Contest_Clauses- _Chart.pdf

cent. One popular incentive is using a limit of a multiple of the highest Form W-2 income amount of any beneficiary over a certain period, such as the average of the last three years. For example, if a beneficiary is to receive $200,000, limited to the Form W-2 income, but the beneficiary has performed only a minimum wage job, earning $15,000 as a gas station attendant, he may receive only $30,000 from the trust. This gives the beneficiary the incentive to improve his job situation and standard of living, so, for instance, if he finds a field in which he can earn $80,000 per year, he can receive an extra $160,000 a year from the trust. Higher multiples may be permitted for certain laudable professions with less income, such as soldiers, police officers, firefighters, teachers, or volunteer/nonprofit workers. This way, a beneficiary is not penalized for going into laudable public service fields. For example, if a teacher has only $30,000 a year in W-2 income, she may have a limit of six times W-2 income instead of two times and thus still may receive an additional $180,000 instead of being penalized with only a $60,000 limit for choosing a laudable but lower-paying profession.

Spendthrift clauses. Spendthrift clauses are meant to protect beneficiaries from spending all their distributions prematurely and to protect trust assets from creditors. In the absence of a spendthrift clause, the beneficiary could assign his or her distribution rights for a lump sum, defeating the purpose of a trust, and creditors could attach trust property to satisfy a beneficiary's debt or judgment. The spendthrift provision forbids interests from being assigned or attached. This helps ensure that the funds remain in the trust and can support the beneficiary for the intended life of the trust.

Exculpatory and no contest clauses. Exculpatory and no contest clauses are provisions that help minimize litigation and prevent challenges to a trust that may tear a family apart in the wake of a death. Broadly speaking, these clauses limit many frivolous suits brought against the trustee by beneficiaries who want to use the court system as just another tool in a private family squabble, or simply as a ploy to receive a greater share of assets by holding the family hostage. These types of clauses may help to avoid court-related expenses, legal fees, and family stress.

An exculpatory clause is one that relieves the trustee of liability, except in the case of gross negligence, recklessness, or willful behavior. If a trustee is performing his or her duties for a nominal fee, he or she should not then be liable under the trust when using ordinary care. In addition, except in gross negligence, recklessness, or willful behavior, a trust should also provide indemnification for the trustee in the event the trustee is held personally liable for actions related to the trust.

A no contest clause states that if a beneficiary contests the trust in any way, the beneficiary loses his or her interest in the trust. This is necessary if there is a difficult family member who may bring claims simply acting out of jealousy or dissatisfaction about the property set aside. Many times this family member's sole purpose is to harass other family members until they give in and give him or her a larger share. This clause provides that if such family member even starts to contest, the family member loses his or her interest unless it can be shown that the whole document is invalid. Note, however, that this may hinder finding fraud by the trustee so, as discussed below, it may be wise to safeguard this by providing for multiple trustees to look after one another or by giving someone the power to replace the trustees.

The enforceability of no contest clauses in trusts, especially testamentary trusts, depends on state law. Florida and Indiana have state statutes that nullify such clauses,[28] but many of the states fall into one of two schemes: (1) the clause applies only if there is no probable cause to the contest; or (2) the clause is enforceable regardless of probable cause. Whether the clause is enforceable, it is still valuable for its deterrence value. Just as a bike lock is really only a deterrence mechanism since most thieves can cut the lock in seconds, deterrence through the risk of forfeiture keeps disputes at bay as beneficiaries may not want to start a challenge for fear of losing their interests.[29]

Mediation and arbitration clauses. Mediation and arbitration clauses may also be used in trust documents. These clauses help avoid and reduce the cost of any litigation. Mediation involves a neutral third party who tries to work through disputes. Arbitration is an informal tribunal with agreed upon arbitrators that rules on the dispute. Either usually will save time, money, and possibly the family dynamic.

Although mediation is not mandatory, mandatory non-binding pre-litigation mediation may help resolve family quarrels and allow family members to express their points of view in a controlled environment rather than during an escalating dispute. Arbitration clauses, on the other hand, have generally been deemed against public policy and unenforceable when used in trust documents. However, arbitration has been permitted in Florida and Arizona[30] or possibly if all parties consent to arbitration. However if there is a dispute with a difficult family member, it may be difficult to get his or her consent.

Even if unenforceable, it may be useful to include a pre-litigation mediation and/or arbitration clause as a way to facilitate a solution to a family dispute. Further, if the grantor has shown an intention that arbitration be used, all beneficiaries may consent to arbitration out of respect to the grantor. Because state laws can change, there is a possibility that a grantor's state may follow the lead of Florida and Hawaii to enforce such binding arbitration clauses by the time the dispute arises.

Trustees

After deciding what type of trust to use, it is important to choose the proper trustee. A good trustee can further the grantor's original purpose, while a bad trustee can thwart it. The trustee holds legal title to the assets, has the power to manage the assets as he or she sees fit, and holds and manages the assets for the benefit of the beneficiaries. There are a number of options for trustees, ranging from individual trustees, institutional trustees, or a combination of both. Certain mechanisms may be used to ensure the trustee acts to carry out the grantor's intentions.

Qualities desired in a trustee. Ideally, the trustee should be trustworthy, respected by the beneficiaries, financially responsible, and familiar with the grantor's wishes. It is important to have a trustworthy trustee because the trustee is granted broad management power. A grantor does not want someone who will embezzle funds, limit distributions so that more is left for a remainder beneficiary, or play favorites among beneficiaries. It is important that the trustee be respected by the beneficiaries or else certain beneficiaries may waste trust funds with frivolous court challenges to the trustee's authority. Constant court challenges can waste a large portion of the trust principal with court and legal fees.

The trustee should be financially responsible. This does not mean that the trustee must be an expert in investing or accounting (as separate financial professionals may be employed by the trustee), but the trustee should have a basic understanding of managing funds, understanding financial statements, and prudent spending. Last, the trustee should be familiar with the grantor's wishes. This is so the trustee knows the specific nuances of the grantor and why he or she would invest in one asset versus another or make a distribution to one beneficiary and not another. While it is often impossible to find a trustee who has all these qualities, a grantor should strive for them when choosing a trustee.

Options for trustees. There are options in appointing trustees, including using more than one trustee or using institutional trustees.

Single vs. multiple trustees. One option is appointing a single trustee versus appointing multiple trustees. A single trustee means one person manages everything and has uncontested discretion, barring certain control mechanisms (see below), to do what he or she thinks necessary. This may be an option for smaller, simpler trusts or when the trustee possesses a majority of the qualities discussed above.

When one trustee may not possess all of the qualities to administer a trust competently or when the trust is simply too large, the grantor should designate multiple trustees. One option may be to grant each co-trustee independent or different powers so that each co-trustee may unilaterally act for the trust with respect to certain matters. Granting each trustee separate powers may create some problems, such as logistical and communication issues. However, granting co-trustees specialized powers may be beneficial. For instance, if the grantor's friend fits all of the ideal qualities but does not know the first thing about investments, the grantor can grant the friend trust management powers, but grant investing powers to a professional investment advisor. This way, an investment advisor can invest the funds and the friend is free to control distributions, filings, and other administrative tasks.

Another option is for the grantor is to require multiple signatures for trust action to occur. For instance, this may be used for siblings so they each will have a say, when the grantor does not wish all the power to be in the hands of just one person, or when the grantor wants his or her friends to consult before a

[30] See Fl. Stat. §731.401 (wills and trusts); Ariz. Rev. Stat. 14-1025 (trusts).

major decision is made. A grantor could require all trustees to sign off before action is taken or require only more than one trustee sign off. In other instances, the trustee may require a simple majority or super majority[31] of trustee signatures.

The main drawback to appointing multiple trustees is that it may complicate trust administration. With multiple trustees, there will be multiple parties who have to be in communication for every decision and who may have differences of opinion. When the consent of a majority of trustees is required to act, it is advisable to have an odd number of trustees to avoid stalemates and tie votes.

Individual trustee vs. institutional trustee. A grantor must also consider whether to use an individual and/or an institutional trustee. Examples of individual trustees are friends or relatives. Typically, individual trustees act for nominal or hourly fees. An institutional trustee is usually a bank, trust company, or other entity that professionally manages assets and performs trust administration.

The major benefit of appointing an individual trustee is that the trustee will have intimate knowledge of the grantor's desires and wishes. The benefits of appointing an institutional trustee are that the grantor receives professional management of his or her assets, a neutral third party will oversee conflicts between relatives and have minimal conflicts of interest, and the trustee will likely outlive any possible individual trustee. The negatives of appointing an institutional trustee are costs and the lack of familiarity with the grantor and his or her desires.

Trustee powers and controlling the trustee. The trustee has legal title to the assets, holds the assets for the benefit of the beneficiaries, and manages the trust's affairs. The trustee generally has a broad ability to manage, use, sell, invest, reinvest, distribute, and dispose of the assets, as well as give them as gifts. Thus, care needs to be taken to ensure the trustee acts in the beneficiaries' best interests. Outside of selecting a trustee with certain qualities, one way to safeguard the beneficiaries' interests is to rely on common law fiduciary duties, including the duty of loyalty, duty of care, and duty of accounting and keeping records.

- The duty of loyalty requires a trustee to act in good faith for the benefit of the beneficiaries. The most common breaches of this duty involve embezzlement, self-dealing, usurping opportunities, and favoritism.
- The duty of care requires a trustee to exercise discretion in administering the trust with the reasonable care, skill, and caution of a prudent person. A higher standard than the "prudent person" may be required if the trustee has greater expertise. Generally, this duty requires the trustee to demonstrate a reasonable good faith effort and skill given the trustee's level of expertise. In order to breach this standard, a trustee must have acted with gross, rather than mere, negligence. However, when this duty is applied to investments, it generally requires the trustee to receive proper advice from an investment advisor or to take reasonable steps to diversify assets, avoid unnecessary market risk, and avoid unnecessary fees. Many trustees will invest in safe assets so the trustee will not have to reimburse the trust for major losses caused by his or her breach of care.
- A trustee also has the duty to provide information, provide an accounting, and maintain records. This duty requires the trustee to inform beneficiaries of material information regarding the trust. For instance, a trustee has a duty to inform the beneficiaries if there is a large claim against the trust assets. The trustee also has a duty to account to the beneficiaries. The duty of accounting usually requires accounting for all receipts and disbursements from the trust. However, the level of detail and frequency depends on the various states. Many states allow a beneficiary to request an accounting at least annually or when reasonably necessary. Finally, the trustee has the duty to maintain basic records such as bank statements, tax records, copies of checks from the trust, and other relevant documents helpful to provide evidence for the accounting. A trustee can be held within breach and liable for damages that result because of the failure to inform the beneficiaries, and possibly removed if these records are not stored in a consistent manner.

A grantor may implement the following safeguards into a trust document to ensure that a trustee will adhere to his or her duties:

- A grantor may limit the trustee's power by requiring multiple trustees and/or multiple signatures. This creates a system of checks and balances. With a second or third trustee, an improper trustee has someone to account to and someone that will be watching over his or her shoulder. The risk of a lone trustee who embezzles funds, makes poor investments, and makes improper distributions will be lessened when there are other trustees.

- A second method is to limit the trustee's powers in the trust document. A grantor may do this by limiting specific trustees to different tasks such as administration, investments, and distributions. For example, a grantor may give a trustee full power of administration, such as filing tax returns, but no power with regard to investments. A grantor may require a trustee to act in concert with another person on deciding discretionary distributions, while an institutional trustee has investment powers. This allows the grantor to tailor the proper powers to better meet the trustee's traits. Another example would be to give a certain individual trustee the final power as to the sale, purchase, management or retention of an investment interest should the co-trustee disagree.
- A grantor may reserve powers over the trustees or give a third person the power. Examples include a veto power, a power to remove and replace a trustee (a "trust protector"), or the power to add additional co-trustees. This may be a less costly way to deal with a dishonest or incompetent trustee or if another trustee is more desirable. The veto power could allow a general veto over all decisions or a specific veto over a limited scope of decisions, such as a sale of assets, discretionary distributions, or changes in institutional trustees. A trust protector allows the power to simply remove the trustee at any time for any reason or conditioned on certain events, such as a lapse of a year. This would save the court fees that would be incurred in removing the trustee by having to show impropriety. The trust protector generally can remove a trustee on demand even at the mere suspicion of impropriety. Finally, a person may have the power to add additional co-trustees. Thus, if a trustee is having trouble, a person may add new trustees to diminish the trustee's power and control, but not embarrass the trustee by removing him or her. Thus, these are informal ways to avoid the time, cost, and embarrassment of a court squabble.

Sections 2036 and 2038 limits on grantor's powers. In an irrevocable trust, a grantor should be careful about appointing himself or herself trustee or granting himself or herself controlling powers because assets given as gifts in trust, and all the appreciation attached with them, may be pulled back into the grantor's estate for estate tax purposes at death. Generally, if a third person holds such power (and there is no reciprocal trust agreement of any sort or he or she does not hold a general power of attorney), there will no issue with asset inclusion. Sections 2036 and 2038 become a concern for an irrevocable trust if the grantor retains the power to determine who will possess, enjoy, or receive the income from property or may alter, amend, revoke, or terminate the trust directly or indirectly.

This means the grantor generally cannot be trustee of his or her own irrevocable trust or he or she will violate Sections 2036 and 2038. Further, a grantor cannot retain an indirect trustee power, such as a veto right or a general right to remove and replace a trustee at will with a related person.[32] Both of these essentially give the grantor the power to control the trustee by allowing the grantor to simply keep vetoing and removing trustees until the decision he or she wants is made. However, the grantor may retain the power to add additional co-trustees, although that is not advisable.[33] Therefore, care must be taken if the grantor is to be a trustee or retain certain powers related to trustees. A mistake could cause inclusion of transferred assets in the grantor's gross estate for death tax purposes and have major tax consequences as discussed in the claw-back section of this article.[34]

Gift and estate tax planning tricks and techniques with trusts

A trust may be funded in several ways, including by a direct transfer or by designating a trust as the beneficiary of insurance policies, annuities, de-

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[31] A simple majority requires at least 51% of the trustees to act. A super majority requires an even greater percentage, such as 66% or 80%, of trustees to act.

[32] There is a safe harbor in Rev. Rul. 95-58, 1995-2 CB 191, which is based on the decisions in Estate of Wall, 101 TC 300 (1993) and Estate of Vak, 973 F.2d 1409, 70 AFTR2d 92-6239 (CA-8, 1992) that a grantor may have the right to remove a trustee and appoint a successor only if the successor trustee is not related or subordinate to the grantor as defined in Section 672(c).

[33] See Durst, 559 F.2d 910, 40 AFTR2d 77-6232 (CA-3, 1977).

[34] See apps.americanbar.org/rppt/meetings_cle/2005/spring/pt/TrustPowersandTaxLiabilities/AKERS_PT_FRI_HAND.pdf.

[35] After a grantor transfers property, a Crummey power allows a beneficiary to withdraw such property for a number of days and if the beneficiary does not withdraw, the power lapses. It is meant to trigger the annual gift tax exclusion to reduce the use of the unified credit.

[36] Section 2514.

fined contribution benefits, or retirement plans. Direct transfers are the simplest, but do not give much leverage when it comes to minimizing taxes, or stretching the annual gift tax exclusion or the unified credit. Other options that may help to minimize tax consequences are discussed below.

Use of the annual gift tax exclusion amount. The use of the annual gift tax exclusion can be a tremendous wealth transfer tool when aggregated among family members. For example, If a grantor and spouse have two children with spouses, and each child has two children themselves, there are six blood-related beneficiaries (children and grandchildren), and eight including the children's spouses. There is a potential of twelve to sixteen gifts considering both grantor and his or her spouse may make gifts. Using an annual gift tax exclusion of $13,000 a year allows this married couple to give up to $156,000 a year to direct blood relatives and $208,000 to all relatives. This allows them to transfer a substantial amount of funds and their future income and appreciation completely tax-free over a short period.

Making a gift in trust, however, generally will not qualify for the annual gift tax exclusion because the gift must be of a "present interest" that can be accessed and enjoyed currently by the beneficiary as opposed to a "future interest" for which the access to the property is restricted to the future. The following are the most common methods for a transfer to qualify as a present interest and thus qualify for the tremendous benefits of the annual gift tax exclusion.

Crummey powers. Granting the beneficiaries of a trust Crummey powers over the transfers to the trust can make what would otherwise be a future interest into a present interest.[35] If the grantor gives the beneficiaries Crummey powers over the transfer, he or she makes the gift in trust of a present interest because the beneficiary will have a right to withdraw up to the annual gift tax exclusion amount. Usually the right to withdraw lasts up to 30 days after the grantor transfers funds to the trust. The transfer counts as a present interest because the beneficiary has a right to the assets for 30 days, but the beneficiary is not supposed exercise the right to withdraw funds so the funds enter the trust tax free.

Care should be taken, however, because an expiration of a power to withdraw is a gift from the beneficiary to the trust.[36] There is an exception in Section 2514(e), stating that the expiration of a power over the greater of $5,000 or 5% of the trust will not be deemed a gift from the beneficiary. The grantor should plan to either put sufficient base principal in the trust or limit the Crummey powers within this exception.

Uniform Gift to Minors Act (UGMA). Under Section 2503(c), a gift may be made into what is called an UGMA trust for a minor. This type of gift will qualify as a present interest and receive annual gift tax exclusion treatment if: (1) the income and property in the trust may be expended by or for the benefit of the minor prior to attaining 21 years old; and (2) any remaining amounts must transfer to the minor at age 21, pass to the minor's estate if the minor dies prior to attaining age 21, or be subject to the minor's general power of appointment.

A major issue with an UGMA transfer is that the minor gains full control of the funds at age 21 when he or she may not be mature enough to manage or spend such funds properly. Many times the minor can be strong-armed into transferring the trust into a second trust that makes restrictions over the life of the minor, but that cannot be guaranteed. However, UGMA trusts may be a great option if the funds are to be used for college or graduate school or if the grantor is not concerned with a child receiving a large sum of money at age 21.

Discounts. Another funding method is for the grantor to use various discounts when transferring assets, including: (1) the minority discount, (2) the lack-of-marketability discount, and (3) lack-of-transferability discounts.

1. A minority discount takes into account the fact that when someone owns a non-controlling share of an entity, he or she is subject to the control of a third person. As a result, the interest is discounted because the interest does not bear full rights of ownership, such as control and dominion over property.
2. A lack-of-marketability discount will apply for most closely held business interests that are not traded on a public exchange. This discount takes into account the fact that there is no readably available market to sell the assets, which makes it harder to get top value, and that a purchaser is buying into a business in which the existing owners may be family members or have specifically tailored arrangements.
3. A lack-of-transferability discount may apply if there is an agreement among the owners of an entity that the interest is not to be transferred except in certain circumstances. This reduces the value of the business since a future purchaser would be buying into these restrictions.

Using these discounts enables a grantor to augment his or her annual gift tax exclusion and unified credit, as well as to minimize transfer taxes. A grantor does this by placing assets in an entity and transferring the interest in the entity. These discounts allow a grantor to value assets at an amount that can be 15% to 50% less than they are actually worth. The transfer is treated as a transfer for less value, or the grantor may be able transfer a greater value within a particular credit or exclusion. If a grantor has $1 million of his or her lifetime exemption left, he or she may be able to transfer $1.5 million to $2 million and essentially save $250,000 to $500,000 on transfer taxes.

Life insurance. The proceeds of a life insurance policy on the life of the grantor will pass outside of the estate of the grantor as long as the grantor or his or her estate is neither the owner nor the beneficiary of the policy, and has not retained any "incidents of ownership" in the policy, such as the right to change beneficiaries or to borrow against the policy. Therefore, another method to fund a trust is to have a life insurance policy on the life of the grantor owned by and payable to the trust. To do this, the grantor establishes an irrevocable trust that is the applicant, owner, and beneficiary of life insurance on the grantor. The grantor may even pay the premiums on the policy by initially funding the trust with enough money to pay for premiums, or by making annual gifts to the trust. The trust should be set up so that the beneficiaries have Crummey powers over the gifts, but do not withdraw the funds. When the grantor dies, the insurance proceeds are paid to the trust tax free.

There are two benefits of this estate planning technique. First, it will provide liquidity to the trust or to the grantor's estate at death. Second, it could possibly save a substantial amount of taxes. Often, the value of many larger estates is tied up in illiquid assets, such as the family business. At the death of the grantor, the estate will need liquidity to pay the estate taxes. It may not be easy to sell off assets to pay the taxes. However, an insurance policy can be taken out on the estimated value of the business and owned in an irrevocable trust. At death, the insurance proceeds will be paid to the trust. The trust will then purchase the business or lend money to pay estate taxes, thus providing the desired liquidity.

Insurance may also allow the grantor to save a substantial amount in taxes. If the premiums on the policy end up substantially lower than the insurance proceeds, the grantor's estate has saved a substantial amount of estate taxes. For example, if the grantor pays $300,000 in premiums during the life of an insurance policy with a face value of $1 million, at the grantor's death $1 million is placed in the trust tax free. While the grantor may have been able to transfer the $300,000 anyway, essentially $700,000 ($1 million - $300,000) gets transferred tax free, creating extra value and avoiding $350,000 in estate taxes on this amount. Therefore, insurance is a good funding option for liquidity purposes and potentially as an investment that avoids the estate tax.

Conclusion

When a client is deciding on how to provide for the ongoing health, welfare, and security of one's family, a trust should be considered . A trust is a separate entity that may be used to achieve the transfer of wealth. It allows the client to designate who ultimately receives his or her property, yet still allows the client to retain control over the transferred assets. Additionally, transferring assets to a trust may result in incredible tax benefits, especially with respect to the gift and estate taxes.

Whether the client is creating a revocable or irrevocable trust, an inter vivos or testamentary trust, the client, as grantor, will face many considerations. Who will be appointed as trustee? Which property will be transferred? Who will be the beneficiaries? How and when will the beneficiaries receive distributions? Which type of trust should be used? All of these questions and more must be answered. However, in doing so, a specifically tailored trust may be created that matches the client's wants and needs, and the needs of his or her beneficiaries.