Estate and Tax Planning with Trusts

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Overview

What is a Trust?

- A fiduciary arrangement that is governed by an agreement (i.e. a trust agreement).
- The agreement is between the grantor and a trustee.
- The grantor transfers assets to the trust, a newly created legal entity.
- The trustee manages the assets for the beneficiaries.

Governing Law

- Arkansas Trust Code
  (Ark. Code Ann. § 28-73-101 et seq.)
- Applicable to trusts "created on, before or after September 1, 2005."
- Common law applies to trusts not governed by the Arkansas Trust Code, or specific provisions not governed by the Arkansas Trust Code.

Types of Trusts

- Revocable Trusts vs. Irrevocable Trusts
  - A trust is "revocable" if it may be amended or revoked at any time by the grantor of the trust.
  - A trust is "irrevocable" if it may not be amended or revoked by the grantor of the trust.
  - What if the terms of a trust do not state whether the trust is revocable or irrevocable?
    - Arkansas Trust Code (2005) (revocable)
    - Common law presumption (irrevocable)

Considerations/Choice of Trust Type

- Inter Vivos vs. Testamentary Trusts
  - "inter vivos" trust
    - created by the grantor during the grantor's lifetime
    - can be either a revocable trust or an irrevocable trust
  - "testamentary" trust
    - created upon the probate of a decedent's last will and testament
    - generally irrevocable

Considerations/Choice of Trust Type

- Client's Objectives
  - Efficient and effective transfer of assets to the next generation
  - Financial security for a surviving spouse and descendants
  - Educational expenses to children and/or grandchildren
  - Special needs beneficiary
  - Probate avoidance
  - Estate and generation skipping transfer tax planning
  - Income tax planning
  - Asset protection planning

Considerations/Choice of Trust Type

- Family Dynamics
- Detailed Asset List
  - List of all assets
  - How are assets titled
  - Value of assets
  - Beneficiary designations on non-probate assets
- Funding the Trust
  - Transfer assets to the Trust
  - Make certain assets payable to the Trust upon death

Revocable Trusts

General – Revocable Trusts

- Created during the lifetime of the grantor.
- Commonly referred to as a revocable living trust.
- May be created by one grantor or multiple grantors.
- Becomes irrevocable upon the incapacity or death of the grantor.
- If multiple grantors, generally becomes irrevocable upon the incapacity or death of one of the grantors.

Benefits of a Revocable Trust

- Probate Avoidance
  - Disposition of assets pursuant to a revocable trust is not subject to the probate process.
  - Ancillary probate may be avoided.
- Privacy
  - The provisions of a revocable trust and the disposition of assets pursuant to the terms of the trust is private.
  - If the revocable trust is not fully funded, this benefit may be partially negated.

Benefits of a Revocable Trust

- Management Upon Incapacity
  - If the grantor becomes incapacitated, a successor trustee takes over.
  - Ensures the trust assets will be managed and used for the grantor's benefit during such period of incapacity.
- Tax Planning
  - Estate tax
  - Generation skipping transfer tax planning
  - Asset protection planning for the next generation(s)

Tax Planning – Revocable Trusts

- Marital Deduction/Bypass Trusts (AB Trust)
  - Upon the death of the first spouse, the typical AB Trust plan provides:
    - Allocation of an amount equal to the decedent's applicable exclusion to the bypass trust; and
    - Allocation of any amount in excess of the applicable exclusion to the marital deduction trust, or distribute such amount outright to the surviving spouse.
  - Goals of the typical AB Trust are:
    - Ensure that both spouses' estate tax exemption amounts are fully utilized; and
    - Control by first decedent over the ultimate disposition of the trust property.

Tax Planning – Revocable Trusts

- Disclaimer Trust
  - Reverse of the AB Trust.
  - Provides that at the first death, 100% of the trust assets are allocated to the marital deduction trust, which can continue to be revocable/amendable by the surviving spouse.
  - Surviving spouse must make the following determinations:
    - The amount of the combined estates, including trust assets, life insurance, retirement accounts, etc.;
    - The current applicable exclusion amount; and
    - The likely applicable exclusion amount at the surviving spouse's death.

Tax Planning – Revocable Trusts

- Disclaimer Trust
  - If combined estates are less than the current/expected applicable exclusion amount, then the surviving spouse may be comfortable leaving everything in the marital deduction trust.
  - If combined estates are close to or greater than the applicable exclusion, then survivor can disclaim to the bypass trust for the benefit of the surviving spouse.
  - File disclaimer within 9 months of first decedent's date of death.
  - Surviving spouse must not accept any benefit from disclaimed assets.

Tax Planning – Revocable Trusts

- Disclaimer Trust
  - AB Trust vs. the Disclaimer Trust, additional considerations:
    - Step-up in basis planning; and
    - Creditor protection planning.
  - Partial QTIP Trust alternative to a disclaimer trust.

Tax Planning – Revocable Trusts

- Portability
  - January 1, 2013 -- Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010.
  - Adopted "Portability"
  - Deceased spouse's unused exclusion amount ("DSUE") may be carried over to the decedent's surviving spouse.

Tax Planning – Revocable Trusts

- Portability
  - DSUE is available to the surviving spouse only if:
  - Executor files "timely, complete and properly prepared" Form 706 on which the DSUE is computed.
  - The estate tax return must be filed even if no estate tax return is otherwise required.
  - Executor makes an election on the Form 706 for portability to apply (706 contains box to "elect out").

Irrevocable Trusts

General – Irrevocable Trusts

- Assets transferred to an irrevocable trust are:
  - Typically not included in the grantor's estate; and
  - Not subject to probate.
- The trust cannot be amended or revoked.
- An irrevocable trust is preferred when the primary goal is to minimize estate taxes and to engage in income tax planning.

Non-Tax Planning Irrevocable Trusts

- Asset Protection Trusts
  - A self-settled spendthrift trust.
  - Established in a jurisdiction that has passed asset protection laws.
  - Must have a trustee, usually a corporate trustee, that is domiciled in the chosen jurisdiction.

Non-Tax Planning Irrevocable Trusts

- Asset Protection Trusts
  - Domestic Asset Protection Trusts.
    - In 1997, Alaska became the first state to permit the creation of self-settled spendthrift trusts.
    - 13 other states that have since passed APT legislation.
    - *Per se* Fraudulent Transfer Rule Cases
      - *Kilker v. Stillman* (2015)
      - *In re Huber* (2013)
      - *In re Cutuli* (2013)

Non-Tax Planning Irrevocable Trusts

- Asset Protection Trusts
  - Foreign Asset Protection Trusts.
    - Created under the law of a foreign country that has passed laws favorable to its creation.
    - Most common reasons for offshore trusts:
      - replace or supplement malpractice insurance;
      - reduce asset exposure and discourage lawsuits;
      - enhance a bargaining position when dealing with creditors; and
      - avoid or supplement premarital agreements.

Non-Tax Planning Irrevocable Trusts

- Special Needs Trusts
  - Created to hold assets in order to preserve the government benefits of an individual who is disabled and regularly depends on such benefits.
  - First Party Special Needs Trust
  - Third Party Special Needs Trust

Non-Tax Planning Irrevocable Trusts

- Special Needs Trusts
  - First Party Special Needs Trust
    - 42 U.S.C. § 1396p(d)(4).
    - Established with assets that are already assets of the beneficiary of the trust prior to the creation of the trust.
    - The assets may have resulted from an unplanned inheritance, gift, personal injury lawsuit, etc.
    - Payback provision required.

Non-Tax Planning Irrevocable Trusts

- Special Needs Trusts
  - Third Party Special Needs Trust
    - Not governed by federal statute.
    - May be created under the terms of an inter vivos or testamentary trust.
    - Established with assets that are not owned by the beneficiary of the trust.
    - No payback provision required.

Non-Tax Planning Irrevocable Trusts

- Gun Trusts
  - Title I Firearms: shotguns, pistols, rifles, etc.
  - Title II of the 1968 Gun Control Act (“GCA”).
  - Title II Firearms are regulated by the National Firearms Act (“NFA”).

Non-Tax Planning Irrevocable Trusts

- Gun Trusts
  - National Firearms Act ("NFA"), as well as state and local law, strictly regulates the transfer and possession of firearms
  - Short barreled shotguns and rifles,
  - Any other weapon capable of being concealed on the person, machineguns, silencers, destructive devices, etc.

Non-Tax Planning Irrevocable Trusts

- Gun Trusts
  - Transfer tax of $200 imposed when the transfer of a Title II Firearm takes place.
  - Transfer of a Title II Firearm may be accomplished only by filing the proper ATF Form and paying the transfer tax.
  - Problem: unregistered transfers from generation to generation.
    - In such cases, the transfer and the possession by the next generation are illegal.
    - Both can be remedied if an ATF Form 5 is filed before the estate of the transferor is closed and the transfer tax is paid.

Non-Tax Planning Irrevocable Trusts

- Gun Trusts
  - NFA Regulations define a "person" to include a "trust".
  - Application information required has historically been different for "natural persons" as opposed to "trusts".
  - A gun trust may be revocable or irrevocable, although a revocable trust obviously provides greater flexibility.
  - If the gun trust is irrevocable, consider a limited right of amendment.

Non-Tax Planning Irrevocable Trusts

- Gun Trusts
  - Main Purpose: to pass Title II Firearms down to the next generation in compliance with all laws.
  - Trustee designation is very important, for legal and practical purposes.
  - "Who is entitled to possess the firearm?"
  - **Final Rule 41F** (effective July 13, 2016) passed with the goal of ensuring that identification and background checks apply equally to individuals, trusts and legal entities making an application to make or receive an NFA firearm.

Non-Tax Planning Irrevocable Trusts

- Gun Trusts
  - Gun trusts should be drafted very carefully.
  - Ensure:
    - Proper nomination of trustees.
    - Guidance to trustees concerning Title II Firearms and compliance with applicable law.
    - The terms of such trusts specifically include provisions applicable to ownership of Title II Firearms.

Gift and Estate Tax Planning – Irrevocable Trusts

- Generation Skipping Transfer Trusts (GST Trusts)
  - A trust to which all or a portion of a grantor's generation skipping transfer tax exemption has been allocated.
  - Permits the trust assets to be distributed to grandchildren or later generations without incurring either generation skipping transfer or estate taxes on the death of your children of the grantor.

Gift and Estate Tax Planning – Irrevocable Trusts

- *Crummey* Trust
  - An irrevocable trust that satisfies the present interest requirement for the annual exclusion.
  - Contains specific beneficiary withdrawal powers.
- 2503(c) Minors Trust
  - An alternative to a *Crummey* Trust.
  - An irrevocable trust that satisfies the present interest requirement for the annual exclusion.
  - All income and principal distributed to the beneficiary upon the beneficiary attaining the age of twenty-one (21).
  - Beneficiary can decide to leave the assets in trust.
  - Discretionary income and principal distributions will be made to the beneficiary prior to attaining the age of twenty-one (21).

Gift and Estate Tax Planning – Irrevocable Trusts

- Irrevocable Life Insurance Trust (ILIT)
  - Utilized to remove insurance proceeds from being included in the gross estate of an individual.
  - *Crummey* withdrawal powers generally incorporated into an ILIT.
  - The ILIT may be funded with annual exclusion gifts to pay premiums.
- Intentionally Defective Grantor Trust (IDGT)
  - Utilized to remove an asset's appreciation and/or income from the grantor's gross estate.
  - Grantor sells an asset to the IDGT in exchange for a promissory note, thereby freezing the value in the grantor's estate.
  - Grantor will retain a power(s) to qualify the grantor as the owner for income tax purposes but not for gift tax purposes.

Gift and Estate Tax Planning – Irrevocable Trusts

- Charitable Remainder Trusts (CRT)
  - A tax-exempt trust in which the donor, or a beneficiary designated by the donor, retains the right to receive an income stream for life or for a fixed number of years (up to 20 years).
  - Two types:
    - Charitable Remainder Unitrust (CRUT)
    - Charitable Remainder Annuity Trust (CRAT)

Gift and Estate Tax Planning – Irrevocable Trusts

- Charitable Remainder Trusts (CRT)
  - Charitable Remainder Unitrust (CRUT)
    - Fixed percentage payout of the value of CRT assets.
    - Payout determined annually.
    - The minimum permissible payout is 5%.
    - The maximum payout is limited by the "10% Remainder Rule".
    - IRS guidelines provide that the projected value of the charitable remainder must be at least 10% of the value of the assets contributed to the CRUT.
    - Payout rate varies inversely with the value of the charitable remainder, meaning the higher the payout rate, the lower the value of the charitable remainder.

Gift and Estate Tax Planning – Irrevocable Trusts

- Charitable Remainder Trusts (CRT)
  - Charitable Remainder Annuity Trust (CRAT)
    - Distinguished from the CRUT by two significant characteristics:
    - First, the payout received from the CRAT by the donor is a fixed dollar amount, determined when the CRAT is initially funded. The payout amount will not fluctuate, irrespective of investment performance, for so long as the CRAT has sufficient principal to fund the payout.
    - Second, after the CRAT is initially funded, additional contributions may not be made (although the client may establish one or more separate CRATs).