IX. PLANNING WITH THE APPLICABLE EXCLUSION AMOUNT

A. Introduction

When clients seek estate planning advice from practitioners, often one of the client's main goals is to transfer property to the next generation while incurring no, or the least amount of, tax. The purpose of the federal transfer tax system, which includes estate taxes, gift taxes and generation-skipping transfer taxes, is to tax property when an interest in such property is transferred to another person. Congress has created some exceptions to the transfer tax system. One of these exceptions is utilization of the applicable exclusion amount (also referred to as the unified credit or the estate or gift tax exemption). In order to achieve the goals of clients, practitioners should have a basic understanding of the rules regarding the applicable exclusion amount.

This Chapter discusses the following issues relating to the applicable exclusion amount and will assist the practitioner in meeting his or her client's goals of minimizing or eliminating federal estate and gift taxes:

- History of the Unified Tax System.
- Unified Credit Against Estate Tax.
- Unified Credit Against Gift Tax.
- The Applicable Exclusion and the Marital Deduction.
- The Family Trust.
- Planning Options to Avoid the Negative Effects of State Decoupling
- Selection of Trustees.

B. History of the Unified Tax System

Before 1977, separate rate schedules and exemption amounts were in effect for the federal estate and gift taxes. The estate tax rate ranged from 3% to 77%, and a specific exemption of $60,000 was allowed. The gift tax rate ranged from 2¼% to 57¾%, and a specific exemption of $30,000 and an annual exclusion of $3,000 were allowed.

In 1976, Congress replaced the separate rate schedules and exemptions with a unified estate and gift tax system. With the 1976 Act, Congress sought to eliminate the disparity between transfers during lifetime and at death, and to eliminate the preference for lifetime transfers which was created by the tax laws before 1976. See, generally, HR Rep. No. 1380, 94th Cong., 2nd Sess. 10-17 (1976), Estate and Gift Tax Reform Act of 1976.

The specific exemption was also changed to a unified credit. The specific exemption created a deduction that reduced the tax at the highest tax rate which benefited the wealthy taxpayer who paid tax at the higher rates. The unified credit is a dollar-for-dollar reduction in the tax due which provides more tax savings for small to medium size estates.

C. Unified Credit Against Estate Tax

1. Definitions

The use of the estate tax applicable exclusion amount may reduce or even eliminate estate taxes. Internal Revenue Code ("IRC") § 2010 grants each estate of a decedent a credit equal to the applicable credit amount against the estate tax.

a. **Applicable Credit Amount**: The applicable credit amount is defined as the amount of tentative tax determined under the estate tax rate computed on the applicable exclusion amount. IRC § 2010(c).

b. **Applicable Exclusion Amount**: The applicable exclusion amount for a given year is stated in IRC § 2010(c). For 2010, the applicable exclusion amount doesn't exist because the estate tax is inapplicable during 2010. Starting in 2011, the applicable exclusion amount will equal $1,000,000.

c. **Tentative Tax**: In order to determine the applicable credit amount, the tentative tax is determined by applying the estate tax rate schedule in IRC § 2001(c) to the applicable exclusion amount. IRC § 2010(c).

> **EXAMPLE:** In 2011, the applicable exclusion amount will be $1,000,000. Using the tax rates under IRC § 2001, an estate of $1,000,000 would create a tentative tax in the amount of $345,800. Therefore, the applicable credit amount for 2011 is $345,800.

2. Use of Applicable Exclusion at Death

In 2011, each U.S. citizen will have an estate tax applicable exclusion in the amount of $1,000,000, which allows a person to transfer such amount at death to anyone without incurring federal estate tax, provided the decedent has not made any lifetime taxable gifts that may be included in calculating the decedent's gross estate. If a person utilized his or her gift tax applicable credit during lifetime, the amount of post-1976 adjustable taxable gifts is added to the decedent's taxable estate when determining the amount of the decedent's gross estate. The tentative tax is then determined on the total amount of the adjustable taxable gifts and taxable estate. If any gift tax was paid during life, the gift tax paid reduces the amount of tentative tax.

The applicable credit amount is then deducted from the tentative tax to determine the net federal estate tax due.

> **EXAMPLE:** Decedent made post-1976 gifts in the amount of $500,000. At Decedent's death in 2011, her taxable estate was $2,000,000. The net federal estate tax is determined as follows:

Taxable Estate	$2,000,000
Adjustable Taxable Gifts	$500,000
Total	$2,500,000
Tentative Tax	$1,025,800

Gift Tax Paid	$0
Total Federal Estate Tax	$1,025,800
Available Applicable Credit	($345,800)
Net Federal Estate Tax	$680,000

➔ **Planning Point:** If gifts were made between September 8, 1976 and January 1, 1977, the applicable credit will be reduced by a portion of the specific exemption that was allowed.

If the value of an estate is less than the applicable exclusion amount, a refund is not available, and the credit is nontransferable. An executor is required to file an estate tax return only if the decedent's gross estate exceeds the applicable exclusion amount. IRC § 6018. If prior taxable gifts were made by the decedent, the applicable exclusion amount is reduced by the amount of the prior gifts to determine whether an estate tax return is necessary.

EXAMPLE: Decedent dies in 2011 with a gross estate of $900,000, and Decedent made taxable gifts in the amount of $500,000 during Decedent's life. Based on the value of the gross estate only, an estate tax return is not required. However, the taxable gifts reduce the amount of the applicable exclusion in determining whether a return is required. Therefore, the applicable exclusion amount is $500,000 and the gross estate exceeds the applicable exclusion, thereby requiring the filing of an estate tax return.

➔ **Planning Point:** Even if a return is not required to be filed, some practitioners file a return in order to start the statute of limitations period on assessments. However, the time and cost associated with filing an estate tax return probably is too burdensome in an estate where valuation issues are not present.

D. Unified Credit Against Gift Tax

1. The Applicable Exclusion and the Determination of Gift Tax

IRC § 2505 is similar to language in IRC § 2010 regarding the estate tax applicable exclusion. Each person is allowed a credit equal to the applicable credit under the estate tax scheme determined as if the applicable exclusion amount was $1,000,000. As the gift tax applicable exclusion will remain constant at $1,000,000, the gift tax applicable credit is $345,800.

EXAMPLE: In 2010, Donor transferred publicly traded stock to Donee. Such stock was valued at $513,000 on the date of transfer. Donor had made no previous gifts and did not make any additional gifts in 2010. Donor filed a gift tax return for the 2010 tax year reporting the $513,000 gift. Because the gift was of a present interest, $13,000 of the gift qualified for the gift tax annual exclusion. Therefore,

> Donor made a taxable gift of $500,000. The tentative tax on such amount is $155,800. Because Donor's available applicable credit is $345,800, no gift tax is due and donor utilized $155,800 of Donor's applicable credit amount (or $500,000 of Donor's applicable exclusion amount).

In general, when determining the gift tax for a given year, that year's current taxable gifts are added to the taxable gifts from previous years, and the tentative gift tax is determined on the aggregated sum utilizing the applicable tax rate from IRC § 2001(c). The tentative gift tax is then reduced by the applicable credit.

> **EXAMPLE:** In 2010, Donor made a taxable gift of $1,500,000 to Son. Donor previously made a $500,000 post-1976 gift that utilized $155,800 of Donor's gift tax applicable credit. The gift tax for 2010 is determined as follows:

Taxable Gift	$1,500,000
Previous Taxable Gifts	$ 500,000
Total Taxable Gifts	$2,000,000
Tentative Tax on Total Taxable Gifts	$780,800
Tentative Tax on Previous Taxable Gifts	$155,800
Gross Gift Tax on 2010 Gift	$625,000
Applicable Credit	$345,800
Applicable Credit used on Prior Gifts	$155,800
Available Applicable Credit	$190,000
Net Gift Tax on 2010 Gift	$435,000

2. Benefits of Lifetime Use of the Applicable Exclusion Amount

The use of the gift tax applicable exclusion amount has several advantages over not making gifts and utilizing only the estate tax applicable exclusion amount.

- Any future appreciation of, or income from, the gifted property is removed from the donor's estate for federal estate tax purposes.
- Any gift tax actually paid by the donor is removed from the donor's estate if the donor survives at least three years after the gift.
- The tax used to pay the gift tax is not itself subject to tax ("tax exclusive"), whereas the tax used to pay the estate tax is subject to tax ("tax inclusive").

E. The Applicable Exclusion and the Marital Deduction

If married clients only use their gift tax and estate tax marital deduction, the clients will have eliminated federal estate tax at the first death, but will have effectively "wasted" the applicable exclusion amount of the first spouse to die. Depending on the size of the surviving

spouse's estate at death, the surviving spouse's estate may incur up to $345,800 in additional federal estate taxes (based on 2011 applicable credits and rates) caused by the lack of use of the first spouse's applicable exclusion. Most practitioners will recommend to married clients that they fully utilize both the marital deduction *and* applicable exclusion amount to eliminate or minimize the federal and state estate taxes at the death of both spouses.

In general, formula clauses, provide for the marital trust to be funded so that no federal and state estate taxes, or the minimum amount of such taxes, would result. This type of planning is referred to as an "optimal marital deduction plan." Depending on the type of formula selected, the plan would create a marital trust share and a family trust share. In general terms, the family trust would hold assets with a value equal to the available applicable exclusion amount, and the amount in excess of the applicable exclusion amount would be held in the marital trust share. The marital trust share must be distributed outright to the spouse or held in a trust that qualifies for the marital deduction. The family trust share can be held in several different ways, as will be discussed in the following section.

> **EXAMPLE:** Decedent and Spouse have a total estate worth approximately $5,000,000. During Decedent's lifetime, they used the gift tax marital deduction to equalize their estates. Neither spouse made any other lifetime taxable gifts. Decedent dies in 2011. At Decedent's death, Decedent and Spouse each owned property in their individual names in the amount of $2,500,000. Decedent did not use any of her gift tax applicable exclusion amount during her lifetime. Decedent's estate plan provided for the "optimal marital deduction." Therefore, under Decedent's plan, the Family Trust receives $1,000,000 and the Marital Trust $1,500,000. The applicable exclusion amount exempts the Family Trust from estate tax, and, because Decedent's executor elects QTIP treatment for the Marital Trust, the value of the Marital Trust qualifies for the marital deduction. Therefore, at the death of the first spouse, no tax is due as a result of using both the marital deduction and the applicable exclusion amount.

> **EXAMPLE:** Spouse dies the following year, 2012, with an estate of $2,500,000. Because a QTIP election was made for the Marital Trust, the value of the Marital Trust at Spouse's date of death is also included in Spouse's gross estate. Therefore, Spouse has a gross estate of $4,000,000. Applying the credits and rates in effect for 2012, a gross estate of $4,000,000 will generate federal estate tax of $1,495,000. If Decedent had used only the marital deduction at her death and not her applicable credit amount, Spouse's estate would have been $5,000,000 at his death creating federal estate tax in the amount of $2,045,000 – an increase of $550,000.

Properly drafted marital deduction and applicable exclusion formulae must take into account property passing outside the will or trust agreement to the surviving spouse or others so that neither the marital trust nor the family trust will be funded with more assets than intended in order to minimize or eliminate federal and state estate taxes.

F. The Family Trust

As discussed above, the family trust is usually satisfied with an amount equaling the available estate tax applicable exclusion amount. There are unlimited ways which the family trust can be administered, and several of them will be discussed below.

1. During Spouse's Life

a. <u>Mandatory Income to Spouse</u>. The trust assets may be held in one trust during the lifetime of the surviving spouse. The trustee may be required to distribute the income to or for the benefit of the surviving spouse during the surviving spouse's life. The trustee may also have discretion to distribute the principal to or for the benefit of the surviving spouse alone or to or for the benefit of the spouse and others, such as decedent's descendants (and possibly descendants' spouses). The trustee's discretion may be limited to ascertainable standards such as health, education, maintenance and support or may be as broad as best interests. If distributions are permitted to be made to anyone other than the spouse, the drafter should consider whether the trustee should be required to give preference to the needs of the spouse. Also the trust may provide for equal or unequal distributions to the beneficiaries.

➔ **<u>Planning Point</u>:** Many clients prefer this type of arrangement to assure that the surviving spouse has a guaranteed income stream for the remainder of the surviving spouse's life. The age of decedent's children will also impact the distribution provisions of the trust.

➔ **<u>Planning Point</u>:** The scope of the trustee's discretion also will impact the selection of trustee – whether the spouse may serve alone or with a co-trustee. The following section discusses the selection of trustees in more detail.

b. <u>Discretionary Payments of Income and Principal</u>. In the alternative, the trust may provide for discretionary distributions of both income and principal to the spouse alone or to the spouse and decedent's descendants. The trustee's discretion may be limited to ascertainable standards or be as broad as best interests. As in the above arrangement, this trust share may be established for the primary benefit of the spouse.

c. <u>Other Provisions for the Spouse</u>. The trust may provide the surviving spouse with other rights such as the following:

- A right to withdraw principal not to exceed the greater of $5,000 or 5% of the trust principal each year. Note that the annual withdrawal right should be limited to the "5 or 5" standard to avoid estate tax and gift tax problems for the spouse under IRC §§ 2041(b)(2) and 2514(e).

➔ **<u>Planning Point</u>:** A properly limited "5 or 5" withdrawal right will result in inclusion in the surviving spouse's gross estate of the amount of property subject to this right at the time of the surviving spouse's death, even if the right is never exercised by the surviving spouse.

- A lifetime or testamentary limited power of appointment in which property may be appointed to one or more persons *other than* the surviving spouse, surviving spouse's estate or creditors of the surviving spouse or the surviving spouse's estate. In the alternative, the decedent may grant the surviving spouse the power to appoint such property to a certain class of beneficiaries such as the descendants of the decedent. Caution should be exercised to avoid giving the spouse a general testamentary power of appointment, as this will result in the trust assets which are subject to such power being includible in the surviving spouse's gross estate.

2. At the Surviving Spouse's Death

a. <u>Outright Distribution to Descendants</u>. At the death of the surviving spouse, the remaining trust assets may be distributed outright to individuals designated by the decedent, such as to the descendants of the decedent, *per stirpes*. If such descendants are minors, the assets should be held in trust at least until the beneficiaries attain the age of majority to avoid the establishment of a guardianship and/or conservatorship.

b. <u>Assets Held in Trust</u>. If the assets are not distributed outright, the assets remaining in the trust may be held in a single trust for the benefit of individuals designated by the decedent, such as decedent's descendants. This type of trust is commonly referred to as a "pot" trust as the assets are held in a single "pot" instead of being distributed into separate shares for each of the beneficiaries. The assets are held in trust until a certain event as determined by the decedent. For example, many clients hold the assets in the "pot" trust until their youngest child reaches a certain age, such as 23, when most children will have completed college. Upon the occurrence of the determined event, the "pot" trust may be divided into separate shares for each of decedent's then living descendants, *per stirpes*, and continue to be held in separate trusts, or may be distributed outright to designated beneficiaries.

Instead of a "pot" trust, the client may decide to immediately divide the remaining trust assets into separate shares at the spouse's death. There are a number of possibilities regarding the administrative provisions of the separate trust shares, and a few of them are outlined below:

- The trustee may have discretion to distribute income to or for the benefit of the beneficiary, and such discretion may be limited by ascertainable standards or be broadened to include best interests.
- A mandatory distribution of income may be required when the beneficiary reaches a certain age, such as age 21.
- Principal distributions may also be discretionary until a certain event when mandatory distributions are required. Examples of events include: the beneficiary reaching a certain age; the beneficiary completing his or her education; or the passage of a specified number of years after the death of the decedent and the decedent's spouse.

➔ **<u>Planning Point</u>:** Many clients choose to stagger the mandatory

distribution of principal.

> **<u>EXAMPLE</u>:** An example of a provision allowing for staggered distributions is as follows:
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> "When such individual reaches age 25, or if such individual has already reached such age but not age 30 when the trust for such individual is established, the trustee shall distribute one-third of the remaining trust property to such individual. When such individual reaches age 30, the trustee shall distribute one-half, or if such individual has already reached such age when the trust for such individual is established, two-thirds, of the remaining trust property to such individual. When such individual reaches age 35, or if such individual has already reached such age when the trust for such individual is established, the trustee shall distribute all remaining trust property to such individual."

- The trustee may be specifically required to consider other assets available to the beneficiary before making any discretionary distribution of income or principal, or may be specifically permitted to ignore such other resources.
- Special discretionary distributions of principal may be permitted for certain purposes such as the following:
  - To enable the beneficiary to make gifts to or in trust for any one or more of the descendants of such beneficiary.
  - To pay tuition directly to an educational organization for the education or training of any one or more of the descendants of such beneficiary.
  - To make payments directly to a provider of medical care for the medical care of any one or more of the descendants of such beneficiary.
  - To purchase real property, including buildings, permanent improvements and fixtures located within such real property, to be used as such beneficiary's primary residence.
  - To establish an office for the practice of a profession or trade by such beneficiary which, in the judgment of the trustee, has a reasonable likelihood of success.
  - To invest in a business in which such individual intends to participate actively and which, in the judgment of the trustee, has a reasonable likelihood of success.
- Certain beneficiaries may be granted a right to withdraw principal not to exceed the greater of $5,000 or 5% of the trust principal each year. <u>See</u> the discussion in Section H.2.a.(2) ("5 or 5 Power") below regarding limitation of withdrawal rights.
- A lifetime or testamentary power of appointment, which may be limited or general, may be granted to certain beneficiaries. Note that the granting of a general power of appointment will result in assets subject to such power being includible in the gross estate of the powerholder.

- Rather than mandatory distribution of principal, the trust may allow the beneficiary the right to withdraw trust property at designated ages. This may avoid the need for a beneficiary who is satisfied with the management of the trust assets by the trustee to create his or her own revocable trust to manage the assets.

There are countless ways in which to distribute the trust assets to the intended beneficiaries. Practitioners should gain an understanding of the family dynamics in order to facilitate a discussion with the clients regarding the various possibilities.

G.

H. Selection of Trustees

Trustees are required to administer trusts actively for years or even decades. In addition, they must be able to handle the increasingly complex tax laws and a volatile investment climate. Thus, in selecting a trustee, the client, with the guidance of his or her advisors, must carefully consider who is the proper individual or entity to serve as trustee. The selection of an appropriate trustee is of prime importance to insure that the grantor's[1] wishes are fulfilled and the trust's beneficiaries receive all of the benefits to which they are entitled.

As discussed below, many factors must be considered when selecting a trustee, and most clients find this process difficult. It is the role of the client's advisors to assist the client by laying out the duties of a trustee and providing guidance to enable the client to evaluate the attributes of each individual or entity the client is considering as a trustee.

1. Non-Tax Considerations

A balance of the factors discussed below and the facts and circumstances of each family situation will play a significant role in the final determination of a trustee. It is advisable for practitioners to consult with their clients every few years, for among many reasons, to review the selections of their trustees (and other fiduciaries) to assure that the individuals or entities selected remain the right choice after factoring in any changes in circumstances.

a. **Most Common and Important Duties of the Trustee**. The grantor and any person being considered as a trustee must understand the amount of time and skill required to serve as a trustee. Some clients appoint a trustee because they feel it is an "honorary" position. However, as anyone who has served as a trustee knows, the position can absorb a large amount of time and requires a great deal of expertise.

(1) **Investments**. A trustee has a duty to make trust property productive. The trustee must prudently invest trust property to assure both sufficient current income for the current income beneficiaries and appropriate capital appreciation for the remainder beneficiaries. The grantor may instruct the trustee in the trust instrument[2] that, in making investment decisions, the trustee should emphasize either current income or long-term appreciation. If the principal is invested so that the principal does not appreciate, the impact of inflation could significantly erode the value of the remainder interest. If the trust's governing instrument or applicable state law is up-to-date, the trustee may be permitted, or even encouraged, to implement a style of investing

promoting total return.

(2) **Exercise Appropriate Discretion While Making Distributions**. One of the trustee's most important duties is to make distributions to beneficiaries in accordance with the grantor's wishes as expressed in the trust instrument. This will often require the prudent exercise of discretion to sprinkle income and, possibly, principal to one or more beneficiaries, in accordance with the trust instrument. The trustee must be loyal and fair to all beneficiaries, both current and remainder. For the trustee to know how the grantor of the trust wants the trustee to exercise his or her discretion, or to ascertain the standard of living the grantor and beneficiaries are maintaining, it may be useful for the grantor and the trustee to discuss this subject (and for the results of the discussion to be reduced to writing for future reference) while the grantor is living and available to participate in such discussion. Although not legally binding, having had such a discussion can prove invaluable in assisting the trustee when the time comes for the trustee to exercise dispositive discretion. In addition, the trustee may have to take into account (but not necessarily be controlled by) the federal income tax situation of each beneficiary to assure that the overall income tax liabilities for the trust and the various beneficiaries will be minimized to the extent consistent with the grantor's objectives.

(3) **Maintenance of Property**. The trustee must secure possession of trust assets, conduct careful recordkeeping and maintenance of trust property, refrain from commingling property and perform other appropriate custodial and bookkeeping functions.

(4) **Other Duties**. The following are some other common and important duties of the trustee:

- Manage assets that are not typical investment assets (*e.g.*, farming operations or oil and gas investments).
- Be aware of and exercise, when necessary, other powers granted in trust instrument.
- Prepare (or arrange for the preparation of) and file tax returns and pay any taxes due.
- Defend the trust against attack.
- Terminate the trust and wind up its affairs.
- Seek and act upon professional advice when necessary.

b. **Characteristics of the Trust That Should be Considered When Selecting a Trustee.** A trustee's duties must be considered in light of the characteristics of the particular trust at issue. These characteristics include:

- The purposes of the trust.
- The prospective size of the trust. For a small trust, the appointment of a corporate trustee may be uneconomical.
- The types of assets the trust will hold.
- The probable duration of the trust.
- The relationships between the trustee and beneficiaries and among the beneficiaries as well as the individual personalities of the beneficiaries and

of the trustee.

- Geographical differences in location of the assets, location of the trustee and location of the beneficiaries and whether or not the trust can be properly administered if any one of these is not in geographic proximity to the other two.
- The need for guardians for minor children to be able to have a co- operative working relationship with the trustees.
- Compensation of the trustee.

No single factor is determinative of who is best to serve as trustee; the client must balance the advantages and disadvantages of the various possible candidates.

c. **Individual Trustee vs. Corporate Trustee**. A large portion of the time spent selecting a trustee will be concerned with deciding whether the trustee should be an individual or an entity (or whether there should be two or more individuals or whether there should be one or more individuals along with an entity). The advantages and disadvantages of individual and corporate trustees are provided below to assist the practitioner in advising clients when facing this difficult decision.

(1) Advantages of an Individual Trustee

- An individual trustee who is a family member or friend of the family may have a better understanding of the family dynamics and be more familiar with the family members.
- If a family business is to be held and managed in the trust, an individual trustee may be more knowledgeable regarding such business operations.
- The costs associated with an individual trustee are sometimes less than those associated with a corporate trustee.
- The trust assets remain in "control" of a family member.

(2) Disadvantages of an Individual Trustee

- Typically, an individual trustee lacks sophisticated financial knowledge and detailed knowledge about trust administration. Even though usually authorized to retain agents and investment counsel to assist him or her in these matters, an individual acting as sole trustee might find that the burdens of investment and administration are too complex and stressful.
- The time commitment necessary to be a responsible trustee may be greater than a given individual has available; most individuals have another "full-time" job, but, with a corporate trustee, trust administration is its "full-time" job.
- An individual trustee may be unduly influenced by the trust beneficiaries.

- An individual may have a real or perceived conflict of interest between his or her duties as trustee and his or her personal interest as a beneficiary or otherwise. For example, if a grantor names his son from his first marriage as trustee of a trust for his second wife, the son and the second wife may end up in conflict. The wife may request distributions for travel and luxuries, and the son may resist because he secretly hopes to preserve the trust assets until the wife's death, when they will be distributable to him. Conflicts of interest can also arise if the trustee, personally, has an interest in any asset in which the trust also will have an interest, such as stock in a closely held business.
- An individual may die, become disabled or become unsuitable to act while serving as trustee or may resign as trustee at any time.

(3) <u>Advantages of a Corporate Trustee</u>

- Where the trust is likely to be of substantial size or hold complex assets - such as closely held business interests or real estate - administration of the trust may require special competence and expertise beyond the ability of any individual, whether a relative, friend or business colleague. A corporate trustee provides professional handling of investment, tax, accounting and other aspects of trust administration, as opposed to individual trustees, who may not have the time or expertise to perform an adequate job. Although an individual named as trustee might be willing to serve without compensation, the resulting savings is often offset by the need to retain and compensate attorneys, accountants, investment advisors and other agents.
- A corporate trustee is intuitively knowledgeable concerning the laws and regulations that impose and relate to the duties of a trustee. Moreover, because they are considered experts in trust administration, corporate trustees are generally held to a higher standard of care than individual trustees.
- A corporate trustee is also appropriate in situations in which a trustee situated in a particular state is needed so that the trust and its beneficiaries can benefit from flexible trust laws, low or no state income tax, a high degree of protection from creditors and/or lack of a rule against perpetuities.
- A corporate trustee's business is audited internally and by state and federal authorities.
- A corporate trustee, unlike an individual trustee, does not die or become legally incompetent.
- Appointing a corporate trustee usually eliminates most adverse tax consequences associated with a spouse or a child serving as trustee because a corporate trustee is independent and is never a beneficiary

of the trust.

- A corporate trustee is a neutral party. The corporate trustee's neutrality helps minimize or eliminate potential conflicts among beneficiaries, especially those who are family members. Should family disharmony appear, the corporate trustee can serve as a liaison between the quarreling family members. Moreover, the corporate trustee is unlikely to show favoritism to one or more beneficiaries while making decisions regarding distributions or investments.

(4) <u>Disadvantages of a Corporate Trustee</u>

- A corporate trustee is sometimes viewed as an insensitive, distant entity that is too rigid and inflexible. Some have the perception that a beneficiary will have to "beg for money" if a corporate trustee is involved. Beneficiaries of smaller trusts sometimes believe that corporate trustees pay less attention to them so they can favor their larger clients.
- The fees charged by corporate trustees can be higher than compensation to be paid to an individual trustee. Furthermore, the fees charged by a corporate trustee for administering a trust may increase at a rate that is irreconcilable with the increase (if any) in value of the trust portfolio. While a corporate trustee can usually do a better job of handling administrative details, investment decisions and accounting matters than an individual trustee, an individual trustee may usually retain accountants, investment advisors, attorneys and others who can provide the trust with essentially the same services that are available from a corporate trustee.
- A corporate trustee usually charges additional fees for managing a closely-held business. A corporate trustee's management of a family business may be less effective than management of that business by a knowledgeable family member.
- A corporate trustee may be quite unfamiliar with a given family's dynamics.
- Clients may perceive a loss of control when designating a corporate trustee as opposed to an individual trustee.
- A corporate trustee is more likely than an individual trustee to reject the administration of a trust if there are provisions in the trust instrument that it finds unacceptable. These provisions may

  deal with the amount of the discretion given to the trustee to make distributions, the extent of liability to which a trustee may be subject for the actions of a predecessor trustee, for a loss of value or for otherwise mishandling trust property or restrictions on the types of actions for which the corporate trustee can charge a fee. Rather than rejecting the administration altogether, the corporate trustee may

demand that the trust instrument be amended to remove the provisions that are unacceptable, which of course may be to the disadvantage to the beneficiaries.

- To serve as trustee, the corporate trustee may need to be a resident or otherwise be qualified to do business within a given state or be able to act in other states where trust assets would be located. Unless adequate provisions are made in the trust instrument for removal and replacement of trustees, there may be an element of inflexibility in the selection of the trustee. The corporate trustee may become unable to act with respect to assets in another state, or one or more beneficiaries may take up residence in another state. Furthermore, a corporate trustee in one state may have to pay state and fiduciary income taxes that would not have to be paid if the trust were administered in another state.

d. Additional Aspects of Choosing a Corporate Trustee. If the grantor chooses a corporate trustee, there are additional considerations beyond a corporate trustee's advantages over an individual trustee. The grantor can take steps to ensure that the disadvantages of a corporate trustee listed above do not turn into pitfalls for the grantor and the beneficiaries.

As mentioned above, the beneficiaries may view a corporate trustee as inflexible and unsympathetic to their financial needs. To avoid having these perceptions turn into a reality, a grantor should do his or her homework by investigating and interviewing several banks to learn about their policies, responsiveness, ability to serve adequately as a "parental substitute," level of professionalism, concern for beneficiaries' needs and fee structure.

Of course, the grantor should also review the corporate trustee's investment performance and investment philosophy. Corporate trustees will typically wish to have authority to invest the assets of all but the largest trusts in their own mutual funds, of which they typically offer a variety designed to serve varying investment objectives. Thus, a corporate trustee typically offers funds designed to maximize income, to generate a balance of income and growth or to produce maximum growth.

The quality of services provided by a corporate trustee varies according to the ability and interest of the personnel assigned to a particular trust. If a client wishes, a trust instrument may express the grantor's desire that a designated trust officer work on, or supervise, the account and provide that the trust should follow the trust officer if he or she later moves to a different corporate trustee. Of course, such a provision introduces a degree of instability and could result in the imposition of higher trustees' fees if the designated trust officer changes employment.

Once a corporate trustee has been selected, the trust instrument may have to be customized to take into consideration the particularities of the corporate trustee selected. Many corporate trustees have specific language they require to be used in estate planning documents before they will agree to serve as trustee. It is advisable to consult with them before their designation, especially if they are to serve immediately or are one of the first successor trustees.

The trust document, of course, can and should provide for the removal of a corporate trustee. As discussed below, because of the usually disadvantageous tax consequences, a beneficiary generally should not be empowered to remove the trustee and appoint himself or herself as successor trustee. *See, e.g.*, Rev. Rul. 95-58, 1995-2 C.B. 191. The beneficiary can sometimes determine that a trust administration problem is not with the corporate trustee as an institution but rather with the account administrator, in which case the beneficiary can request another account administrator.

Often the grantor may name one or more individuals and a corporate trustee as co- trustees. The right to exercise discretion with respect to distributions might be vested with a "special trustee" who is familiar with the family situation and who is appointed solely for this purpose. This special trustee might understand the needs of the various family members better than a corporate trustee. The details of investments, recordkeeping and other administrative matters would normally be handled by the corporate trustee. Alternatively, a family member might be designated as the trustee, with the right to delegate other responsibilities (*e.g.*, investment management and custodial activities) to professionals. In this situation as well, the individual trustee would make the determinations concerning the discretionary distributions of income and principal.

If a special trustee is used, the trust document should give each co-trustee exclusive authority over specific activities of the trust. Doing so may avoid ambiguities in trust administration and adverse tax consequences that would follow if certain powers were shared with the other trustee. See, e.g., IRC § 2041.

However, the use of multiple trustees can present problems. Unless a statute or the trust instrument provides otherwise, each trustee may be liable for any loss arising from actions taken by a majority of the trustees. Usually these problems can be anticipated by appropriate provisions in the trust instrument to the effect that a majority vote of the trustees is to control and that a trustee is not to be liable if he or she specifically dissents from the decision of the majority. Moreover, a trustee may be authorized to delegate the trustee's powers, but, in the absence of specific governing instrument language, the trustee may not be relieved of liability for actions taken by the person to whom delegation was made.

e. Trustee Who is Also a Beneficiary. An individual beneficiary can serve as trustee. However, the grantor should consider possible conflicts of interest that may exist or arise between the person he or she considers naming as trustee and the interests of such person as a beneficiary. For example, where the trustee is the income beneficiary, he or she may be tempted to administer the trust in such a way as to increase the income even at the risk of diminishing the principal. Where the trustee has also a discretionary power to invade the principal if the income is insufficient for his or her support, there is a greater danger that the trustee will unduly favor him or herself. A conflict of interest situation also arises where the surviving spouse is named to act as trustee for him or herself and the children from the grantor's prior marriage are named as the remainder beneficiaries. Worse yet, a child and surviving spouse may be named co-trustees, with the child having the discretion to make distributions to the surviving spouse that would reduce the child's remainder interest. In several states, by statute, a current beneficiary may not usually act as sole trustee if he or she has the discretionary power to distribute trust income or principal to him or herself. *See, e.g.*, N.Y. EPTL 10-10.1; Wis. S.A. 701.19(10).

These conflicts can usually be solved by appointing an additional or substitute trustee. If the grantor did not originally appoint the beneficiary as sole trustee, but because of the disclaimer, death or resignation of a prior trustee or co-trustee the beneficiary becomes the sole trustee, the courts will ordinarily appoint a new co-trustee or will refuse to permit the trustee to exercise discretionary powers without first obtaining the approval of the court. *See, e.g.*, W.Va. Code §§ 44-5-13. However, many courts have decided that, in situations in which the grantor appointed the beneficiary as sole trustee in spite of the fact that he or she was also a beneficiary, the trustee may administer the trust notwithstanding the danger that the trustee may favor him or herself. *See, e.g.*, *Lovett v. Peavy*, 316 S.E.2d 754 (Ga. 1984).

2. Tax Considerations

In examining the tax considerations of selecting a trustee, the main question to consider is what limits, if any, are (or should be) imposed by the trust instrument or state law regarding to whom and for what purposes the trustee may make discretionary distributions? This question will be addressed below with regard to a spouse's serving as a trustee, and a few supplementary remarks will be made regarding a child's serving as a trustee.

a. Definitions. A basic understanding of a few terms is necessary before proceeding to the following discussion.

(1) Powers of Withdrawal. If a trust's grantor has conferred on another person an unrestricted power of withdrawal over trust property, and if such person dies holding such power, the value of the property subject to the power of withdrawal is included in such person's gross estate for federal estate tax purposes. IRC § 2041(a)(2); Treas. Reg. § 20.2041-1(b). Even if the person exercises or releases the power, the value of the property still will be included in such person's gross estate if the person exercised or released the power in a manner that, if the release or exercise were a transfer of property owned by such person, such transfer would be included in his or her estate under IRC §§ 2035 to 2038. Also, for estate tax purposes, a lapse of a power is considered a release of such power. IRC § 2041(b)(2).

Under IRC § 2514(b), the exercise or release of a general power of appointment is a transfer for gift tax purposes. Also, for gift tax purposes, a lapse of a power is considered a release of such power except to the extent the lapse relates to the greater of $5,000 or 5% of the trust property. IRC § 2514(e). Additionally, if a trustee has a beneficial interest in trust property and has an unrestricted power to distribute trust property to another beneficiary, the exercise of such power constitutes the making of a gift. However, if such power is limited by a reasonably fixed or ascertainable standard, the exercise of such power will not be subject to gift tax. Treas. Reg. § 25.2511-1(g)(2).

> **EXAMPLE:** Decedent was the trustee of a trust established by her father, and the trust instrument allowed Decedent to make distributions, not limited by any standard, for the benefit of herself and her brother. During Decedent's life, Decedent distributed $100,000 of principal to her brother. Because Decedent had an unrestricted power to distribute the trust principal to herself and her brother and she distributed

$100,000 of principal to her brother, Decedent is considered to have made a gift of $100,000 to her brother. Further, upon Decedent's death, any remaining assets in the trust will be includible in her gross estate for federal estate tax purposes.

(2) **<u>Ascertainable Standards</u>**. If a trust grantor gives another person an unrestricted power to distribute trust assets, such power is considered a general power of appointment if the person has the power to distribute the assets to or for the benefit of him or herself. IRC § 2041(b)(1). The value of the trust assets will be included in the estate of a person who holds such power. IRC § 2041. If, however, such a power is limited by an "ascertainable standard relating to health, education, support or maintenance," the power is not considered a general power of appointment, and property subject to such power is not included in the estate of the powerholder. IRC § 2041(b)(1)(A).

➔ **<u>Planning Point</u>:** When ascertainable standards are used and general power treatment is sought to be avoided, the use of additional, broader words and phrases like "happiness" or "pleasure" or "absolute control" should not be used as such use may convert an otherwise non-general power of appointment to a general power of appointment.

(3) **<u>Joint Powers</u>**. A power to distribute trust property to oneself not limited by an ascertainable standard is not a general power of appointment if the holder of the power cannot exercise the power except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to an exercise of the power in favor of the holder. IRC § 2041(b)(1)(C)(ii).

<u>EXAMPLE</u>: Mother created a testamentary trust for Son and Daughter, naming Son and Daughter as co-trustees. Son and Daughter were entitled to receive income and principal distributions, without being constrained by any standard, in the sole and absolute discretion of the trustees. Son predeceases Daughter. Son's dispositive power as co-trustee is not a general power of appointment because, to exercise his power, he would have had to be joined by Daughter, who would have had a substantial economic incentive not to allow Son to invade trust property frivolously or recklessly. If Daughter were to die immediately after Son's death, however, she would have a general power of appointment, and the full value of the trust property would be includable in her taxable estate.

(4) **<u>5 or 5 Power</u>**. Another exception regarding the rules of general powers of appointment is that a power of withdrawal limited to the greater of $5,000 or 5% of the value of the trust property ("5 or 5 power") is not a general power of appointment and does not cause inclusion of the entire value of the trust property in the gross estate of the powerholder. IRC § 2041(b)(2). However, a 5 or 5 power will result in inclusion in the powerholder's gross estate of the amount of property subject to the power at the time of the powerholder's death, even if the power is never exercised.

(5) Income Tax Considerations: Grantor Trusts

(a) Definition of "Grantor." The "grantor" is the person who creates a trust. For income tax purposes, however, the grantor may also be a substantial powerholder other than the person who created the trust. IRC § 678. When a person retains or is given substantial control of a trust, that person is considered the grantor for income tax purposes and is taxed on the trust's income, and the trust entity is disregarded for income tax purposes. IRC §§ 674(a); 675; 676; 678. If the grantor retains control of only part of a trust, the grantor is treated as the owner of only the portion of the trust controlled. Income from the other portion is taxed to the trust or its beneficiaries.

(b) Adverse Party; Treatment of Spouse. Even if the grantor retains a power or right listed in subparagraph (e) below, he is not considered the owner of the trust for income tax purposes if an adverse party must consent to the grantor's exercise of control. An adverse party is a person who has a substantial beneficial interest in the trust and who would be adversely affected by the exercise or non-exercise of the grantor's power. IRC § 672(a). Trust beneficiaries generally are adverse parties. A beneficiary who has a right to only a portion of a trust's income or principal is only an adverse party as to that portion. A remainder beneficiary is generally not an adverse party with respect to a power over income. Income beneficiaries are generally adverse to distributions of principal only during the term of their interests. A grantor is also treated as owner of the trust if one of the powers listed in subparagraph (e) below is given to a non-adverse party. A grantor is considered to have retained any power or interest given to his spouse for transfers in trust after March 1, 1986. IRC § 672(e).

(c) Independent Trustee. IRC § 674(a) sets forth a general rule that the grantor shall be treated as the owner of any portion of a trust where the beneficial enjoyment of income or principal is controlled by the grantor or a non-adverse party, or both, without the consent or approval of an adverse party. IRC § 674(c) provides that, if half or more of the trustees are "independent" (and neither the grantor nor his or her spouse is a trustee) within the meaning of IRC § 674, the general rule of IRC § 674(a) does not apply and the grantor will not be taxed on the trust's income. Who is "independent?" IRC § 674(c) defines this term in the negative:

> Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor . . . .

➔ **Planning Point:** If the grantor of an irrevocable trust desires not to limit income and principal distributions by "a reasonably definite…standard which is set forth in the trust instrument" (see IRC § 674(b)(5) and IRC § 674(d)), and assuming grantor trust treatment is not desired, a grantor should choose at least half "independent" trustees within the above definition.

Treas. Reg. §§ 1.674(c)-1 confirms that an independent trustee may hold the power to sprinkle income or principal to any beneficiary without causing grantor trust status.

(d) **Related or Subordinate Party**. A trustee is deemed "related or subordinate" if the trustee is not an adverse party (as defined above) and is the grantor's spouse (if living with the grantor), parent, issue, brother or sister, an employee of the grantor, a corporation or any employee of a corporation in which the stockholdings of the grantor and the trust are significant with respect to voting control, or in which the grantor is an executive. IRC § 672(c).

EXAMPLE: Mother establishes a trust for the benefit of Son and Daughter and appoints her Brother as trustee. No distributions may be made that would discharge Mother's obligation of support. (see IRC § 677(b)). No one has the power to add beneficiaries to the trust (see IRC § 674(b) and (c)). Brother has no beneficial interest in the trust, and has the power to sprinkle income and principal between the beneficiaries. If Brother can exercise this discretionary distribution power without the consent of either beneficiary, Mother will be taxed on all trust income. The sprinkling power is held by a related or subordinate party, and no consent of an adverse party is required. If Brother has the discretionary distribution power but distributions to Son or Daughter must be approved by the other child, Mother will not be taxed on the trust income. The other child is an adverse party because any distributions to Son reduce the amount available to Daughter and vice versa.

What if Mother appoints Bank instead of Brother as the third trustee? In that case, the trust falls within the exception in IRC § 674(c) for powers held by independent trustees, so the trust will not be a grantor trust.

(e) **Grantor Trust Rules**. The grantor trust rules generally apply when the grantor:

- Derives benefits from the income (IRC § 677),
- Retains the power to revoke the trust or withdraw trust property (IRC §§ 676 and 678),
- Retains power to control beneficial enjoyment (IRC § 674),
- Retains power to exercise certain administrative powers over the trust's operation (IRC § 675) or
- Retains a reversionary interest in either principal or income (IRC § 673).

1. **Benefits From Income.** A grantor is treated as owner of a portion of a trust of which income can be distributed to the grantor or the grantor's spouse, held or accumulated for future distribution to the grantor or the grantor's spouse or used to pay premiums on policies insuring the life of the grantor or the grantor's spouse. If trust income is applied to discharge the grantor's or the grantor's spouse's legal obligation of support, income will be taxed to the grantor to that extent. IRC § 677.

2. **Power To Revoke.** A power of revocation gives the grantor the power to end all or part of a trust and take back the trust property. The grantor is treated

as owner of the trust to the extent of that power. IRC § 676.

3. **Control of Beneficial Enjoyment.** A grantor is treated as the owner of a portion of a trust over which the grantor and/or a non-adverse person has the power to control who receives income or principal from a trust without an adverse party's consent. IRC § 674. IRC § 674(b) enumerates eight exceptions for powers that can be held by anyone and not result in grantor trust status. The regulations discuss these eight powers in detail. Treas. Reg. § 1.674(b)-1(b). An example of such a power is a power to distribute principal to trust beneficiaries limited by a reasonably definite standard set forth in the trust instrument that is held by the grantor or another person. IRC § 674(b)(5). A reasonably definite standard is one that is clearly measurable and allows the holder to be held legally accountable. Treas. Reg. § 1.674(b)-1(b)(5).

> **EXAMPLE:** A power to distribute principal for the education, support, maintenance or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute principal for the pleasure, desire or happiness of a beneficiary is not limited by a reasonably definite standard. Treas. Reg. § 1.674(b)-1(b)(5).

4. **Power Over Income.** An additional exception to the general rule of IRC § 674 is IRC § 674(d). IRC § 674(d) provides that a power to distribute, apportion, or accumulate income limited by a reasonably definite standard can be given to any trustee other than the grantor or, if living with the grantor, the grantor's spouse. The power must be exercisable without consent of any other person. Treas. Reg. § 1.674(d)-1.

5. **Power to Remove and Replace Trustee.** If the grantor holds an unrestricted power to remove, substitute or add trustees and to designate any person including the grantor as successor trustee, the trustee's powers are deemed to be exercisable by the grantor for purposes of determining grantor trust status and the trust will not qualify as a non-grantor trust under IRC §§ 674(c) and 674(d). Treas. Reg. § 1.674(d)-2.

6. **Administrative Powers.** Generally, if the grantor or a non-adverse party has the power to deal with trust property for less than adequate consideration, to substitute assets for other assets of equivalent value (acting in a non-fiduciary capacity), to borrow funds without adequate interest or security, or to control certain other trust administrative functions in a non-fiduciary capacity, the grantor is considered the owner of the trust for income tax purposes. IRC § 675.

7. **Reversionary Interest.** For transfers in trust after March 1, 1986, a grantor generally is treated as the owner of that portion of a trust in which he has a reversionary interest, if the value of the reversionary interest at the time of the transfer exceeds 5% of the total property, based on IRS valuation tables. IRC § 673.

(f) Person Other Than Grantor Treated As Owner. A person other than the person who created and funded a trust, including the grantor's spouse, may

be considered the owner of all or part of the trust if he or she: (1) has an exclusive power to vest principal or income in himself/herself; or (2) previously released such a power and retained one of the rights that would cause the trust to be taxed to a grantor. IRC § 678(a). This rule does not apply to a power over income if the grantor is treated as the owner under IRC §§ 673-677. IRC § 678(b); Treas. Reg. § 1.678(b)-1. As an owner of the trust property for income tax purposes, the individual must include the trust income, deductions and credits on his or her personal income tax return instead of the trust's income tax return. IRC § 678 commonly applies in the case of beneficiaries who hold *Crummey* withdrawal rights.

➔ **Planning Point:** IRC § 678 does not contain an explicit exception for a trustee whose powers are limited by an ascertainable standard. The same is true for beneficiaries who hold withdrawal rights. However, many practitioners believe such a trustee or beneficiary should not be taxed on trust income under IRC § 678. See *U.S. v. De Bonchamps* 278 F.2d 127 (9th Cir. 1960); cf. Treas. Reg. 1.678(c)-1(b), (c) (regarding the applicability of IRC § 678 to support trusts). But in PLR 8211057, the IRS applied IRC § 678 to a trustee who held withdrawal rights despite the existence of an ascertainable standard. A solution to this possible income tax problem is to designate a co-trustee to serve with the trustee who is also a beneficiary.

Note that IRC § 678 is the only provision of the Internal Revenue Code under which grantor trust status can apply, by the explicit terms of the statute, after the "real" grantor of the trust has died. Thus, any trust coming into existence under a post-death revocable trust or under a will cannot be a grantor trust for income tax purposes unless under IRC § 678.

b. Considerations When a Spouse is Trustee

(1) Power of Appointment. When a spouse is serving as trustee of a family trust (also known as a credit shelter trust or a non-marital trust), the trust instrument must be drafted carefully to avoid inclusion of the value of the trust assets in the spouse's estate. Otherwise, the purpose of establishing the family trust is defeated. If the spouse is serving as the sole trustee, any power to make discretionary principal distributions should be limited by ascertainable standards (health, education, maintenance and support), and the trustee should be expressly prohibited from using trust funds to satisfy his or her legal obligations, including any support obligations. In the absence of these restrictions, the spouse, as sole trustee would be considered as possessing a general power of appointment, thereby causing the trust assets to be includible in the spouse's estate. IRC § 2041. To avoid inclusion of the family trust property in the spouse's estate if such restrictions are not used, there should be a co-trustee (or a sole trustee who is not the spouse) named who is vested with the sole discretion to make distributions.

The value of trust assets remaining in a general power of appointment marital trust at the spouse's death is includible in the spouse's gross estate, and, therefore, giving a spouse with such a general power unrestricted dispositive rights as trustee does not create any adverse tax consequences. However, with a QTIP marital trust, if the spouse is given any powers that result in the spouse holding a general power of appointment, including a power, unconstrained by an "ascertainable standard," to make discretionary principal distributions as a trustee, the value of the

assets held by the QTIP trust will be includable in the surviving spouse's gross estate under IRC § 2041(a)(2) in addition to IRC § 2044. The inevitability of such inclusion would make effectively impossible a partial QTIP election when the marital trust is created. Therefore, it is important that the governing instrument of a QTIP trust be drafted to avoid the spouse having, or being deemed to have, a general power of appointment.

If a spouse/trustee has a beneficial interest in trust property and has an unrestricted power to distribute this trust property to another beneficiary, the exercise of such power constitutes the making of a taxable gift. However, a taxable gift will not result if such power is limited by a reasonably fixed or ascertainable standard that is set forth in the trust instrument. Treas. Reg. § 25.2511-1(g)(2).

➔ **Planning Point:** If a client wishes to have a corporate trustee serve as the original trustee and designate the spouse as a successor trustee, the practitioner could give the corporate trustee a broad power to make principal distributions and provide that, upon the corporate trustee's resignation, the distribution standard will switch to an ascertainable standard. This should add more discretionary power to the corporate trustee and avoid a completed gift or inclusion of the value of trust property in the spouse's gross estate.

➔ **Planning Point:** Courts have expressed disagreement over whether a transfer of an income interest upon the exercise of a limited power of appointment results in a taxable gift. *Self v. United States*, 142 F.Supp. 939 (Ct. Cl. 1956) (no taxable gift of actuarially determined value of income interest upon exercise of limited power of appointment over principal); *Estate of Regester v. Comm'r*, 83 T.C. 1 (1984) (finding a taxable gift of actuarially determined value of income interest upon exercise of limited power of appointment over principal; expressed disagreement with *Self*).

(2) Income Tax Consequences. With regard to income tax consequences when a grantor's spouse is trustee or a co-trustee of an *inter vivos* irrevocable trust, it is necessary to analyze the trust's administrative and dispositive provisions to determine grantor trust status. Most importantly, under IRC § 672(e), a grantor is generally treated as holding any power held by his or her spouse. Thus, if the spouse holds any power over a portion of a trust under IRC § 674(a) (which is not within the IRC § 674(b) exceptions), IRC § 675, IRC § 676 or IRC § 677, the trust will be a grantor trust with respect to such portion. To avoid the problem (assuming avoidance of grantor trust status is desired), the spouse's discretion over disposition of income should be limited (see IRC § 674(b)(6) and (b)(7)), and the spouse's power over disposition of principal should be restricted by a reasonably definite standard that is set forth in the trust instrument. (see IRC § 674(b)(5)). If grantor trust status is desired, that status should be triggered by including in the trust instrument one or more administrative powers set forth in IRC § 675, or a power to add beneficiaries other than after-born or adopted children, that would apply to any trustee and should not be dependent on the identity of the trustee because who is the trustee can change at any time.

(3) **Irrevocable Life Insurance Trusts**. The governing instrument of a typical irrevocable life insurance trust contains provisions that allow sprinkling of principal and

income to family members during the life of the insured. After the insured's death, the trust may pay out immediately to the family members, or be retained in further trust, possibly even as a dynasty trust. Obviously, the insured should not be the trustee. If the insured has control over the insurance policy through the trust, he or she will have "incidents of ownership," which will cause the policy proceeds to be included in the insured's taxable estate under IRC § 2042. Inclusion of ascertainable standards is of no avail in avoiding inclusion under IRC § 2042. If the trust holds a second-to-die policy, neither insured should be a trustee.

What if the spouse of the insured acts as trustee and the trust holds a single-life policy on the life on the grantor? If the spouse can distribute property to herself, not subject to an ascertainable standard, he or she would be deemed to have a general power of appointment. This would cause all trust income to be taxed to the spouse under IRC § 678 and the trust property to be included in the spouse's taxable estate under IRC § 2041.

What if the distributions were subject to an ascertainable standard? Even assuming the spouse did not contribute any property to the trust, the trust would be a grantor trust as to the grantor since the exception of IRC § 674(d) would not be met because the trustee was the spouse of the grantor. For this purpose, a spouse's deemed gift to an irrevocable insurance trust because of a gift-splitting election does not make her a donor for purposes of IRC §§ 673-677, 2036 or 2038. PLR 200130030.

Of course, income tax consequences regarding an irrevocable insurance trust are not ordinarily a serious concern because most if not all income in such a trust typically occurs inside one or more life insurance policies, and such income ordinarily does not lead to income taxes.

(4) Discharge of Support Obligations. As alluded to above, an insidious problem arises if a beneficiary of the trust is a dependent of the trustee spouse. If the spouse has the ability to discharge the spouse's support obligations to the dependent with trust assets, the spouse is considered to have a general power of appointment over the trust assets, as the spouse can use the trust assets to benefit him or herself by discharging his or her support obligations. Treas. Reg. § 20.2041-1(c)(1). This is true even if the spouse's powers are limited by ascertainable standards. Additionally, if a spouse/trustee actually distributes trust income or principal to discharge a support obligation, the distributions may result in trust income or principal being taxable to the spouse to the extent of such distributions. IRC § 678.

> **EXAMPLE:** Spouse is the trustee of Trust. In year X, Trust has income of $10,000. The Spouse, as trustee, does not distribute the trust income to the income beneficiaries in year X. However, in year X, Spouse does distribute $50,000 of trust principal to discharge Spouse's support obligations to Daughter. $10,000 of the principal distribution may be deemed trust income distributed to Spouse.

The problems associated with discharging the spouse's support obligations can be eliminated by appointing a co-trustee to serve with the spouse and restricting the spouse from participating in the distributions that discharge support obligations.

<u>EXAMPLE</u>: The following is an example of language used to restrict the spouse's powers:

No individual who is a trustee may make, or participate in determining whether, or to what extent, to make, any discretionary distribution or application of income or principal to or for any beneficiary in a manner that would reduce or discharge a legal obligation, including a support obligation, of such individual.

(5) <u>Removal of Trustee</u>. If the spouse is granted the right to remove a trustee and appoint another trustee who is "related or subordinate," (<u>see</u> IRC § 672(c)) the spouse may be considered as having a general power of appointment if the appointed trustee would have the unrestricted right to distribute trust assets. If the spouse's distribution power is not limited to an ascertainable standard and a co-trustee is not appointed, the value of the trust assets may be includible in the spouse's gross estate. If the removal and replacement power is limited to appointing someone who is not related or subordinate, such as a corporate trustee, then the spouse is not considered as having a general power of appointment. Rev. Rul. 95-58, 1995-2 C.B. 191. Also, if the spouse is required to have the consent of an adverse party (<u>see</u> IRC § 672(a)) in order to remove and replace a trustee, the issues regarding the power of appointment are eliminated.

c. <u>Considerations When a Child is Trustee</u>. The tax rules that apply when a child of the property owner serves as trustee or a co-trustee are very similar to those applying when a spouse is serving as trustee or co-trustee. Indeed, in the estate and gift tax context, the rules are virtually identical. There is, however, an important exception worth noting in the context of what will trigger grantor trust treatment for income tax purposes when a child of the property owner serves as trustee or a co-trustee: the spousal unity rule of IRC § 672(e) has no application.