# TRUSTS: LEGAL & TAX ASPECTS

## POST TCJA


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# Trusts – Legal and Tax Aspects

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## Today's Instructor

Arthur Joseph Werner, JD, MS (Taxation), is the president and is a shareholder in the lecture firm of Werner-Rocca Seminars, Ltd. Mr. Werner's lecture topic specialties include business, tax, financial and estate planning for high net worth individuals.

Art received his B.S. in Accounting and his M.S. in Taxation from Widener University. He holds a J.D. in Law from the Delaware Law School.

Art lectures extensively in the areas of Tax Planning and Compliance as well as Estate and Financial Planning, Financial Planning to CPAs, EAs, and other tax professionals, and has presented well in excess of 2500 eight-hour seminars over the past twenty-five years as well as numerous webinars and video presentations. Mr. Werner has been rated as having the highest speaker knowledge in his home state of Pennsylvania by the Pennsylvania Institute of Certified Public Accountants, was awarded the AICPA Outstanding Discussion Leader Award in the State of Nevada, the Florida Institute of CPAs Outstanding Discussion Leader Award, and the South Carolina Association of CPAs Outstanding Discussion Leader Award.

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# Disclaimer



# Definition

- What is a Trust?
  - Device of protection
    - Protect assets
    - Protect current beneficiaries
    - Protect future beneficiaries

## The "Players"

- The Trustor
  - a/k/a Settlor or Grantor
- The Trustee
  - Can be human or non-human
- The Beneficiaries
  - Must equal 100 % of the eventual distribution of the trust corpus



## The "Three Questions"

- All trusts can be specifically defined and classified by asking three specific questions of them
- Understanding these three questions can best help you understand the purpose of the trust and the technique or techniques that it is being used for

## Question #1

- How is the Trust created? (Trusts can be created in only in one of two ways.)
  - Inter-vivos (a separate legal document)
  - Testamentary (within a Last Will and Testament)




## Question #2

- Can the Trust be changed, altered, amended, or revoked?
  - Yes (Trust is revocable)
  - No (Trust is irrevocable)

## Caveat

- Can you have a revocable inter-vivos trust?
- Can you have an irrevocable inter-vivos trust?
- Can you have a revocable testamentary trust?
- Can you have an irrevocable testamentary trust?



## Question #3

- For Federal Income Tax purposes, how is the Trust classified?
  - Grantor
  - Simple
  - Complex

- So – WHAT IS INCOME?????

## Probate

- What is "Probate"?
  - Legal definition: The act of proving that an instrument purporting to be a Last Will and Testament was executed in accordance with legal requirements and of determining its validity thereby. In addition a Probate Court is a special court of law having specific jurisdiction of proceedings incident to the settlement of a decedent's estate.



## Problems of Probate

- Higher Costs
- Delays
- Publicity
- Retainage of Assets
- Court Supervision
- Additional Professional Fees

## Tax Considerations in Trusts

- Income Tax Issues
- Estate and Gift Tax Issues
- Basic Planning Techniques



## Income Tax Issues

- Grantor Trust Rules
  - A "Grantor  Trust" is a trust that for income tax purposes does not exist.  All income in a Grantor Trust is properly reported on the Trustor's 1040.
  - All Revocable Trusts are Grantor Trusts
  - Some Irrevocable Trusts are Grantor Trusts
    - IRC §§671 – 678 define when the terms of an Irrevocable Trust create a Grantor Trust for income tax purposes

## Income Tax Issues (cont.)

- General Rules
  - For the most part, Subchapter J of the Internal Revenue Code is very similar to the parts of the Internal Revenue Code dealing with Individual Income Taxation.
    - There are four tax brackets (10%, 24%, 35%, and 37%), however, the brackets are compressed compared to individual rates (ex: for 2023, the 37% tax bracket becomes effective when income exceeds $14,450)



## 1041 Income Tax Rate Schedule – 2023 (with compressed tax brackets)

| Income Amount | Marginal Rate |
|---|---|
| 0 - $2,900 | 10% |
| $2,901 - $10,550 | 24% |
| $10,551 - $14,450 | 35% |
| $14,451 and above | 37% |

**(Note: The 12%, 22%, or 32% brackets that apply to individuals do not apply to fiduciary entities!)**

# Affordable Care Act Taxes

- Estates and Trusts are subject to the 3.8% surtax on the lesser of:
  - Undistributed net investment income, or
  - the amount by which adjusted gross income exceeds the top bracket for estate and trust income taxation.



# Income Tax Issues (cont.)

- General Rules
  - Income Distribution Deduction
    - All income that is properly distributed from the trust is deducted from trust income
    - Simple Trust: All income must be distributed (potential for a "deemed distribution")
    - Complex Trust: Trustee has certain discretion (potential for 65 day election)

## Transfers with Control

- Revocable Trust
  - No taxable gift because transfer was not complete
  - Upon the death of the Trustor, however, the assets of the Revocable Trust are a part of the taxable estate of the Trustor (Internal Revenue Code §2038



## Transfers with Control (cont.)

- Transfers within three years of death
  - Applies to transfers of life insurance policies to Irrevocable Life Insurance Trusts
  - The transfer of ownership of a life insurance policy from an individual who dies within three years of said transfer to anyone else (including a trust) where the insured is the transferring individual will cause the death benefit of the policy to be a part of the taxable estate (IRC §2035)

## Transfers with Control (cont.)

- Transfers with retained life interests
  - Applies to transfers of an asset where the transferor retains the use and enjoyment of the transferred asset for the remainder of his or her life (IRC §2036)
  - Trusts that are susceptible to this IRC section are GRITs, GRATs, GRUTs, and QPRTs



## Transfers with Control (cont.)

- Transfers conditioned upon surviving the decedent
  - Applies to transfers of an asset where the transferor places a condition that if the recipient of the asset dies before the transferor of the asset, then the asset is returned to the (IRC §2037)

# Estate Planning

- Marital Deduction / Unified Credit Trust
  - “A/B” Trust
  - Description / Explanation as to how trust works



Portability Election (IRC §2010(c))

- When a decedent is survived by a spouse, the amount of the Estate Tax exclusion for that decedent's estate that is not used by that decedent's estate is "portable" – that is, it can be used for gift or estate tax purposes by the surviving spouse.

## Portability Effect

- The effect of Portability makes the unused "basic exclusion amount“ to pass to a surviving spouse.
- The "basic exclusion amount" is thus similar to an exemption, and it is often referred to as an "exemption."
- The “basic exclusion amount” applies to the total of estate and gift tax transfers.
- The “basic exclusion amount” is subject to cost of living adjustments



## Reasons NOT to Elect Portabil

- Second Marriages
- Financial Immaturity
- Lack of Trust in Surviving Spouse
- Growth of Assets
- Asset Protection Issues

## Advantages of Trusts over Portability

- The use of trusts can offer a certain number of "safe harbors" that portability does not
  - Example: All future appreciation in the value of assets in a Credit Shelter Trust is sheltered from estate tax in the surviving spouse's estate, which is not true of assets that pass to a surviving spouse via portability
- A trust may be a better choice if the client is seeking asset protection to make certain that the proceeds from the estate last not just the lifetime of the surviving spouse but can also provide for the next generation.



## Advantages of a Credit Shelter Tru

| | |
|---|---|
| Asset protection (generally not available using DSUE) | Appreciation exempt from surviving spouse's estate (but no step-up) |
| GST protection | Statute of Limitations is not extended on first spouse's 706 |

## The "Split – Interest" Trust

- GRITs, GRATs, GRUTs, and QPRTs
  - The "acronyms" of estate planning!
  - Purposes
    - Continued control of income by the Trustor
    - Discount in the value of the gifted asset in an "objective" manner
    - Potential growth of the asset outside of the living estate of the Trustor / Transferor

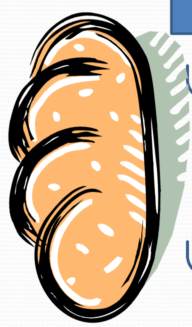


## Terms

- **GRIT** – **G**rantor **R**etained **I**ncome **T**rust
- **GRAT** – **G**rantor **R**etained **A**nnuity **T**rust
- **GRUT** – **G**rantor **R**etained **U**ni**t**rust
- **QPRT** – **Q**ualified **P**ersonal **R**esidence **T**rust

## Visualization of the Trust

$1,000,000



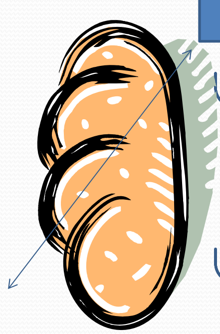
Income to Trustor for a set period of time (**example: 10 years**)

Remainder to Trustor's child at expiration of time



## Visualization of the Trust (cont.)

$1,000,000



Income to Trustor for a set period of time (**example: 10 years**)

Remainder to Trustor's child at expiration of time

## Present Value Analysis

- Four Variables
  - **PV** (Present Value)
  - **FV** (Future Value)
  - **i** (Interest Rate per Period)
  - **N** (Number of Periods)

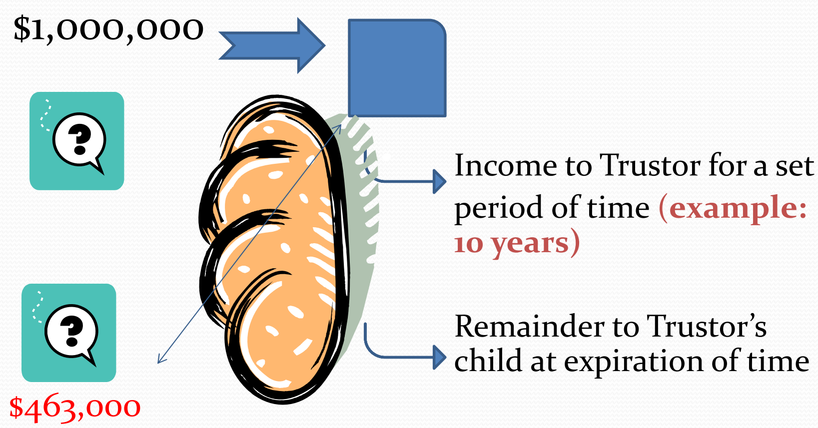


## Our Example

- Assume:
  - **FV** = \$1,000,000
  - **i** = 8% (assume IRS long-term rate)
  - **N** = 10 years
  - **PV** is our variable to be calculated

**PV ≈ \$463,000**

# Visualization of the Trust (cont.)






# Problems with Technique

- IRC §2036
  - Trust must terminate before the death of the Trustor, otherwise, the trust assets are valued as a part of the estate of the Trustor using the date of death value of the assets

## Congressional Actions

- Creation of IRC §2702
  - Eliminates GRITs
    - Exception #1 – The GRIT was established before September 20, 1989
    - Exception # 2 – The Beneficiary of the GRIT is not lineally related to you
    - Exception #3 – The asset in the GRIT is the Trustor's primary home or vacation home (A QPRT)
    - Exception #4 – The Trust is a GRAT or a GRUT



## The "Charitable" Trusts

- CRATs, CRUTs, CLATs, and CLUTs
  - The "acronyms" of charitable planning!
  - Purposes
    - Continued control of income by the Trustor
    - Potential immediate charitable deduction by the Trustor while he or she is alive
    - Potential elimination of capital gains
    - Potential elimination of estate taxes

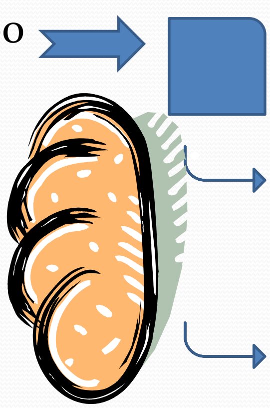
# Terms

- **CRAT** – **C**haritable **R**emainder **A**nnuity **T**rust
- **CRUT** – **C**haritable **R**emainder **U**ni**t**rust
- **CLAT** – **C**haritable **L**ead **A**nnuity **T**rust
- **CLUT** – **C**haritable **L**ead **U**ni**t**rust



# Visualization of the Trust

$1,000,000

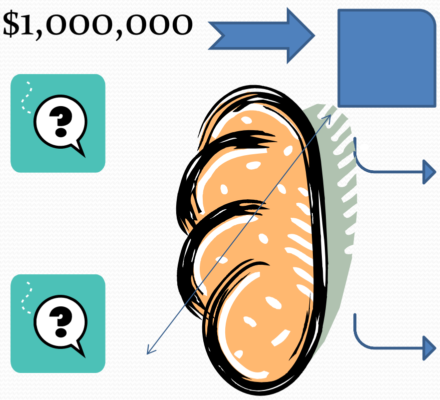


Income to Trustor for a set period of time **(example: life of Trustor)**

Remainder to Charity (named by the Trustor)

# Visualization of the Trust (cont.)

$1,000,000



Income to Trustor for a set period of time **(example: life of Trustor)**

Remainder to charity (named by the Trustor)



# Present Value Analysis

- Four Variables
  - **PV** (Present Value)
  - **FV** (Future Value)
  - **i** (Interest Rate per Period)
  - **N** (Number of Periods)

## Our Example

- Assume:
  - **FV** = $1,000,000
  - **i** = 8%
  - **N** = 10 years
  - **PV** is our variable to be calculated

**PV ≈ $463,000**

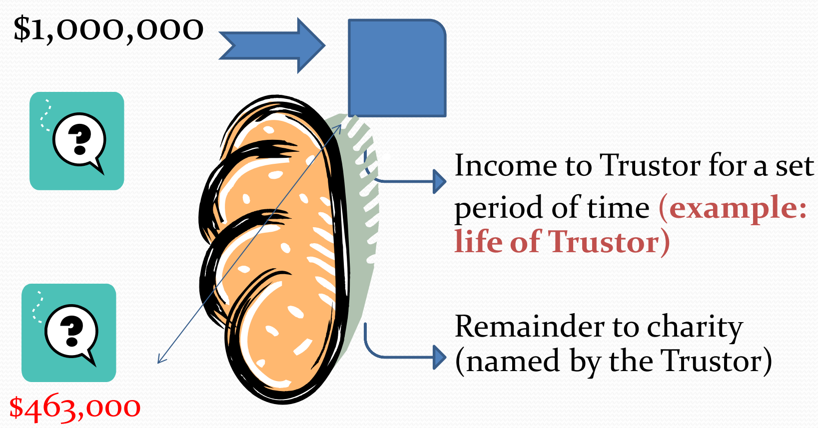


## Our Example

- Assume:
  - **FV** = $1,000,000
  - **i** = 8% (either a guaranteed annuity or a unitrust factor)
  - **N** = 10 years (from the IRS actuarial table)
  - **PV** is our variable to be calculated

**PV ≈ $463,000**

## Visualization of the Trust (cont.)






## Charitable Lead Trust

- Opposite of Charitable Remainder Trust
- Used to provide benefits to a charity first, then provide a remainder benefit to heirs
- Will discount the value of assets passing to heirs

## SECURE ACT 2.0 CHANGES
## IRA Qualified Charitable Distribution (QCD) to a "Split-Interest Entity"

- The secure 2.0 Act expands the IRA charitable distribution provision to allow for a one-time, $50,000 distribution to a "Split-Interest Entity".
- The term "Split-Interest Entity" means:
  - A Charitable Remainder Annuity Trust (Sec 664(d)(1));
  - A Charitable Remainder Unitrust (Sec 664(d)(2)); or
  - A Charitable Gift Annuity (Sec 501(m)(5)).
- Both the $100K and $50K amounts will be inflation adjusted after 2023 to the nearest $1,000.

**Effective Date: January 1, 2023**



# Irrevocable Life Insurance Trust

- Purposes of the ILIT
  - To keep the death benefit out of the Trustor's estate
  - To control the gifting of the premium payments during the Trustor's lifetime
  - To control the payout of the death benefit at the time of the Trustor's death

## IRC §2042

- This section of the Internal Revenue Code determines when the death benefit of a life insurance policy is added to the estate of the deceased insured
- It requires an understanding of the working of a life insurance policy



## Life Insurance Policy "Players"

- All life insurance policies have the following "players":
  - **Owner**
  - **Insured**
  - **Beneficiary**

## When §2042 is in Effect

- Four Instances
  - When the Owner and the Insured are the same
  - When the estate of the Insured is the beneficiary
  - When the death benefit is required to pay an obligation of the estate
  - When the insured can exercise an "incidence of ownership" in the policy



## The "Supertrust"

- The ILIT is sometimes referred to as a "Supertrust" because it accomplishes multiple goals
  - The ILIT keeps the death benefit out of the Trustor's estate
  - At the same time, the ILIT can control the beneficiary's access to the trust corpus

## "Crummey" Powers

- In order to insure that gifts of life insurance premiums to the ILIT conform to Federal Gift Tax "Present Interest" rules, language in the ILIT must conform to the 1967 Tax Court case *"Crummey v. Commissioner of Internal Revenue"*
  - Letter to beneficiaries must be sent
  - 30 day waiting period must be met



## Contact Information

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