ADVANCED PLANNING

Wealth strategies

Understanding the uses of trusts

WEALTH TRANSFER

OVERVIEW

The purpose of this brochure is to provide a general discussion of trusts as commonly established by private individuals to benefit their families and/or charitable causes. It includes the essential elements of trusts, their advantages, tax and non-tax reasons for using them, and the various types of trusts commonly used in personal estate planning.

SHOULD YOU HAVE A TRUST?

Reasons for establishing trusts are as different as the people who have them but regardless of the difference in their personal circumstances, many people discover that a trust is a smart addition to their estate strategy.

A properly structured trust can be a prudent way to hold and distribute assets. Depending on the type of trust established, it can protect assets from creditors, reduce estate taxes, and allow for greater control over asset management and distribution after death. Because Prudential and its financial professionals cannot give tax or legal advice, we encourage individuals to consult with their tax and legal advisors to explore the concepts discussed below. This group can work with the individual to help determine if, and how, a trust can be used as part of the individual's estate strategy.

WHAT IS A TRUST?

A trust is an arrangement where one person agrees to hold property for the benefit of another person or persons. This is especially useful in situations where the beneficiary is vulnerable or under legal disability such as when:

- One spouse wishes to protect assets from their creditors so that they may benefit the other spouse.
- The beneficiary is a minor.
- The beneficiary is unskilled in financial matters.

This is only a partial list. In practice, the kinds of situations and outcomes are very broad as illustrated by the examples later in this piece.

ESSENTIAL ELEMENTS OF A TRUST

Like a contract, a trust is usually in writing. The trust is a legal entity responsible for paying its own taxes similar to an individual or corporation but no matter the particular form, a trust arrangement has these essential elements:

- **Grantor**
  The grantor establishes the trust and transfers legal custody of money or other property to carry out their wishes. The grantor may also be called the "settlor," "trustor," "donor," or "testator."

Prudential

1049318-00003-00 Ed. 09/2024

- **Trustee**
  The trustee agrees to hold legal title to money or property and manage and distribute it according to the grantor's stated purpose. These two acts, taken together, agreeing to the grantor's purpose and taking title to the assets, give rise to a legal duty to honor the trust terms, also known as a fiduciary duty. The trustee may be an individual or a corporate entity such as a bank or trust company.

- **Beneficiary**
  Although the trustee holds legal title to trust assets, the trust's beneficiary is its true owner to the extent the beneficiary enjoys the rights and privileges given to them by the grantor. Every trust must have at least one beneficiary but most have at least two: a primary beneficiary and a contingent beneficiary. Beneficiaries are often not specified by name but as classes of persons. For example, a grantor's spouse and lineal descendants may form a primary class of beneficiaries while the grantor's siblings and their descendants are a secondary or contingent class. Beneficiaries can be individuals or organizations and a trust will typically specify which beneficiaries receive either income, principal, or both, under what circumstances and when.

- **Trust Res**
  Trust res (or corpus) is the specific identifiable property, or an interest in such property, owned by the trustee. The beneficiary's rights begin with the property transferred by the grantor to the trustee, but continue in property the trustee may subsequently acquire through gift, purchase, or exchange. Most jurisdictions recognize that a valid trust may be formed where the trust is named as the beneficiary of a life insurance policy even if it may have no other property interests.

THE VALUE OF USING LIFE INSURANCE WITHIN A TRUST

The types of assets a grantor may place in trust are wide-ranging; they can include securities, annuities, real estate, or life insurance, among others.

Life insurance owned in trust offers certain advantages. Relatively small transfers on the part of the grantor—the premiums—can result in a much larger amount of money when the death benefit is paid. In this way, the grantor can leave a significant amount in trust for the benefit of their loved ones no matter how their personal situation may change during life.

Life insurance death benefits are liquid and so can be used for many different purposes such as investing in new, trust-owned property or to cover the grantor's estate costs by purchasing assets from the estate.

And in most cases, life insurance death benefits are income tax free, making it one of the most tax-efficient assets available.

Other examples of potential benefits of using life insurance in connection with trust planning:

- Depending on the trust and how it is structured, the death benefit can be invested for the exclusive benefit of a surviving spouse with any remaining value passing to other family members at the spouse's death.

- Rather than transferring low-basis stock to a trust, where it may be taxed when it's sold, the grantor can give it to charity and fund a life insurance policy in the trust to replace the stock's value for their heirs.

- If income-producing assets need to remain in the grantor's possession, subjecting them to estate costs such as taxes, the grantor can use some of the income to fund a life insurance trust to help pay the estate costs and avoid a forced sale of assets at death.

TYPES OF TRUSTS

Trusts have varied uses and purposes but all fall into one of two classes: living and testamentary. Living trusts can be either revocable or irrevocable and testamentary trusts are created at death based on terms in your will. The discussion that follows focuses on some of the more commonly used trusts including an explanation of any tax advantages.

- **Revocable Living Trust**
  A revocable living trust is a trust created during the grantor's lifetime and allows the grantor (you) to maintain total control over the trust during your life. For instance, the grantor can change the trustee, withdraw property from the trust, or terminate the trust altogether. It becomes effective once the grantor and trustee sign the trust document and property is transferred into the trust. Upon the grantor's death, the revocable living trust terminates or becomes irrevocable. Because of the grantor's ability to revoke the living trust, this type of trust does not provide any tax advantages but it is an efficient and effective way to transfer property at death.

  A revocable living trust is an efficient and effective way to transfer property at the time of the grantor's death. Other estate objectives that can be met by using a revocable living trust include:

  Advantages

  - **Reducing Probate Costs** - Property passing under a will is subject to attorney's and executor's fees and court costs associated with the probate estate. Property transferred during the grantor's lifetime to a revocable living trust may not be subject to probate expense.
  - **Eliminating Probate Delays** - A revocable living trust avoids the delay of probate proceedings and permits beneficiaries to receive property more quickly.
  - **Privacy** - Wills may be made public as part of the probate process. Because a revocable living trust is not subject to probate, generally its contents do not have to be revealed. The identity of beneficiaries and trust assets can be kept confidential from outsiders.
  - **Avoiding Multiple Probate Proceedings** - Real estate and other tangible property located in a state other than the decedent's state of residence may require separate probate proceedings in that state. Separate probate proceedings may be avoided by transferring the out-of-state real estate to a revocable living trust.
  - **Managing Property in the Event of Disability** - The trustee can manage the trust property for the benefit of a disabled or incapacitated grantor without incurring the expense of court involvement in appointing a guardian of the property. The trust can provide continuity of investment and management of assets after the grantor's death. This is an important factor if the trust beneficiaries are unwilling or unable to manage the trust property.
  - **Self Determination** - It is common for the grantor to act as trustee maintaining direct personal control of trust assets until such time the grantor is unwilling or unable to serve.

  Disadvantages

  - **Initial Costs** - Normally the cost of creating a revocable living trust exceeds that of a comparable will. The trust instrument and a separate "pour-over" will must still be drafted. Additional legal documents, such as deeds and other documents used to transfer ownership, may be necessary to fund a revocable living trust.
  - **Probate Proceedings May Be Unavoidable** - The grantor may hold additional property outside the living trust that may require separate probate proceedings. In addition, many states allow creditors a certain period of time to file a claim or be forever cut off. The only way to begin this time period is to initiate a probate proceeding.

- **Funding the Trust Can Be Time-Consuming** - The trust is created during the grantor's lifetime and becomes operative when funded. The transfer of stock certificates, corporate and government bonds, real estate, and other assets can be time-consuming and complicated. If the funding of the trust is not completed, the goal of avoiding probate concerning those assets will not be achieved.

- **Irrevocable Living Trust**
  An irrevocable living trust is a trust that is established by the grantor while they are still alive and which, by its terms, cannot be revoked or terminated by the grantor. One reason to choose irrevocability is to remove the trust assets from the grantor's taxable estate. An irrevocable life insurance trust (ILIT) is probably the most common example of an irrevocable living trust.

- **Testamentary Trust**
  A trust established under a decedent's will is known as a testamentary trust and the grantor is referred to as the "testator," that is, the maker of the will. Testamentary means "at death" and such a trust has no legal value or effect until the testator's death as it does not come into being until the testator dies. Because a testamentary trust is not actually established until death, the trust may be modified or revoked beforehand by amending the will. After the grantor's death, the testamentary trust becomes irrevocable. Because it is created by a will, the assets of a testamentary trust are subject to probate and may be taxed as part of the estate.

SELECTION AND DUTIES OF A TRUSTEE

Trustee Duties
A trustee has a broad duty to act in a fiduciary capacity on behalf of the beneficiaries while complying with the terms of the trust document and applicable state laws. The trustee's duties generally include:

- **Investments** - The trustee controls the trust assets. The trustee must invest and reinvest the trust assets in a prudent manner.

- **Distribution** - The trustee is responsible for making trust distributions as directed by the trust terms.

- **Accountings** - The trustee may be required to provide trust accounts to the beneficiaries and/or the probate court as provided by the trust instrument or under applicable state laws.

- **Taxes** - The trustee is responsible for preparation of the trust's tax returns and payment of any taxes owed by the trust. A revocable trust generally does not require a separate tax return.

- **Trust Termination** - The trustee must distribute the trust property at the end of the trust term according to the trust provisions.

Factors in the Selection of a Trustee
The trustee (or a successor trustee) may be one or more individuals, an institution (e.g., a corporate trustee or charitable organization), or a combination of both. The trustee has ongoing obligations to the trust beneficiaries. Due to the serious nature of the role, the trustee should be reliable and honest and possess a good understanding of how the grantor intends the trust to operate. It is a good practice to name at least one, and preferably two, successor trustees. Other factors to consider before deciding whom to select as trustee include:

- **Duration of Trust** - When the trust is intended to last for the lifetime of a beneficiary, or for the maximum period of time permitted by law, it may be advisable to name a corporate entity as the ultimate successor trustee. Alternatively, the trust can permit the individual trustee(s) to select their own successors. A named corporation in the business of trusteeship (or its successor) is normally available when called upon to serve.

- **Size of the Trust** - A corporate trustee may have minimum size requirements for a trust whereas individual trustees usually have no such requirements.

- **Investment Capabilities and Philosophy** - A corporate trustee may have greater resources and knowledge with respect to the investment and management of trust assets than an individual trustee. A corporate trustee may be a more conservative manager than an individual in selecting investments. The grantor must decide whether the trustee will have an investment philosophy compatible with their own.

- **Costs** - Individual trustees may be willing to serve without compensation or at lower rates than a corporate trustee.

- **Availability of Individuals** - Clients who are considering individuals, such as family members, to serve as trustee must make sure that these individuals have the time, the willingness, and the ability to properly manage trust assets.

- **Beneficiary Understanding** - An individual trustee may have greater personal knowledge of the grantor's desires and be more in tune with the needs of individual beneficiaries. However, an individual trustee may be reluctant to make difficult decisions or resolve conflicting interests involving family members. A corporate trustee is not tied emotionally to the beneficiaries and may be more capable of making impartial decisions.

- **Co-Trustees** - Use of an individual and a corporate trustee may balance diverse interests and talents but may increase trustee fees. The trust should clearly identify how the trustees will act, such as how many trustee signatures are needed to execute transactions.

- **Tax Considerations** - If the grantor names themselves as trustee, their powers over principal and income may make the trust income taxable to them or cause inclusion of the trust assets in their estate.

MAXIMUM TRUST LIFE

Generally, most states allow trusts to continue for the life of some ascertainable person or class of persons alive at the time the trust is made effective, plus 21 years. This is referred to as the rule against perpetuities.

For example, assume the youngest measuring life of a trust is a newborn when the trust becomes effective and the newborn goes on to live for 95 years. Using the rule against perpetuities, the trust could continue on for 95 years + 21 years = 126 years. It should be evident why it's important to identify in advance the contingent trustees who will carry on the affairs of the trust.

Some states have modified or repealed their rule against perpetuities (or permit elections to have the trust not be subject to the rule) allowing the creation of trusts lasting centuries or even into perpetuity. One benefit of trusts formed in these states is that assets may not be subject to estate taxes for a very long time. This type of multigeneration trust is sometimes referred to as a "dynasty trust."

However, the innovations in state-level modifications to the rule against perpetuities are relatively new, i.e., not more than a few decades old, and may yet have to endure legal challenges by the federal government.

NON-TAX BENEFITS OF TRUSTS

Trusts are often created to help reduce or minimize transfer tax consequences (i.e., gift tax, estate tax, and generation-skipping tax). However, they may offer advantages other than tax savings. The following is a short discussion of some of the non-tax advantages of using trusts.

- **Grantor Control**
  Through the terms of the trust document, the grantor can control the manner in which the property is invested and the way income and principal are distributed to the beneficiaries even after their death.

- **Financial Management**
  A properly selected trustee can provide financial management for beneficiaries who are not capable of handling such matters. Frequently, trustees are selected for their good judgment even though they may have little financial management experience. In these situations, trustees have the authority to hire accountants, attorneys, financial professionals, or other professionals to advise them.

- **Protection Against Creditors**
  A spendthrift provision in the trust instrument may protect a beneficiary's interest in the trust property against claims made by their creditors until the income or principal of the trust is distributed. Thus, a spendthrift provision can serve as protection if the beneficiary becomes involved in bankruptcy or divorce proceedings.

- **Flexibility in Dispositive Arrangements for Family Members**
  Specific terms in the trust relating to distribution of income or principal can help to assure that a young child's inheritance will be distributed according to the parent's wishes. Some advantages in using trusts with respect to the future benefit of children are:

  - **Grantor Sets the Rules.** The grantor can set the standard for making discretionary trust distributions by directing the trustee to be generous or to make distributions sparingly to encourage beneficiary self-sufficiency.

  - **Meeting Differing Needs of Children.** As stipulated by the terms of the trust document, the trustee can have the power to allocate funds unequally among the children irrespective of their needs and ages. For example, if one child receives a college scholarship for tuition and another child does not, the trustee can have the flexibility to allocate a greater proportion of trust resources to help pay the college expenses of the second child.

  - **Avoids Conservatorship.** If a minor inherits property outright upon death (rather than through a trust), the court will appoint a guardian or conservator to administer (protect) the property on behalf of the minor. This court procedure is costly and cumbersome and the appointed person may be someone unknown to the family.

  - **Use of Staggered Distribution Ages.** The trust instrument can direct a staggered distribution of trust property at specified ages so that the beneficiaries receive the property in stages. This is a common method for making distributions to children because it allows greater time for the children to mature and learn how to handle financial affairs. An example might be income annually plus 1/4 of trust corpus at age 25, 1/3 at age 30, 1/2 at age 35, and the remainder at age 40. If no trust is in place, the children's inheritance will be distributed to them at the age of majority.

  - **Caring for a Disabled Beneficiary.** A trust can permit the grantor to make special arrangements for a disabled beneficiary who may need care and financial help for life. The trust may direct the trustee to provide payment for medical expenses and a broad range of other costs.

  - **Protection Against Unexpected Order of Deaths.** Specific provisions can be included in a trust to provide instructions in the event of a beneficiary's death before, after, or simultaneous with that of the grantor. A trust in effect at the beneficiary's death can insulate property from estate taxes and claims of a spouse and/or creditor and provide for the deceased beneficiary's surviving children.

COMMON TRUSTS IN ESTATE DOCUMENTS

This section focuses on specific types of trusts often included in estate documents. While many of the trusts result in transfer tax savings, more importantly, they allow the grantor to do what they really want to do with their wealth. The ability to provide continued care for a spouse or minor children, to support a favorite charity, and to ensure a grandchild's education are just a few of the common objectives that can be managed through a trust. For married couples, one of the most common objectives is to ensure that maximum use is made of each spouse's applicable exclusion amount, though with recent advances in tax law, such as allowing portability of the deceased spouse's applicable exclusion to the surviving spouse, this need is reduced for smaller estates. A common estate technique involves using a credit shelter trust in conjunction with the unlimited marital deduction to defer estate taxes until the death of the surviving spouse. First, a discussion of the basic components of this technique.

- **The Applicable Exclusion Amount**
  U.S. citizens and residents are allowed a tax credit against taxes stemming from their cumulative dispositions of property. This results in an individual's ability to transfer property during life and/or at death free of estate and gift taxes. The value of property that can be transferred without gift or estate tax—known as the applicable exclusion amount—is the amount that would generate a gift or estate tax liability equal to the allowable applicable credit.

  The Tax Cuts and Jobs Act of 2017 changed, through 2025, the estate, gift, and generation-skipping transfer (GST) taxes, which are unified and indexed for inflation, rounded down to the nearest $10,000. In 2024, the amount is $13.61 million per person or $27.22 million per married couple. The highest tax rate is 40% and there continues to be a full step-up in basis for capital assets excluding income in respect of a decedent (IRD).

  Executors can now permanently transfer the unused applicable exclusion (estate or gift) to a decedent's surviving spouse with the timely filing of an estate tax return. In all years, the estate tax applicable exclusion amount available at death is reduced by the gift tax applicable exclusion amount used during the individual's lifetime. The following chart summarizes the changes to the estate tax applicable exclusion amount:

YEAR OF DEATH	APPLICABLE EXCLUSION AMOUNT	UNIFIED CREDIT AMOUNT
2024	$13,610,000	$5,389,800

- **Unlimited Marital Deduction**
  The biggest single step that most married couples can take to defer estate taxes at their death is to qualify the transfer of property for the unlimited marital deduction.

  This allows the first spouse to die to leave all of their property to the surviving spouse and avoid federal estate taxes. The marital property will be included in the estate of the surviving spouse and potentially subject to taxation at their death. Now with permanent portability, the decedent can pass any unused applicable exclusion to their surviving spouse.

  If the surviving spouse is a U.S. citizen, the marital bequest can be made outright or in trust.[1] Some factors to consider when deciding whether a marital trust should be considered are as follows:

  - The cost of establishing and administering the marital trust compared with the value of the property that would be transferred into the trust.

- The effect of applicable state law entitling the surviving spouse to a specified percentage of the deceased spouse's estate. The creation of a trust for the surviving spouse may cause them to elect a statutory share under state law thereby defeating the deceased spouse's wishes.
- The surviving spouse's ability to manage the marital assets wisely versus the need for investment guidance.
- The need for creditor protection.
- The need to protect the inheritance of other family members.

[1] Where the surviving spouse is not a U.S. citizen, in order to qualify for the marital deduction, property must pass into a special type of trust called a qualified domestic trust (QDOT).

Marital Trusts

The trust must meet requirements established in the Internal Revenue Code to qualify for the unlimited marital deduction. Generally, a transfer will not qualify for the marital deduction if the transfer results in a "terminable interest." There are three exceptions to the terminable interest rule: (1) a power of appointment trust, (2) an estate trust, and (3) a qualified terminable interest property trust (QTIP).

- **The Power of Appointment Trust** - A power of appointment trust is a marital trust in which the surviving spouse is entitled to income for life, payable at least annually, and the surviving spouse has a general power of appointment over the property in the trust. A general power of appointment allows the surviving spouse to give the trust property to whomever they desire.
- **An Estate Trust** - An estate trust is one in which the surviving spouse is given an interest for life with the remainder passing to their estate. The advantage of an estate trust is that the income does not have to be paid annually to the surviving spouse. If the trust is in a lower income tax bracket, the trustee can accumulate income within the trust.
- **A Qualified Terminable Interest Property (QTIP) Trust** - The QTIP trust provides a way for a spouse to protect the interests of heirs (perhaps their children from a prior marriage) while still providing for the surviving spouse. The grantor spouse can provide that their spouse will receive only the income from the property. At the death of the surviving spouse, the property must pass to the person or persons named as trust beneficiaries. This otherwise nondeductible terminable interest qualifies for the marital deduction. The major advantage of a QTIP marital trust to a grantor is, at the surviving spouse's death, the remaining trust property passes to beneficiaries selected by the grantor.

  Four conditions must be met before QTIP treatment is allowed:

  - The decedent-spouse must make a transfer of property.
  - The surviving spouse must receive all trust income, payable at least annually, for life.
  - The trust may provide for discretionary principal distributions only to, or for the benefit of, the surviving spouse. No trust income or principal may be diverted from the spouse (by the spouse or others) during the spouse's lifetime.
  - The decedent-spouse's executor must make an irrevocable election on the decedent's federal estate tax return. The election provides that, to the extent the QTIP property has not been consumed during the surviving spouse's lifetime, its value at the death of the surviving spouse will be included in the surviving spouse's estate.

The QTIP trust can provide the following advantages:

- Financial management of assets for a spouse who is not willing to handle, or capable of handling, such matters.
- Protect assets against claims of creditors or claims of a new spouse should the surviving spouse remarry.
- Permit the deceased spouse to control the ultimate distribution of the trust property unlike other types of trusts that qualify for the unlimited marital deduction.
- Provide estate tax flexibility. An executor may elect to qualify only part of the QTIP trust property for the unlimited marital deduction and pay some estate tax at the first death. The executor of the deceased spouse's estate will therefore be able to re-assess the decedent's estate and make adjustments to maximize the potential overall estate tax savings.

Because of the unlimited marital deduction, there is a tendency to focus only on the advantages of passing wealth between spouses free of gift and estate tax. While this may be effective with smaller estates, this approach fails to take into account the ultimate consequences on the combined estates of the spouses where the surviving spouse inherits all the family wealth after the death of the first spouse. In large estates, passing all of the wealth to the surviving spouse under the unlimited marital deduction will potentially result in increased estate tax at the surviving spouse's death. The opportunity to pass significant wealth from the first spouse to other family heirs free of transfer tax through the use of exemptions and exclusions may be reduced or lost.

Credit Shelter Trust

The counterpart to the marital trust is the credit shelter trust (CST). In the most common scenario, the estate is divided into two parts at the death of the first spouse, the marital trust and the credit shelter trust. The credit shelter trust takes property equal to the applicable exclusion amount and generally provides lifetime benefits to the surviving spouse but will bypass their estate at death. In this way, use of a credit shelter trust can help "shelter" assets and their appreciation from taxation at the second spouse's death.

The credit shelter trust is also known as a "B Trust" or a "Bypass Trust." Though the portability rules may appear to reduce the need for a credit shelter trust, the trust still may enable a married couple to shelter up to two times the applicable exclusion amount from estate tax. The benefits to the surviving spouse include:

- The potential to receive all the income from the CST for life, if so directed by the trust document.
- If the trustee is the surviving spouse, they may be given the right to invade trust principal to provide for their own health, education, maintenance, and support. Alternatively, an independent trustee may be given virtually unlimited discretion as to the distribution of trust principal.
- The surviving spouse may have a limited power of appointment to name the beneficiaries who will receive the remaining trust property at their death. The power should specify that the trust property cannot be directed to the spouse's estate, creditors of the spouse, or creditors of the estate.
- The CST may have many beneficiaries in addition to, or instead of, the surviving spouse.

IRREVOCABLE LIFE INSURANCE TRUSTS

Irrevocable life insurance trusts (ILITs) are intended to make the proceeds of life insurance policies available to trust beneficiaries in a manner that will not subject the policy proceeds to unnecessary transfer tax or income tax. When properly drafted, an ILIT can provide lifetime benefits to the grantor's surviving spouse and heirs and be excluded from both taxable estates. Typically, ILITs are used to accomplish four goals:

- To exclude the policy proceeds from the estates of the grantor and their surviving spouse.
- To help meet the liquidity needs of the grantor's estate.
- To provide income for the grantor's survivors.
- To shelter property from creditors at death.

ILIT Overview

The ILIT is created during the grantor's life generally for the benefit of family members. The trust is funded with a life insurance policy on the grantor or the grantor and their spouse. Usually, the trustee acquires a new policy with cash transferred to the trust from the grantor. In order to avoid inclusion of the policy in the grantor's estate for estate tax purposes, the grantor retains no ownership rights, control, or beneficial interest in the trust. Although an existing policy may be transferred to the trust, if the grantor dies within three years of the transfer date, the policy will be included in their estate.

To fund the trust, the grantor transfers money to the trust for premium payments, using the annual gift tax exclusion or the gift tax applicable exclusion amount. Limited powers to withdraw the cash transfers (often called Crummey powers) are granted to the beneficiaries to ensure that the transfers of the annual premium amounts qualify for the annual gift tax exclusion.

Advantages

- When the trust is properly structured, the ILIT property, including the life insurance proceeds, is not included in the grantor's taxable estate. For new policies, the trustee should apply for the insurance as the owner. For existing insurance that is transferred to the ILIT, the grantor generally must survive for three years after the transfer for the death benefit to be excluded from the grantor's estate.
- The grantor's spouse may have a limited interest in the trust without causing the insurance proceeds to be included in their taxable estate. Note: Using a community property checking account to make gifts to a trust that will benefit the surviving spouse will pull the trust proceeds into the surviving spouse's taxable estate. Care must be taken to keep all gifts separate.
- The trust protects the policy and proceeds against creditors.

Disadvantages

- It is irrevocable. A grantor cannot amend or revoke the trust.
- Grantor loses control over the policy and cannot receive any direct economic benefit from the trust.
- It involves preparation that can be complex and an estate planning attorney must be used.

USE OF THE TRUST TO AVOID GENERATION-SKIPPING TRANSFER TAX

The generation-skipping transfer (GST) tax was enacted to recoup estate taxes that were lost when property was transferred to an individual described as a skip person. A skip person is someone who belongs to a generation that is two or more generations below that of the transferor through the family line or anyone who is more than 35 years younger. GST tax may be incurred whether the transfer is made outright or in trust for the benefit of a skip person.

The GST tax is currently levied on amounts exceeding the gift and estate tax exemption amount ($13,610,000 in 2024), as indexed for inflation, at the same flat rate of 40% as the gift and estate tax. But because the GST tax exemption is not unified with the gift and estate tax exemption, double taxation totaling 80% can result if not properly planned for. A complete discussion of the GST tax is beyond the scope of this brochure.

- **Dynasty Trust (Generation-Skipping Trust)**
  The dynasty trust, also referred to as the "family bank" or a GST trust, is a multigenerational trust (subject to the rule against perpetuities) that, when properly established and administered, can conserve family wealth by preventing inclusion of the assets in the taxable estates of each successive generation.

  The GST tax can be permanently avoided with respect to all benefits derived by succeeding generations through leveraged use of the estate owner's lifetime GST exemption allocations to gifts that are likely to appreciate substantially in value over time.

  Trust-owned life insurance policies are a useful vehicle for leveraging relatively small GST exemption allocations—the premiums—into a potentially multimillion-dollar tax-free asset for the benefit of succeeding generations.

USE OF CHARITABLE TRUSTS FOR CHARITABLE GIVING PURPOSES

Charitable trusts may be established for the sole benefit of a charity or, in the case of split-interest trusts, for the benefit of charities and individual non-charitable beneficiaries. Split-interest trusts provide for a charitable interest that arises either before or after that of the non-charitable beneficiaries. Transfers to certain split-interest trusts qualify for the charitable deduction. If a split-interest trust qualifies as a charitable remainder trust or a charitable lead trust, the donor may be able to claim a charitable deduction for the interest passing to charity.

- **Charitable Remainder Trusts**
  A charitable remainder trust (CRT) is an irrevocable split-interest trust (created during life or by will) that provides for the income interest to be paid to non-charitable beneficiaries, which may include the donor, and the remainder interest to be paid to charitable beneficiaries. The income from a CRT may be paid to one or more persons for their entire lives, however long or short, or for a fixed period of years not exceeding 20. At the expiration of the income interest, the trust principal (the remainder) passes to the named charity.

  CRTs are commonly used to mitigate capital gains tax on highly appreciated property when the property is sold. Typically, the appreciated property is transferred to the CRT and then sold by the tax-exempt trust with the proceeds reinvested to produce an income stream for the donor. A CRT is appropriate for a donor who wishes to benefit a charity in the future but desires a current charitable deduction and income stream from the property during their lifetime.

  When property is contributed to a CRT, the donor receives a current income tax deduction equal to the present value of the remainder interest based on the federal discount rate (called the 7520 rate) in effect at the time. If a person other than the donor and their spouse are the income beneficiaries, the donor is deemed to have made a gift of a portion of the income interest to these income beneficiaries.

  There are two types of charitable remainder trusts: a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT). The following illustrates several differences between a CRAT and a CRUT.

- **Charitable Remainder Annuity Trusts**
  - Requires annual cash payments of a fixed percentage of the initial fair market value of the contributed property be made (equal to or greater than 5% and not exceeding 50%).
  - Based on the applicable 7520 rate, the charitable beneficiary's remainder interest must actuarially equal or exceed 10% of the initial fair market value of all contributed property. A low 7520 rate can make it difficult for trusts with younger beneficiaries to meet the 10% requirement.
  - No additional property can be added to the CRAT after the initial contribution.

- **Charitable Remainder Unitrusts**
  - Requires annual cash payments of a fixed percentage of the trust assets, as valued not less frequently than annually, equal to or greater than 5% and not exceeding 50%. If trust assets increase in value, the amount distributed to the income beneficiary increases. If the value of the trust assets decreases, the amount distributed decreases.
  - Annual payments may be limited to the net income of the trust.
  - As with a CRAT, the charitable beneficiary's remainder interest must actuarially equal or exceed 10% of the fair market value of the contributed property as of the date of the contribution to the trust.
  - Unlike a CRAT, additional property may be added to the CRUT after the initial contribution.

- **Wealth Replacement Trusts**
  When property is contributed to a CRT, the donor's heirs are effectively disinherited of it. To compensate for this loss, one option for the donor is to fund an irrevocable life insurance trust. At the donor's death, the life insurance policy proceeds can be passed to the heirs income and estate tax-free, helping replace the value of the asset that went to charity. The savings from the charitable income tax deduction and the CRT income stream may help offset the cost of the life insurance.

- **Charitable Lead Trusts**
  A charitable lead trust (CLT) is an irrevocable split-interest trust (created during life or by will) that is in effect the inverse of the CRT: the income interest is paid to a charity, and the trust principal (remainder interest) passes to non-charitable beneficiaries when the trust terminates. As with the CRT, any charitable deduction is figured by applying the 7520 rate to the income interest and subtracting it from the trust's beginning value.

  Also like a CRT, the income interest in a CLT can be either an annuity interest or a unitrust interest. In a charitable lead annuity trust (CLAT), the income interest is a fixed dollar amount every year. In a charitable lead unitrust (CLUT), the income is a fixed percentage of the value of the trust's assets. The assets are valued every year and, if the value increases, the distribution to the charity increases and vice versa.

  Unlike a CRT, a current income tax deduction is allowed with a charitable lead trust only if the donor assumes liability for tax on all trust income during the trust term. (There can be no deduction, then, if the CLT is testamentary in nature because its donor is deceased.) Apart from its charitable purpose, the main benefit of the CLT is to reduce or eliminate gift or estate tax on the transfer of assets to or for the benefit of the family. CLTs are most often used to achieve estate tax savings and are created at death when the assets used to fund them have a cost basis equal to their current value.

Generally, to reduce gift and estate taxes when passing property to family members, a CLT is structured as a non-reversionary lead trust. The grantor funds the CLT with income-generating property providing the charity with guaranteed annual income payments based on the fair market value of the trust for a period of time. At the end of the specified period, the remainder interest passes to the grantor's family members or other non-charitable beneficiaries. If someone other than the grantor is the remainder beneficiary then a portion of the assets will not be included in the grantor's estate. However, in this case, the grantor has made a gift of the remainder interest to the remainder beneficiary. The annual gift tax exclusion cannot be applied toward this gift of a remainder interest because it is not a gift of a present interest in property. However, the value of the gift may be discounted for gift tax purposes.

If the remainder beneficiaries are expected to be skip individuals, there are generation-skipping issues and a CLAT should be used in place of a CLUT. In determining the value of the trust's remainder interest for GST tax purposes, the CLAT is valued as of the date of original contribution whereas the CLUT is valued as of the date of distribution. Assuming growth over the years, the CLUT will create a much greater "unknown" GST tax exposure.

USE OF FUTURE INTEREST TRUSTS

Charitable split-interest trusts are for individuals who wish to transfer an asset to charity and enjoy a benefit for themselves or their families over and above a charitable income tax deduction. For those who would like a similar benefit and not involve a charity, the solution may be a non-charitable future interest trust. These allow a grantor to enjoy an asset during life while committing its ultimate disposition to or for the benefit of family members—in other words, making a gift while keeping it for themselves for a convenient period.

The advantage of these trusts as compared with simply leaving assets to heirs at death is that the asset values can be discounted thereby reducing or eliminating gift and estate taxes. The key, as with charitable split interest trusts, lies in the principle of the time value of money: a dollar of value received in the future is worth less than a dollar receivable today. As discussed above in the discussion of split interest charitable trusts, its application is codified in U.S. Tax Code Section 7520. In brief, the value of the asset at the time of the transfer minus the future value of the interest retained by the grantor, discounted by the 7520 rate in effect in that month, will equal the value of the remainder interest gift. This remainder interest gift is considered a "future gift" and does not qualify for the annual gift tax exclusion or the allocation of GST tax exemption. Also, if the grantor dies before the trust terminates and distributes the property to the remainder beneficiaries, the entire trust assets will be included in the grantor's taxable estate.

Non-charitable future interest trusts:

- Grantor retained annuity trust (GRAT);
- Grantor retained unitrust (GRUT); and a
- Qualified personal residence trust (QPRT).

- **Grantor Retained Annuity Trust (GRAT)**
  With a grantor retained annuity trust (GRAT), the grantor transfers property and retains the right to a fixed annuity interest for life or a specified period of years. The annuity may be paid using any type of property including cash. The trust is irrevocable. At the end of the trust term, the remaining principal passes to a remainder beneficiary. Distributions must occur at least annually and equal a fixed percentage of the trust's asset value as of the date the property is transferred. The annuity interest may never vary but if the trust depletes its assets, the trustee is under no obligation to make up any shortfall.

- **Grantor Retained Unitrust (GRUT)**
  A grantor retained unitrust (GRUT) is very similar to the GRAT described above. The chief difference is in the method used to calculate the amount of the trust payments made to the grantor. A unitrust's interest is calculated by multiplying the value of the trust assets, as determined annually, by a fixed percentage value. If the value of trust assets increases, the amount of the distribution to the grantor increases. Correspondingly, if the value of the trust property decreases, the distribution decreases.

  Generally, the GRUT is not as popular as the GRAT especially in periods of low interest rates.

- **Qualified Personal Residence Trust (QPRT)**
  A qualified personal residence trust (QPRT) is an irrevocable trust where the type of transferred property is limited to a residence of the grantor. It is very similar to a GRAT except the "payment" to the grantor is the right to occupy the residence during the trust term; at the end of the term, title to the residence vests in the trust's remainder beneficiaries.

LOOKING TO THE FUTURE

As you can see, there are many types of trusts that can be used as part of an individual's overall planning strategy. Individuals will continue to need to consider non-tax reasons for the use of trusts.

These non-tax reasons include ensuring that assets pass to the intended beneficiaries at the time and in the manner desired and the need in many cases to protect the assets passing to beneficiaries from creditors. In such an environment, trusts will still provide significant benefits.

Individuals should consult with a financial professional for more information on how life insurance, in combination with trusts, can be used to help protect those they love.