Moore & Associates

Irrevocable Trust

Overview

An irrevocable trust is a trust that cannot be modified or terminated by the grantor. The grantor, who transferred assets into the trust, effectively gives up rights of ownership to and beneficial enjoyment of the transferred assets.

An irrevocable trust is appropriate when a grantor desires to remove an asset from his or her estate. A primary reason for setting up an irrevocable trust is for estate tax avoidance. This type of trust can be designed to convey all incidents of ownership over the assets (including control and beneficial enjoyment) to the trust, effectively removing the trust's assets from the grantor's taxable estate. If the trust is established as a non-grantor trust for Federal income tax purposes, the grantor also is relieved of the income tax liability on the income generated by the assets.

The assets held in the trust can include (but are not limited to) a business, investment assets, cash and life insurance policies.

Requirements

State law sets out the requirements for a trust to be valid and the rules governing trust administration.

Logistics

An individual grantor (also known as the settlor or trustor) enters into a trust agreement with a third party who agrees to serve as trustee. The trust agreement names the beneficiaries, specifies the dispositive provisions of the trust (who gets what and when), establishes rules for the administration of the trust and specifies the powers of the trustee.

Tax Ramifications

Income Tax Issues

Non-grantor trusts are subject to income tax as a separate entity under the Internal Revenue Code (Code). The Code significantly compresses trust income tax brackets in comparison to individual income tax brackets, potentially resulting in much higher tax rates being applied to trust income.

Generally, a trust as a separate income tax entity follows rules similar to that of an individual taxpayer. The Code sets out several modifications to the individual rules such as a reduced personal exemption and different rules in computing a trust's charitable deduction, etc. Most importantly, to help mitigate a non-grantor trust's income tax liability, a trust can deduct under certain circumstances income distributed to the beneficiaries during a taxable year so that the distributed income is taxed to the individual beneficiaries at their presumably lower income tax rates.

A trust also can be a "grantor trust" for income tax purposes, and not be taxed as a separate entity. This means the grantor (or some other person) is the owner of the trust for income tax purposes. The owner must include all items of trust income, gain, loss, deductions, and credits in calculating his or her individual income tax liability.

To attain grantor trust status, a trust agreement can provide certain powers to the grantor or a third person. For example, if the grantor or a third person has the right to acquire trust assets in a non-fiduciary capacity by substituting assets of equivalent value, the trust will be a grantor trust. However, certain powers will cause the trust to be a grantor trust, but will also cause inclusion of the trust in the grantor's estate for estate tax purposes. For example, a power to revoke the trust causes grantor trust status but also causes inclusion.

Gift Tax Issues

The federal gift tax annual exclusion allows a donor to give an unlimited number of donees up to the current annual exclusion amount each in a year without having the gifts be treated as taxable. By utilizing and complying with certain "gift splitting" provisions of the Code (including the filing of a gift tax return to consent to gift splitting), a married couple can each use their respective annual exclusions for a beneficiary even if only one spouse actually transfers property.

Only a gift of a "present interest" qualifies for the gift tax annual exclusion. A gift of a "future interest" is ineligible for the annual exclusion. A gift to a trust is a gift of a present interest only under certain conditions: (1) when the beneficiary has a right to withdraw the amount of the gift from the trust; (2) when the beneficiary has the present right to trust income; or (3) when the trust is for the exclusive benefit of a minor and meets certain requirements.

In Crummey v. Commissioner, the Court of Appeals held that a gift to a trust is a gift of a present interest to the extent the beneficiary has a right to withdraw their share of the gift.[1] Henceforth, withdrawal rights in a trust are known as "Crummey rights," and a trust containing Crummey right provisions is known as a "Crummey trust." There are several requirements for a Crummey right to be effective. For example, the trustee must give the beneficiary notice of the contribution and the beneficiary's withdrawal right. Also, the beneficiary must have a reasonable amount of time to decide whether to exercise the right before it lapses. Although there is no set number of days that qualifies as reasonable, the Service has approved a withdrawal period as short as 30 days.

In addition to relying on the gift tax annual exclusion to make tax-free gifts, an individual may gift a certain amount of assets free of federal gift tax by allocating portions of what is referred to as their "unified credit." If a donor gifts assets to a donee during any given taxable year the value of which exceeds the annual exclusion amount, the donor can apply their "unified credit" against any federal gift tax that would otherwise be due on the value of the gifts in excess of the annual exclusion amount. Any portion of the unified credit not applied during lifetime to offset gift tax may be used at death by an individual's estate against any estate

1 397 F.2d 87 (9th Cir. 1968)

tax due. The amount of assets the unified credit effectively exempts from gift and/or estate tax is referred to as the "applicable exclusion amount." The applicable exclusion amount for gift and estate tax purposes in 2015 is $5.43 million.

Estate Tax Issues

A primary goal of creating an irrevocable trust is to remove the trust assets from the grantor's estate for estate tax purposes. There are, however, several ways in which the assets of an irrevocable trust can be includible in the grantor's estate. More specifically, a decedent's taxable estate will include any property transferred by the decedent in which the decedent retained a beneficial interest (including the right to income) or the right to control who owns or enjoys the use of the property. This may apply indirectly by way of example if the trustee has the ability to control the ownership or use of the property, if the grantor can replace and substitute one's self as the trustee of the trust or if the decedent retained the right to alter, amend, revoke or terminate the terms of the trust.

If the trust includes life insurance policies on the grantor's life and the grantor/insured retained any incidents of ownership over the policies, the policy proceeds may be included in the grantor's estate. An example of such a right would include the right to borrow against the policy's cash surrender value. Similarly, if the grantor gifted existing policies on the grantor's life to a trust and died within three years of the transfer, the proceeds may be included in the estate.

Additional Considerations

Asset Protection

An irrevocable trust can protect assets from creditors of the grantor and the beneficiaries. This may have particular value for persons in litigation-prone occupations. A trust in which the grantor retains a beneficial interest will generally be subject to the grantor's creditors' claims. A grantor's creditors generally cannot access an irrevocable trust unless they can show (1) that the grantor conveyed the assets to defraud creditors or (2) that the trust is a sham or the alter ego of the grantor. Typically there is a statute of limitations on claims of fraudulent conveyance. In order to protect the trust assets from claims of the creditors of the beneficiaries, the trust agreement can contain a spendthrift clause that prevents a beneficiary from transferring or encumbering his or her interest in the trust prior to distribution.

Irrevocable Trust as a Vehicle for Owning Life Insurance

An irrevocable trust can be a useful vehicle to hold life insurance policies. As discussed above, if an insured has any incidents of ownership in a policy on his or her life, the proceeds of the policy will be includible in the grantor's estate. Transferring ownership of existing policies on the insured to an irrevocable trust can remove the proceeds from the estate (assuming the grantor lives three years after making the transfer). A grantor can gift money to a trust to purchase and pay premiums on new life insurance policies. Assuming the trust agreement is properly drafted, the proceeds trust can be removed from the grantor's taxable estate.

Children or other beneficiaries can own policies directly without causing inclusion in the grantor's estate. However, a trust can have substantive non-tax advantages over direct ownership. In creating the trust, the grantor can delay the time when the beneficiaries receive the proceeds until a certain age when the grantor feels the beneficiaries will be more responsible as specified in the trust agreement. As discussed above, a trust may also protect the proceeds from the beneficiaries' creditors.

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