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## The role of trusts in estate planning

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### Introduction

Trusts are among the most useful and versatile of tools in estate planning but relatively few people understand what they are, when they should be used and how they operate. In that regard, a trust is a legal entity through which the legal title to property is separated from the right to its beneficial enjoyment. Legal title to trust property is held by the trustee but the right to its beneficial enjoyment belongs to the beneficiaries of the trust. This means that the trustee as a fiduciary must manage and distribute trust property for the beneficiaries of the trust in accordance with the terms of the trust and applicable state law.

There can be more than one trustee and trustees may be individuals or corporations such as a bank or a trust company. As to beneficiaries, every trust must have at least one beneficiary though there may be more. Likewise, beneficiaries may be individuals or organizations and they may have interests in the income or principal of the trust or both. Regarding “income” beneficiaries they are parties who have a right to receive income from the trust or to whom the trustee has the discretion to distribute such income. On the other hand, a party that has a right to trust principal after the interest of the income beneficiary terminates is called a “remainder” beneficiary or “remainder man.”

### Living and testamentary trust

Trusts are basically classified as living or testamentary trusts. Living trusts are established by a person called the grantor or settlor and take effect during that person’s life. Testamentary trusts, on the other hand, are established under the terms of a person’s will and only take effect at that person’s death. (The person who creates a will is called the testator.)

### Revocable living trusts

In addition, living trusts may be revocable or irrevocable. Revocable trusts are those over which the grantor retains total control including the right to change the trustee, remove trust property or terminate the trust. (It should be noted that these trusts become irrevocable upon the grantor’s death.) Revocable trusts are typically designed to provide the following benefits to the grantor or their family:

- **Probate costs reduced** - Property that passes through an executor’s hands is subject to executor’s commissions and probate court costs but property including life insurance proceeds received by the trustee of a revocable living trust is not, and therefore, may go to the family at lower cost.

- **Elimination of probate delays** - A revocable living trust avoids the delay of probate proceedings and permits beneficiaries to receive property more quickly.
- **Financial management** - A trustee can provide financial management for beneficiaries who are not capable of handling such matters themselves.
- **Privacy** - Will and estate accounting are matters of public record in many states. On the other hand, a trust document does not need to be revealed and the beneficiaries and trust assets do not have to be known to outsiders. Consequently, by passing property to the family through a revocable trust rather than under the grantor's will the grantor can avoid publically disclosing who received what and how much.
- **Children's inheritances** - A trust permits parents to avoid placing large sums of money in children's hands at a young age. Moreover, since minors may not receive funds directly at their parent's deaths the estate must go through the process of having a custodian appointed. If the funds go into a trust this problem is avoided.
- **Management of property in the event of disability**

The trustee can manage the trust property for the benefit of an incapacitated grantor without the need to have a conservator appointed by a court. This can be a very significant benefit to the grantor and the family if the grantor becomes disabled since the process of getting a court to act is time consuming and expensive.

### **Irrevocable living trusts**

As previously stated, irrevocable living trusts are established during the life of the grantor and, as their name implies, may not be modified or revoked by the grantor. One of the main reasons for creating such trusts is to remove the trust property from the grantor's estate. Various types of irrevocable trusts are as follows:

- **Irrevocable Life Insurance Trusts ("ILITs")** - A common use of irrevocable trusts is to acquire life insurance to provide estate tax liquidity without causing the life insurance to be included in the grantor's gross estate. The way for a prospective insured to avoid estate tax on death proceeds paid on their life is to establish an ILIT and provide the trustee with funds to make the purchase. Specifically, the trustee and not the insured should be the applicant, owner and beneficiary of the policy and the trust must be in existence when the application is submitted. It is not adequate that the application refer to a trust that is not in existence but is created a short time later. This is so that the trust is seen as a separate legal entity that is administered by an independent trustee that is not just the alter ego of the insured. Otherwise, the death proceeds will be included in the insured's gross estate if the insured dies within three years of the purchase. The reason is that the situation will be seen as being no different than if the insured had purchased the policy and transferred it to the trust within three years of death. (Remember, IRC §2035 requires death proceeds to be included in the insured's gross estate when the insured has made a transfer of the policy within three years of death.)

In situations where the prospect is unwilling to spend the time and money to have an ILIT established before applying for the coverage (often because they do not know if they're insurable or insurable at a price they are willing to pay) a trial application should be used to determine underwriting. Then, if the prospect is willing to proceed with the actual purchase, an ILIT can be established to make the application.

#### Qualifying for the annual gift tax exclusion

When making gifts to the trust to finance premium payments it is desirable to have such gifts qualify for the annual gift tax exclusion. That is because it allows the insured grantor to contribute \$14,000 (as adjusted for inflation) to the trust annually for each beneficiary gift

tax-free. (\$28,000 per beneficiary if the insured grantor is married and the couple elects to split the gifts.) In order to qualify for the annual gift tax exclusion, however, the gifts must qualify as “gifts of present interest” and that can be accomplished by providing in the trust instrument that the trust beneficiaries have Crummey withdraw rights as to the gifts.

The name “*Crummey*” comes from a court case in which it was decided that where a beneficiary has a right to withdraw gifts to the trust, those gifts qualify as gifts of present interests. This approach operates by providing in the trust instrument that when contributions are made to the trust, the trustee must notify the beneficiaries that each of them has a right to withdraw their share of the gift. This power of withdraw only exists for a limited period of time such as 30 days. That window of opportunity is sufficient, however, to make the gifts to the trust gifts of present interests that qualify for the annual gift tax exclusion.

#### Consideration in Selecting a Trustee

The insured grantor should not be a trustee of the trust since even powers held as fiduciary would be deemed “incidents of ownership” that would cause the proceeds to be included in the grantor’s estate. The insured grantor may have the power to remove a trustee and replace it with another as long as the new trustee is not a related or subordinate trustee. Examples of related or subordinate trustees are the grantor’s spouse, children, grandchildren, employees and business partners. A related or subordinate trustee may be appointed, however, where the related or subordinate trustee’s powers are limited by an “ascertainable standard.” This means that the related or subordinate trustee can make only discretionary distributions to the trust beneficiaries for their maintenance, education, health, and support (referred to as “MESH” powers).

#### Providing Estate Liquidity

If the trustee is required to use the insurance proceeds to pay the death taxes and administrative costs of the grantor’s estate, the proceeds so applied will be included in the grantor’s estate. In order to avoid the above problem, while providing liquidity, the trust should state that the trustee has the discretion to either lend money to the estate or purchase assets from the estate. This will give the estate liquidity without causing the proceeds to be included in the estate.

#### ILIT Checklist

1. Consider submitting a trial application prior to setting up an ILIT to determine the prospects insurability.
  2. Select a trustee.
  3. The ILIT should be drafted by the grantor’s lawyer and signed by the grantor.
  4. A federal tax identification number should be obtained for the ILIT.
  5. Open a bank account in the name of: (Name of Trustee) for the (Name of Trust) dated (Date of Trust).
  6. Make gift of cash to the trust.
  7. Send written Crummey notice letters to the trust beneficiaries.
  8. Apply for a policy with the owner and beneficiary names as (Name of Trustee), trustee for the (Name of Trust) dated (Date of Trust).
  9. Continue to make gifts to the trust and send Crummey withdrawal notices to the trust beneficiaries as appropriate.
- **Spendthrift Trusts** - A spendthrift trust is one in which the beneficiary cannot transfer their interest in the trust to a third party and the beneficiary’s creditors cannot reach the assets in the trust as long as they remain in trust. (In those situations when the trust beneficiary needs goods

or services the trustee can make payment directly to those providing the goods and services without exposing the payments to the beneficiary's creditors.) The result is that a discretionary spendthrift trust provides protection from creditors in bankruptcy, divorce and post judgment collection proceedings. Fortunately, life insurance can be used as an excellent means of funding such trusts. In such cases, the trustee should be the applicant owner and beneficiary of the policy with the premium dollars provided to the trust through gifts by an appropriate family member such as a parent or grandparent.

- **Dynasty Trusts** - A number of states allow trusts to last for long periods of time, and consequently, they are called "dynasty trusts". A life insurance policy can be the best funding vehicle for such trusts that function as a family bank or family asset pool that keeps assets in the trust while making them available to the trust beneficiaries. For example, the trust can purchase recreational property like a vacation home or a boat for the use of trust beneficiaries. In addition, the trust can make secured loans to beneficiaries such as for the purchase of a home or to start a business. In fact, the business can be owned by the trust and the appreciation on the business kept in the trust and shielded from transfer taxes and the creditors of beneficiaries.
- **Charitable Remainder Trust** - Assume that an individual has highly appreciated property that they would like to sell and use the proceeds for retirement income. Assume further that they do not want to pay capital gain taxes on the sale but would like to benefit their favorite charity in the process. All of these goals may be accomplished by having the individual create a charitable remainder trust through which the property can be sold without incurring a taxable gain. This is because under such a trust the grantor can retain the right to receive income from the investment of the sale proceeds and at the end of their income interest the remaining property in the trust goes to the charity. In addition, the individual gets a charitable income tax deduction for the value of the remainder interest going to the charity. The bottom line is that the individual gets a higher income stream while enjoying an offsetting charitable deduction.
- **Wealth Replacement Trust** - As noted above, in the case of charitable remainder trusts the individual grantor and the charity are happy. The problem is that the grantor's family may be displeased because they have lost a part of their inheritance that has gone to the charity. This can be made up for the family, however, by having the grantor establish a wealth replacement trust. Under this approach the grantor of the charitable remainder trust would also create an irrevocable life insurance trust or ILIT for the benefit of the family and make gifts to the trust with which the trustee may purchase life insurance. Due to the improved income stream that the grantor has from the charitable remainder trust this should be affordable and will present the family with income tax free death proceeds at the grantor's death.
- **Grantor Retained Annuity Trust** - In the case of a grantor retained annuity trust or "GRAT" an individual establishes an irrevocable trust and transfers property to the trust in return for a right to receive income for a certain period of time or the grantor's life which ever is shorter. At the end of the grantor's income interest, the property remaining in the trust typically passes to family members. That remainder interest going to the family is a gift at the time the GRAT is established and valued for gift tax purposes using certain published government interest rates. The bottom line is that if the property placed in the trust is producing a greater rate of return than the government interest rates, the remainder going to the family will be undervalued for gift tax purposes and that means a savings in gift taxes. This is particularly significant during this time of low interest rates to the extent that it is more likely that the grantor has property producing a greater rate of return than the government rates.

## Testamentary trusts

As previously stated, testamentary trusts are established under a person's will and have no effect until the testator's death and the probate of their will. Generally, such trusts are created for young children, relatives with disabilities and others that may inherit large sums of money from the testator's estate. In that regard, such trusts can be used to unify the testator's estate by directing that employee plan benefits, insurance proceeds and similar payments be paid to the trust so that all of the testator's assets are managed together and distributed as the testator directs in the trust's language.

Two common types of testamentary trusts are as follows:

- **Trusts for minor children** - In a situation where the testator and their spouse have both died leaving minor children a testamentary trust can be used to hold assets for the children until they reach a specified age. This avoids the need to have a court appoint a conservator to manage the children's inheritance.
- **Bypass/Credit Shelter Trust** - A testamentary trust called "Bypass" Trust can be used under an individual's Will to provide that property equal to their applicable estate tax exclusion (\$5,450,000 in 2016) be placed in the trust with the remainder of the estate given to the surviving spouse under the marital deduction. This approach avoids any estate tax at the testator's death because the amount in the Bypass Trust is shielded by the applicable estate tax exclusion while the balance of the estate is covered by the marital deduction. By taking the Bypass Trust/Marital Deduction approach, the advantage becomes apparent when the surviving spouse dies. That is because the value of the property in the Bypass Trust will not be included in the spouse's estate and will not be subject to estate tax. The reason is that the spouse will not be deemed to own the property in the Bypass Trust and only property that the spouse owns at death is subject to the estate tax. This means that whatever is left in the Bypass Trust, at the spouse's death, can go to the couple's children or other beneficiaries free of estate tax.

## Keeping up with change

Trusts are one of a number of tools that we have at our disposal to help meet a prospect's needs. Like any tool, a trust is only good as long as it fits the task at hand. This means that producers should be asking prospects if they have trusts that are either owners or beneficiaries of life insurance policies. If so, producers need to ask if the reasons that the trust was originally established still apply. If not, the prospect needs to consider speaking with their lawyer about what can be done to modify or terminate the trust to better fit their current needs. Questions should also be asked as to whether the life insurance is performing as originally illustrated and as currently needed. This may require getting an in-force illustration to compare the policy's performance to current needs. If the policy is not performing as currently needed it may have to be modified or replaced in conformity with applicable state regulations.

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