Wealth Coach of Kentucky

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GUIDEPOST

Irrevocable Trust

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Irrevocable trusts are often used to facilitate estate planning and asset protection planning, and can also be used as part of an income tax strategy. An irrevocable trust is a trust created by an individual (the grantor) to hold assets for the benefit of another (the beneficiary). Generally, once created, an irrevocable trust cannot be modified or terminated by the grantor (though another party may have powers to amend or terminate the trust). The grantor, who transfers assets to the trust, effectively relinquishes control of the transferred assets.

An irrevocable trust can hold any asset that is assignable by the grantor. Often, irrevocable trusts are funded with business interests, real estate, marketable securities, cash and life insurance policies.

Creating an Irrevocable Trust

State law generally defines the requirements for a trust to be valid and the rules governing trust administration. To establish an irrevocable trust, the grantor (also known as the donor, settlor or trustor) enters into a trust agreement with the trustee. The trust agreement names the beneficiaries and trustee(s), specifies trustee powers, stipulates the dispositive provisions of the trust (who gets what and when), and establishes rules for the administration of the trust. Any issue or question not specifically addressed in the trust document is generally governed by state law.

Since the grantor typically retains limited ability to alter a trust's terms after the trust is executed, it is important that the grantor carefully considers the key provisions of an irrevocable trust. Following are some of the components of an irrevocable trust that a grantor and the drafting attorney should discuss prior to the trust's execution.

- **Situs**. The trust's situs is the state where the trust is considered "located." The trust's situs can impact income taxes, the applicable jurisdiction for any potential litigation that may occur as a result of the trust, the asset protection available to trust assets, and the length of time for which the trust can exist. Though the default situs is usually the grantor's state of domicile, consideration must be given to the grantor's objectives for the trust to determine whether selecting a different situs is more appropriate.
- **Trustee**. For most trusts, the trustee is given considerable power and control over trust assets. For this reason, determining who (or what entity) will serve as trustee is one of the more important decisions a grantor will make.

  To avoid inclusion of assets in the grantor's estate, the grantor generally should not serve as trustee.

  A beneficiary may serve as trustee; however, distributions to the trustee/beneficiary should be limited to an ascertainable standard (such as health, education, maintenance and support) to prevent inclusion in the beneficiary's estate and to protect trust assets from the beneficiary's creditors.

  Generally, the greatest estate and asset protection is achieved by naming an independent party as trustee. An independent trustee is generally a person (or, in the case of a corporate trustee, a bank or trust company) with no beneficial interest in the trust and who is not related or subordinate to the grantor or a trust beneficiary.

  Where a grantor wishes to maximize the estate tax reduction and asset protection afforded by an irrevocable trust but also wishes for a beneficiary to have some control over trust assets, the trust can name an independent trustee and a beneficiary to serve as co-trustees, giving the tax sensitive powers to the independent trustee.
- **Trust Protector**. Including a trust protector provides a grantor the opportunity to ensure the trust remains flexible in light of unexpected circumstances or changed tax laws. The trust protector's role is to modify the terms and/or actions of the trust when necessary to carry out the grantor's original intent. A trust protector's powers may be extremely broad, including the power to add or remove a trustee, terminate the trust, change the trust's situs, add or remove beneficiaries or alter distribution provisions. Generally, the grantor and the trust beneficiaries (or a party subordinate to the grantor or trust beneficiaries) should not serve as trust protector.

- **Distributions**. Distribution provisions range from fully discretionary trusts (which defers all distribution decisions to the trustee) to trusts limited to an ascertainable standard (as described above). A discretionary distribution standard should be used only where an independent trustee is named.

  Additionally, the trust can include distribution incentives to encourage certain behaviors while not undermining the beneficiary's motivation to pursue a professional career, higher education, or the furtherance of important social or charitable causes. For example, the trust could require that a beneficiary maintain a certain grade point average or complete an undergraduate degree to receive distributions or the trust could make distributions to match a beneficiary's earned income. Conversely, the trustee can withhold distributions for specific conduct such as substance abuse or poor academic performance.

  To protect the trust assets from a beneficiary's creditors, the trust agreement can contain a spendthrift clause that prevents a beneficiary from transferring or encumbering his/her interest in the trust prior to distribution.

  The grantor should also consider whether the trust will be a long-term trust (retaining assets in trust for the lifetime of the beneficiary, or longer) or whether assets will be distributed outright when the beneficiary attains a certain age. Long-term trusts typically provide greater asset protection.

- **Avoiding Estate Inclusion**. One of the primary benefits of utilizing an irrevocable trust is the grantor's ability to remove trust assets, and future appreciation, from the grantor's taxable estate and to protect trust assets from the grantor's creditors. Therefore, when drafting an irrevocable trust, care must be taken to ensure trust assets are not inadvertently included in the grantor's estate. There are several ways an irrevocable trust can be includible in the grantor's estate.
  - Internal Revenue Code (IRC) §2035 provides that a transfer of a life insurance policy by an insured within three years of death will result in estate inclusion of all policy proceeds.
  - IRC §2036 could result in trust assets being included in the grantor's estate if the grantor retains a beneficial interest (including the right to receive income) in trust assets or if the grantor has the right to control who owns or enjoys the use of trust assets. This may apply indirectly if the trustee has the ability to control the ownership or use of the property, and the grantor can replace the trustee with himself/herself. (Note that, in some situations, a donor may retain a beneficial interest over trust assets where an independent trustee has discretionary distribution rights.)
  - Assets may also be included in the grantor's estate under IRC §2038 if the grantor retains the right to alter, amend, revoke, or terminate the terms of a beneficiary's enjoyment of trust assets.
  - If a trust owns life insurance on the grantor's life, IRC §2042 provides that inclusion of death benefit proceeds may occur if the grantor/insured has any incidents of ownership (i.e., power to change the beneficiary, borrow against cash value, etc.) over trust-owned life insurance.

Funding an Irrevocable Trust

Any transfer to an irrevocable trust for less than full consideration will be considered a gift to the trust. The annual gift tax exclusion amount allows a donor to give up to $15,000 (in 2019) to an unlimited number of recipients per year without being deemed a taxable gift. However, only "present interest" gifts qualify for the annual gift tax exclusion. A contribution to a trust is a present interest gift only under certain conditions: (1) when the beneficiary has a right to withdraw the amount of the gift from the trust; (2) when the beneficiary has the present right to trust income; or (3) when the trust is for the exclusive benefit of a minor and meets certain requirements.

- **Crummey Withdrawal Rights**. In *Crummey v. Commissioner*, the Court of Appeals held that a gift to a trust is a gift of a present interest to the extent the beneficiary has a right to withdraw his/her share of the gift. In reference to that case, withdrawal rights in a trust are known as "Crummey rights." The Internal Revenue Service (IRS) imposes several requirements for a Crummey right to be effective. For example, the trustee must give the beneficiary notice of the contribution and withdrawal right. Also, the beneficiary must have a reasonable amount of time to decide whether to exercise the right before it lapses.

If a trust beneficiary fails to exercise a withdrawal right, and if that power ultimately lapses, the lapse constitutes the release of a general power of appointment. The release of a general power of appointment is a taxable gift. As such, the withdrawal beneficiary is considered as making a taxable gift of the lapsed amount to other trust beneficiaries. An exception to this rule exists if the lapse of the power does not exceed the greater of (i) $5,000 or (ii) 5% of the value of trust assets.

There are three ways to prevent a taxable gift over unexercised withdrawal rights in excess of the "5 or 5" amount. First, separate shares can be created for each beneficiary. Because the beneficiary is the sole beneficiary, the gift resulting from the lapse of the withdrawal right is incomplete. (Essentially, one cannot make a gift to oneself.) Second, "hanging" powers are often used. Generally, with a hanging power, the withdrawal right lapses up to the "5 or 5" amount but keeps intact any withdrawal rights in excess of that amount until such time (if ever) when the "5 or 5" amount can absorb the lapse. Third, under the testamentary power of appointment option, the withdrawal right lapses up to the "5 or 5" amount, and any non-lapsed amount may be appointed at the withdrawal beneficiary's death.

In addition to relying on the annual gift tax exclusion to make tax-free gifts to an irrevocable trust, an individual may utilize the basic exclusion amount (in 2019, $11.4 million) to make tax-free gifts to the trust. Alternatively, an irrevocable trust could be funded with loans or by way of a sale.

Using an Irrevocable Trust to Own Life Insurance

Ownership of life insurance through an irrevocable trust enables the trust grantor to remove policy values from his/her taxable estate. Upon the grantor's/insured's death, the trustee receives life insurance proceeds income and estate tax free. If policy proceeds are needed to fund estate tax liability, the trustee can use the proceeds to either lend money to the deceased grantor's estate or to purchase assets from the estate.

An irrevocable trust may apply for a new policy on the life of the grantor (or, in some situations, another individual). In the case of new coverage, the irrevocable trust purchases the life insurance and the trust is owner and beneficiary of the policy.

Alternatively, circumstances may arise which result in a need to transfer an existing policy into an irrevocable trust. In this event, special measures must be taken to preserve the income and estate tax benefits of the policy. As set forth above, IRC §2035 provides that a transfer of a policy by an insured within three years of death will result in estate inclusion of all policy proceeds. However, under IRC §2035(d), the three-year inclusion rule does not apply to a bona fide sale for adequate and full consideration. A sale of a policy to a trust, however, gives rise to its own set of issues, namely policy valuation, trust funding, and the transfer for value rule under IRC §101(a).

- **Policy Valuation.** Since the three-year rule does not apply to a bona fide sale for adequate and full consideration, it is crucial that the policy be appropriately valued; otherwise, a policy transferred for less than fair market value will be treated as a part gift/part sale. Such transfers could result in estate inclusion, under the three-year rule, of policy proceeds in excess of the consideration received.

  Generally speaking, the fair market value of a permanent policy will be equal to its interpolated terminal reserve plus unearned premiums. (However, in the first year of a policy's issue, the value typically will be premiums paid.) The value of a term policy will generally be equivalent to unearned premium. This information can be obtained by requesting IRS Form 712 from the insurance carrier.

  Note, however, that the carrier will typically not provide a precise value to be used for gift tax purposes. Information provided on Form 712 may serve as evidence of the fair market value price, but actual fair market value may differ depending on the type of policy in question and other outside factors present. For example, in the case where death of the insured is imminent, fair market value of the policy may be closer to the death benefit face amount. Therefore, clients contemplating a sale should consult their CPA for guidance on valuation. If the situation warrants, the most conservative approach would be to obtain a professional appraisal.

- **Trust Funding.** To effect a sale of a policy to an irrevocable trust, the trust will need to obtain the funds to purchase the policy. Typically, this can be accomplished through the annual gift tax exclusion or through a single lifetime exclusion gift. While a more aggressive planner might employ a promissory note, repayment at the applicable federal rate is still required. Of course, future annual gifts would then be needed to satisfy ongoing premiums and to service the note. For this reason, funding the trust with an income producing asset may be preferred since the trust's income can be used to facilitate the purchase of the policy and to pay its ongoing premium obligation.

- **Transfer for Value Rule-** While the bone fide sale strategy can prevent application of the three-year rule, it can trigger application of the transfer for value rule in the absence of proper planning. Under IRC §101(a)(1), transfer of a life insurance policy for valuable consideration results in the loss of the otherwise tax-free treatment of death proceeds. However, an exception to the transfer for value rule is where the policy is transferred to the insured. The sale of a policy to a grantor trust (in which the insured is the grantor) would fall under this exception to the transfer for value rule. The IRS has suggested that an existing life insurance policy can be sold by a grantor to a grantor trust without transfer for value issues,[1] and has specifically provided that a sale of an existing policy by a non-grantor trust to the insured's grantor trust falls within the exception.[2]

Tax Considerations

Estate Tax

Assets owned by a properly administered irrevocable trust can be excluded from the grantor's taxable estate. As a result, utilizing an irrevocable trust to own highly appreciating assets or life insurance can significantly reduce the grantor's exposure to estate tax liability.

Income Tax

For income tax purposes, an irrevocable trust can either be a grantor trust or a non-grantor trust. To qualify as a grantor trust, the trust must include certain provisions that result in the grantor (or another individual) being deemed the owner of trust assets for income tax purposes. If considered a grantor trust, the grantor must include all items of trust income, gain, loss, deductions, and credits in calculating his/her individual income tax liability. Grantor trust status, in effect, allows the donor to make additional "gifts" to the trust equal to the trust's income tax liability, without incurring additional gift tax. In addition, grantor trust status prevents transactions between the donor and the trust (i.e., the transfer of property and receipt of annuity payments) from being a taxable event.

If drafted as a non-grantor trust, the trust will be a separate entity for income tax purposes and trust income will be taxed according to trust tax laws. The trust will generally be considered either a simple trust or a complex trust. A simple trust distributes all income to trust beneficiaries and trust beneficiaries report their distributable share of income on their personal income tax returns. Complex trust rules typically apply where trust income is not mandatorily distributed to the beneficiary. With a complex trust, generally, income retained in the trust is taxed to the trust at trust rates and income distributed to a beneficiary (or for his/her benefit) is taxed to the beneficiary at his/her personal rates.

Generation-Skipping Transfer (GST) Tax

The GST exemption (in 2019, $11.4 million) may be significantly leveraged if applied towards the grantor's lifetime transfers to an irrevocable trust. Typically, this is done by allocating the grantor's GST exemption to gifts made to the trust. If properly structured, the contribution can be transferred gift, estate, and GST tax free. If gifts are used to pay premiums on life insurance, upon the insured's death, the GST exemption would be considerably leveraged, enabling the grantor to pass substantially greater assets in a tax and asset protected trust.

1 Revenue Ruling 85-13.
2 Revenue Ruling 2007-13.

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