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Deconstructing Trusts

Learn about the intricacies of trusts to help clients plan for any outcome.

WHITE PAPER

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Using trusts as estate planning solutions

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Overview

Trusts are legal documents that can be as short as one page or as complex constituting hundreds of pages. In reviewing trusts, however, some common principles apply to all.

Let us start by looking at some commonly used terms.

Important terms to know

- **Trust** – An arrangement whereby property is legally owned and managed by an individual or corporate fiduciary as trustee for the benefit of another, called a beneficiary, who is the equitable owner of the property.
- **Trust instrument** – A document, including amendments thereto, executed by a grantor that contains terms under which the trust property must be managed and distributed. Also referred to as a trust agreement or declaration of trust.
- **Trustee** – The individual or bank or trust company designated to hold and administer trust property (also generally referred to as a "fiduciary"). The term usually includes original (initial), additional, and successor trustees. A trustee has the duty to act in the best interests of the trust and its beneficiaries and in accordance with the terms of the trust instrument. A trustee must act personally (unless delegation is expressly permitted in the trust instrument), with the exception of certain administrative functions.
- **Settlor** – Term frequently used for one who establishes or settles a trust. Also called a "trustor" or "grantor."
- **Irrevocable trust** – A trust that cannot be terminated or revoked or otherwise modified or amended by the grantor. As modern trust law continues to evolve, however, it may be possible to effect changes to irrevocable trusts through court actions or a process called decanting, which allows the assets of an existing irrevocable trust to be transferred to a new trust with different provisions.
- **Revocable trust** – A trust created during lifetime over which the grantor reserves the right to terminate, revoke, modify, or amend.
- **Special needs trust** – Trust established for the benefit of a disabled individual that is designed to allow him or her to be eligible for government financial aid by limiting the use of trust assets for purposes other than the beneficiary's basic care.
- **Spendthrift provision** – A trust provision restricting both voluntary and involuntary transfers of a beneficiary's interest, frequently to protect assets from claims of the beneficiary's creditors.
- **Living trust** – A trust created by an individual during his or her lifetime, typically as a revocable trust. Also referred to as an "inter vivos" trust, "revocable living trust" or "loving trust."
- **Grantor** – A person who creates or contributes property to a trust. If more than one person creates or contributes property to a trust, each person is a grantor with respect to the portion of the trust property attributable to that person's contribution except to the extent another person has the power to revoke or withdraw that portion. The grantor is also sometimes referred to as the "settlor," the "trustor," or the "donor."
- **Grantor trust** – A trust over which the grantor retains certain control such that the trust is disregarded for federal (and frequently state) income tax purposes, and the grantor is taxed individually on the trust's income and pays the income taxes that otherwise would be payable by the trust or its beneficiaries. Such tax payments are not treated as gifts by the grantor to the trust or its beneficiaries. Provided the grantor does not retain certain powers or benefits, such as a life estate in the trust or the power to revoke the trust, the trust will not be included in the grantor's estate for federal estate tax purposes.
- **Beneficiary** – A person who will receive the benefit of property from an estate or trust through the right to receive a bequest or to receive income or trust principal over a period of time.
- **Annual exclusion** – The amount an individual may give annually to each of an unlimited number of recipients free of federal gift or other transfer taxes and without any IRS reporting requirements. In addition, these gifts do not use any of an individual's federal gift tax exemption amount. The annual exclusion is indexed for inflation and is $16,000 per donee for 2022. Payments made directly to providers of education or medical care services also are tax-free and do not count against the annual exclusion or gift tax exemption amounts.
- **Crummey trust** – An irrevocable trust that grants a beneficiary of the trust the power to withdraw all or a portion of assets contributed to the trust for a period of time after the contribution. The typical purpose of a Crummey trust is to enable the contributions to the trust to qualify for the annual exclusion from gift tax.
- **Exemption/Unified credit** – The amount of money or assets that can be transferred as a gift, or transferred at death, without incurring federal taxation. It can be calculated as the amount of tax forgiven by the IRS to a transferor. In that case, it is called the "unified credit." The terms are synonymous. Other synonyms include the "exemption amount," the exemption equivalent, or applicable exclusion amount. The current exemption amount is $5 million adjusted for inflation since 2010. The 2021 exemption is $11.7 million. Married spouses can share each other's exemption so the total in 2021 is $23.4 million. When spouses share either their annual exclusions or exemption amounts, it is sometimes referred to as "split gifting."

Basic provisions to look for

There are a number of trust provisions, usually contained in separate sections of a trust, to look for. Trust sections are usually called "Articles."

Contact your Lincoln wholesaler for more information on the library of specimen agreements available on the Advanced Markets Resource Center.

1. **Introduction** – The introduction names the grantor(s), trustee(s), addresses and date of the trust.

Specimen provision

> This TRUST AGREEMENT made this ______day of_______, by and between
>
> ______(name)_____ of ______(city, state)_____, hereinafter called "grantor," and ______(name)_____ of ______(city, state)_____, called "trustee.

2. **Situs** – Trusts can be created in all 50 states. The governing law of a trust is known as "situs." The situs of a trust need not be the same state where the grantor, trustee or beneficiaries reside. As such, a number of states compete for trust business in order to have the trust situs in their states, even though all the parties reside elsewhere. Some states require that at least one of the trustees either reside in the state or are licensed by the state. In such circumstances, trust companies can be used to meet this requirement. The trust company may have only minimal duties to meet this residency rule, or the trust company can have complete trust powers, or can have powers somewhere in-between. The law gives the grantor the right to have widespread discretion in establishing trust powers, since the trust "corpus" (or "principal") originally was the grantor's property. Situs articles are usually near the bottom of the trust document.

Specimen provision

> The trust hereby created shall be administered in the State of _____(state)_____ and in all respects shall be governed by the laws of the State of _____(state)_____.

3. **Crummey withdrawal powers** – The gift tax annual exclusion (currently $15,000) is not allowed for gifts of future interests in property. What distinguishes a future from a present interest is the postponement of the right to use, possess, or enjoy the property. Most importantly, life insurance is deemed to be such a future interest, including life insurance in trusts. An interest may vest immediately in the donee, and yet it will be a future interest if the donee cannot enjoy or use it presently. The answer to this problem was enunciated in a case called *Crummey v. Commissioner* a 1968 decision by the Ninth Circuit Court of Appeals that was subsequently accepted by the IRS. *See Rev. Rul. 73-405 [Crummey, 397 F.2d 82 (9th Cir. 1968)].*

   In the typical Crummey trust, a periodic contribution of assets to the trust is accompanied by an immediate withdrawal power that gives the beneficiary the right to withdraw the contribution for a limited time. However, the expectation of the donor is that the power to withdraw will not be exercised (although there should be no express agreement to this effect). The beneficiary's limited withdrawal right (a Crummey power) causes the gift to the trust to be a gift of a present interest that can be sheltered by the annual gift tax exclusion. It is the presence of a legal right, not the likelihood of its exercise, that is the determining factor.

In Letter Ruling 199912016, the IRS considered four factors in determining whether a beneficiary's withdrawal (Crummey) right qualified gifts to a trust as present interest gifts:

1. The trust is required to give the beneficiary reasonable notice in which to exercise the withdrawal right;
2. The beneficiary is given adequate time following notice in which to exercise the withdrawal right;
3. Upon exercising the withdrawal right, the beneficiary will have the immediate and unrestricted right to an amount equal to the amount contributed to the trust; and
4. There is no understanding or agreement, expressed or implied, that the withdrawal will not be exercised.

Specimen provision

Each member of the class of persons consisting of the living beneficiaries of this trust (each such member being herein referred to as the "withdrawal beneficiary") shall have the right upon and after the making of any gift by an individual to the trust estate (including, without limiting the generality of the foregoing, any direct or imputed gift resulting from the payment of any premium under any policy of insurance held hereunder), to make withdrawals from the trust in accordance with the following provisions:

Each withdrawal beneficiary living at the time of the gift shall have the right to withdraw money or other property equal in value (when withdrawn) to the value of the gift (determined at the time the gift was made) divided by the total number of withdrawal beneficiaries living at the time of the gift; provided, however, that the total amount becoming subject to withdrawal by any one withdrawal beneficiary as a result of gifts to the trust by any one donor in any one calendar year shall not exceed the amount of the federal gift tax annual exclusion available to such donor for such gifts (plus the amount of any such exclusion available to the spouse of such donor for such gifts, unless the donor notifies the trustee that the gifts are not to be "split" for federal gift tax purposes.

Grantor trust provisions

Trusts can be treated as tax paying entities unto themselves. Such trusts are usually referred to as "non-grantor trusts." If a non-grantor trust applies for life insurance, New Business requires that the trust has its own Taxpayer Identification Number or TIN. The other option is for the trust's tax consequences to be transmitted back to the grantor and included on that person's individual income tax return (Form 1040).

In general, most trusts today are grantor trusts. The reason for this is trifold.

1. First, individual tax brackets are generally more generous for an individual, as opposed to a trust. In 2021, a non-grantor trust reaches the top tax bracket with only a mere $13,050 of income. For a married couple filing jointly, the top tax bracket is reached at $628,300 of income. Thus, for many grantors, it is less tax expensive to bring the trust's tax consequences into their personal returns, as opposed to having the trust pay the tax itself.

2. The second reason is that if the grantor pays the tax, the trust corpus is not diminished, thus making more assets available for the beneficiaries.

3. A third reason is that with a grantor trust New Business only requires the grantor's Social Security number (SSN) and not a trust TIN. Thus, you do not have to file a request to the IRS for a trust TIN.

The grantor rules are applied in a very mechanical way. Under Subpart E of the Internal Revenue, there is essentially a list of provisions, that if included in the trust document, one creates a grantor trust. The underlying rationale is if the grantor, that is, the creator of the trust, maintains certain "strings" of control over the trust, then all the income from said trusts must be reported on the grantor's individual tax return. *Grantor trust rules can be found under IRC §§ 671–678.*

The key to creating a grantor trust is to use a provision that creates a grantor trust for income tax purposes, but which is of a nature not to result in the trust being included for estate tax purposes.

The most used provision is known as a **substitution power**, which provides that "a power to reacquire the trust corpus by substituting other property of an equivalent value," held in a nonfiduciary capacity by any person who can exercise it without the approval or consent of any person in a fiduciary capacity (trustee), will cause grantor trust treatment. *See IRC 675(4)(C).*

Even though section 675(4)(C) refers to a power to reacquire "trust corpus," this power causes the grantor to be treated as the owner of trust corpus and all of the trust income, including ordinary income not allocable to corpus. The regulations provide that "the determination of whether the power [of substitution] is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration." To repeat, because grantor trust status depends upon the power being held in a "nonfiduciary" capacity, the power of substitution should not be held by the trustee [or else the requirement in the initial sentence of section 675(4) will not be satisfied].

Specimen provision

During the grantor's lifetime, the grantor's spouse shall have the power (both in her individual capacity and as a trustee of any other trust of which she may be a trustee) at any time and from time to time, acting only in a fiduciary capacity, within the meaning of section 675(4) of the Code, without the approval or consent of any person, including the trustees, to acquire the assets [other than any stock described in section 2036(b) of the Code or any policy insuring the life of the grantor's spouse] of any property held herein by substituting property of an equivalent value. Equivalent value shall mean fair market value as determined for federal gift tax purposes under the regulations under section 2512 of the Code. This power is not assignable, and any attempted assignment will make this power void. The grantor's spouse may at any time during her lifetime irrevocably release such power, in whole or in part, by delivery of an acknowledged, written instrument to the trustees.

An alternate provision to create a grantor trust is contained in many trusts specifically designed to own life insurance. These trusts are commonly referred to as ILITs. A grantor is treated as the owner of any portion of the trust whose income ***may*** be applied to the payment of premiums of policies of insurance on the life of the grantor or the grantor's spouse. This statutory provision appears to be very broad. It provides that giving a trustee the power to pay life insurance premiums from the income of a trust will cause all the income and corpus of the trust to be a grantor trust. Some commentators believe that, in fact, not prohibiting the trustee from making such payments would seem sufficient to trigger creation of a grantor trust.

Specimen provision

The trustee may pay the premiums, which may become due and payable under the provisions of any insurance policies held hereunder; however, the trustee shall be under no obligation to do so, nor shall the trustee be obliged to make certain that such premiums are paid by the grantor or others or to notify any persons of the nonpayment of such premiums. Upon notice at any time during the continuance of this trust that premiums due upon such insurance policies are in default, or that premiums to become due will not be paid either by the grantor or by any other person, the trustee, within the trustee's sole discretion, may apply any cash values attributable to such policies to pay any premium, or may borrow upon any and all such policies for the payment of premiums due thereon, or may use the cash values of such policies as collateral for external third-party loans to pay premiums, and may take any and all action which the trustee, in the trustee's sole discretion, deems appropriate with respect to all policies held in the trust.

Power to purchase life insurance – In the best drafted life insurance trusts, it is best to have a comprehensive provision allowing for the purchase of life policies by the trustee. The following Specimen provision is an example of a very inclusive provision.

Specimen provision

The trustee shall have the power to purchase life insurance, payable to any trust held hereunder, on the life of any individual in which any beneficiary hereunder may have an insurable interest; to enter into any form of split-dollar arrangement with respect to such insurance (including, without limitation, a split-dollar arrangement with the grantor, the grantor's spouse or another trust of which any trustee hereunder is acting as a trustee notwithstanding that such arrangement may constitute an act of self-dealing), to pay any premiums on any such life insurance policy held hereunder, to exercise with respect to said insurance policies held hereunder from time to time all options, rights, elections and privileges exercisable with respect to said policies, including, but not limited to, the right to demand and collect from the company or companies issuing said policies all such proceeds as shall be payable to the trustee, to designate and change the beneficiaries thereunder (provided, however, that the trustee may not designate either the grantor or the grantor's estate as such beneficiary), to modify, exchange, surrender or cancel any such policies of insurance, to borrow upon and pledge any said policy in connection with a loan, to assign and distribute any and all of the rights thereunder to or for the benefit of any beneficiary under this agreement of trust, to direct the disposition of dividends or surplus, to convert said policies into different forms of insurance and to elect methods of settlement with respect thereto; provided, however, that nothing herein to the contrary shall prevent the investment trustee from entering into a split-dollar agreement under which the grantor and/or the grantor's spouse pays the IRS-approved tax value for his or her interest under said split-dollar agreement; provided further that no investment trustee of any trust hereunder shall participate in the exercise of any discretion [including, but without limitation, any discretion which would constitute an "incident of ownership" within the meaning of section 2042(2) of the Code] with respect to any insurance policy on his or her life [in which case, such powers shall be exercisable by the remaining trustees; provided, further, that the trustee may, by an acknowledged, written instrument delivered to the beneficiaries hereunder, irrevocably renounce the power to use the income (including capital gain)] to pay for insurance on the life of the grantor and/or the grantor's spouse.

Not having such specificity is not necessarily fatal to having a trust purchase life. A number of states, in their laws relating to trusts, specifically mandate that life insurance may be purchased by any trust with a situs in the state and that there need not be any trust provision relating to life insurance or its purchase. Since these laws are state specific, one must check a particular state's trust law to see if such a statutory provision exists.

Also, many trusts contain provisions that allow the trust to purchase any type of insurance. Such a provision, by definition, includes the power to purchase life insurance.

Specimen provision

The trustee shall have the power to purchase insurance of any kind as a trust asset and in the amounts which the trustees consider advisable. This shall include the power to protect the trust estate and the trustees personally against any hazard.

Irrevocability provision – The preponderance of trusts that Lincoln receives are irrevocable trusts. The reason for this is IRC 2038. This provision that if a trust can be revoked by the grantor, the trust assets are includible for estate tax purposes, whether or no such trust is actually revoked. Since the reason for ILITs, in most cases, is to prevent the life insurance death benefit from being taxable in the estate of the grantor, irrevocable trusts are used, blocking IRC 2038. These provisions are usually simply a single sentence or two long.

Specimen provision

The grantor does not reserve any right to alter, amend, revoke or terminate this trust agreement, and the grantor acknowledges the same to be irrevocable. Without exception, the grantor renounces all interests, either vested or contingent, including reversionary interests and possibilities of reverted or appointment, which the grantor may at any other time be held to have in the income or principal of any trust hereunder and all incidents of ownership in any insurance policy held hereunder.

Asset protection – Besides tax advantages, trusts can afford asset protection. Of importance to many grantors is the desire to prevent creditors of any beneficiary from getting at trust assets. Among the creditors that these grantors want to block are spouses (and ex-spouses), the IRS and judgment creditors of any beneficiary. Such protection is usually referred as "spendthrift" provisions. Some states, such as Delaware, automatically provide for spendthrift protection by statute. Many other states require a specific **spendthrift clause** be written into the document.

A spendthrift clause refers to specific language which limits the ability of assets to be reached by the beneficiary or their creditors. A spendthrift trust usually states that the trustee is not required to distribute income or principal to any beneficiary, and often spendthrift trusts do so to prevent a financially unstable beneficiary from mismanaging the funds. Beneficiaries and their creditors cannot usually place liens or other judgments on the assets of the trust themselves, but a creditor may get a garnishment against the payments actually distributed to the beneficiary.

Specimen provision

No beneficiary of this trust, including but not limited to the grantor, shall have the power to anticipate, transfer, sell, assign or encumber any payment or distribution of either principal or income to be made under the provisions of this trust. Any anticipation, transfer, sale, assignment or encumbrance by any such beneficiary, whether of principal or income, whether by voluntary act or by operation of law, shall be void and of no effect whatsoever. No distribution or payment shall be made by the trustee to any creditor, assignee, receiver, referee in bankruptcy, or trustee in bankruptcy of any such beneficiary.

An important tool for asset protection is to make distributions to beneficiaries solely within the discretion of the trustee. Courts have held that spendthrift trusts, which require distributions to be made for the support of the beneficiary may be reached by creditors for support-related debts, but creditors generally cannot seize assets of a spendthrift trust that allows the trustee to distribute property based solely on the trustee's discretion.

Specimen provision

The trustee shall have the power to pay, or apply for the benefit of, any beneficiary herein such amounts of trust income and principal as trustee, in its sole discretion deems advisable.

A trust that is recognized as a valid spendthrift trust under state law will also be recognized in bankruptcy. *See 11 U.S.C. § 541(c)(2).*

Advanced provisions

Many grantors are enthusiastic about irrevocable trusts until they ask questions, such as “Can I keep all the income?” or “Can I remove property from the trust for my benefit?” For many years, the answer to both questions was a simple “NO!” The reason for this is one of the most complicated sections (and one of the most important) relating to the estate tax. *See section IRC 2036.*

The purpose of IRC 2036 is to include in the estate tax purposes the situation where a person transfers property to a trust or third person yet retains “strings” in the transfer by retaining control of enjoyment of the property or trying to retain income or access to property that is transferred. The theory of IRC 2036 in such a situation is that the person really did not transfer the property, but instead really still owns the property. Accordingly, such transfers should be disregarded, and the property included for estate tax consequences.

IRC 2036 will be invoked if each of the following requirements are satisfied:

- The transferor made a lifetime transfer of property after March 3, 1931;
- The transferor retained the possession or enjoyment of, or the right to the income from, the transferred property; and
- The possession or enjoyment of income was retained for:
  - The transferor’s life;
  - Any period not ascertainable without reference to the transferor’s death; or
  - Any period that does not actually end before the transferor’s death.

Possession or enjoyment refers to “situations in which the owner of property divested himself of title but retained an income interest or, in the case of real property, the lifetime use of the property.” Although most common with real property, this can also occur with personal property, like artwork, where the transferor transfers ownership, but retains the right to possession.

The most common example of **right to income** is where a grantor transfers income producing property in trust, retaining the right to income for his life, with the remainder going to children of the grantor upon her death.

If the income from transferred property is to be distributed to the transferor at the exclusive discretion of an independent trustee, the property generally will still be included in the transferor's gross estate under this section.

There are two main situations which trigger inclusion:

1. If the facts give rise to the inference that there was an unstated or implied agreement or understanding to the effect that either (i) the trustee would pay all (or a fixed portion) of the income to the settlor; or (ii) the trustee would pay any or all the income to the settlor upon the latter's demand.

2. If, under applicable state law, the transferor's creditors can reach the income of the trust. The theory of includability here is that if creditors of the grantor can reach the trust property, the grantor has retained beneficial enjoyment, hence triggering estate tax includability under IRC 2036. More will be said about this in the next section.

The powers referred to in triggering IRC 2036 can be narrow, such as the retained right to choose between two beneficiaries, or broad, such as the retained right to choose among a prescribed class of persons.

The following powers retained by the transferor cause inclusion of the entire property in the estate of the transferor:

- To accumulate all income.
- To distribute trust income or corpus to a person other than the person prescribed in the document of initial transfer. However, if the transferor's power to distribute corpus is limited to distributions to the income beneficiary, §2036(a)(2) does not apply as a power that effects only the remainder interest in the property is excluded from the reach of this section.
- A contingent power to designate the persons to possess or enjoy the property or the income therefrom is subject to §2036(a)(2), even though the contingency activating the power failed to occur before death.

The following powers do not trigger IRC 2036 includability:

- Transfers that are bona fide sales for an adequate and full consideration in money or money's worth;
- A power that does not affect enjoyment of income during transferor's life;
- Powers subject to an ascertainable standard; and
- Pre-death termination of retained power over the transferred property.

Solutions

Fortunately, over the past three decades, creative estate planners — along with state legislatures wanting to encourage trust business within their borders — have established situations where a grantor can get at income or principal from the irrevocable trust and still avoid IRC 2036 and estate tax inclusion.

Domestic asset protection trusts aka “self-settled” trusts

General rule throughout the U.S. before 1987: Any trust from which a distribution may be made to the grantor by the trustee is considered “self-settled” and the trust property was permanently subject to the claims of the grantor’s creditors regardless of the motivation for creating the trust. The IRS held that this was a retained benefit triggering IRC 2036 includability.

In 1998, Alaska enacted AS 34.4.110 providing complete asset protection for a self-settled trust if the grantor was not trying to defraud a known creditor. In essence, the statute reversed the prior creditor law. If the trustee can provide a distribution to the grantor at the trustee’s sole discretion, the grantor’s creditors could not go after the trust assets to satisfy the claim. This not only provided additional asset protection, but also eliminated the retained benefit argument for IRC 2036 inclusion. As of 2021, 19 states have followed Alaska, and changed the creditor laws to protect self-settled trusts from claims of the grantor’s creditors. The IRS has somewhat begrudgingly acquiesced that a self-settled or DAPT in one of the 19 states should be excluded from the grantor’s gross estate if the gift to the trust is complete. *See Rev. Rul. 76-103, Rev. Rul. 2004-64, and PLR 200944002.*

Specimen provision

During the grantor’s life, the trustee shall administer the trust pursuant to this paragraph:
The trustee may, but shall not be required to, distribute as much of the net income and/or principal of the lifetime trust as the trustee may at any time and from time to time determine to such one or more of the grantor, the grantor’s wife and the grantor’s descendants in such amounts or proportions as the trustee may from time to time select for the recipient’s health, education, maintenance or support in his or her accustomed manner of living.

Spousal lifetime access trusts (SLATs)

IRC 2036 has two “legs” which must both occur in order to create estate tax. The first leg is that a person must be the transferor of property. The second leg is that same person must retain the interest in the property triggering taxation. In a SLAT, the two legs of the transaction are different persons, and therefore, IRC 2036 does not apply. Usually the two persons are spouses.

Spouse A transfers property to a trust using that spouse’s individual property (not joint or community property). Spouse B is the beneficiary of the trust and can receive income or principal. Thus, the transferor and beneficiary are completely separate. Each spouse creates a trust for the other spouse, avoiding the state law creditor and tax **reciprocal trust doctrines**. This occurs by making the trusts sufficiently different so the doctrines will not apply. The trusts can be created at different times, with different assets and trustees, and with very different terms. In one trust, the beneficiary spouse can be entitled to distributions each year, have a lifetime broad special power of appointment, can change trustees, withdraw principal under a limit equal to the greater of $5,000 or 5% of the value of assets in the trust. In this trust, the other spouse, the transferor or grantor would have no entitlement to distributions, no power to change trustees, and no power of appointment. In essence, this spouse can only gift separate property, including cash, to the trust. *See Rev. Rul. 95-58, safe harbor.*

Specimen provision

The trustee may, but shall not be required to, distribute as much of the net income and/or principal of the lifetime trust as the trustee (excluding, however, any interested trustee) may at any time and from time to time determine to the grantor’s then spouse and the grantor’s descendants in such amounts or proportions as the trustee may from time to time select, for any purpose. Any net income not so distributed shall be accumulated and annually added to principal.

Special power of appointment trusts (SPATs)

This is the newest and perhaps most exciting trust development to get income or principal back to a grantor without triggering IRC 2036 includability of trust assets in the estate of the grantor. The special power of appointment trust, or SPAT, has been only recently used to solve the IRC 2036 problem even though it is specifically mentioned in the trust laws of many states, as well as in the Internal Revenue Code. It has been touted as a "magic bullet" by some planners.

In many instances a SPAT offers unique benefits you may not achieve otherwise. Legally, there are two types of **powers of appointment.** A power of appointment gives a third-party person to change ownership of property, which is not legally owned by the "holder" of the power. In a trust, the assets are legally owned by the trustee. One can give a "power of appointment" to a third person who has no rights in the trust, to transfer ownership of trust assets to someone else. Under the tax law, if a person holds a "general power of appointment" they can distribute assets to themselves. Since they can distribute assets to themselves, IRC 2041 says that such a holder is actually the same as an owner of the assets and it is included in their estate for tax purposes.

A "special power of appointment" means the holder cannot appoint the assets to themselves or to their estate. They can appoint assets to anyone other than themselves. This special power is given to a "holder" who, again, has the power to give trust assets to anyone except himself, his creditors, his estate, or creditors of his estate. The holder can be a trust beneficiary or a third person. This power is usually used, of course, to make distributions from the trust to someone other than a beneficiary — usually back to the grantor/settlor of the trust. As such, they are not subject to estate tax.

The advantage of a SPAT is that the settlor is not a beneficiary of the trust. However, we may use the special power of appointment as a means to give assets back to the settlor at some future point. This also makes the trust non-self-settled, so one can obtain a spendthrift protection. Unlike the domestic asset protection trust, or DAPT, the SPAT may provide meaningful protection in all 50 states. Even though the settlor can get assets back, since he/she is not a transferor of the assets (the power holder is) it does not result in the trust being in the settlor's estate.

Unlike the DAPT, the SPAT can be used to provide meaningful protection in all 50 states.

Because a settlor of a SPAT has no beneficial interest in trust assets, he or she retains no ownership interest in those assets. This means no includability of trust assets in his or her estate. This further means that she or he does not have to list trust assets on a bankruptcy schedule (unless they were transferred within 1-year of filing bankruptcy), in a post-judgment debtor's examination, or in a deposition. This is a benefit that very few, if any, other asset protection structures have. For practical reasons, it is best to name a holder who is not the trustee or is not a beneficiary. Most trustees do not want to hold special powers because of their fiduciary duties to the trust. One of the benefits to a third-party holder is that the law does not impose any fiduciary duties on them. Likewise, the exercise of the power is not deemed to be a gift, and therefore, is completely void of any potential taxation concerns. Also, naming a beneficiary may create a conflict for the beneficiary. If they exercise the power, the trust will have less assets that can be distributed to themselves as a beneficiary. Trust protectors, or financial professionals (CPA or attorney) can be holders, as can a personal friend.

Specimen provision

Notwithstanding anything to the contrary herein, from and after one (1) year from the date of this trust agreement and until the grantor's death, [here you name the actual person who has the power] shall have the power acting solely in a nonfiduciary capacity, to appoint some or all of the then remaining income and principal of the trust to or for the benefit of any one or more persons who are descendants of the grantor's grandparents, by a signed writing delivered to the trustee and specifically referring to this power of appointment. Said [name of holder] shall not appoint any such property to themselves, their creditors or their estate.

Conclusion

Understanding the intricacies of trusts may seem complicated but will help guide you toward creating tax-efficient legacies for your clients. Lincoln's Advanced Sales team can navigate through any proposed outcome to provide clients with successful solutions and strategies.

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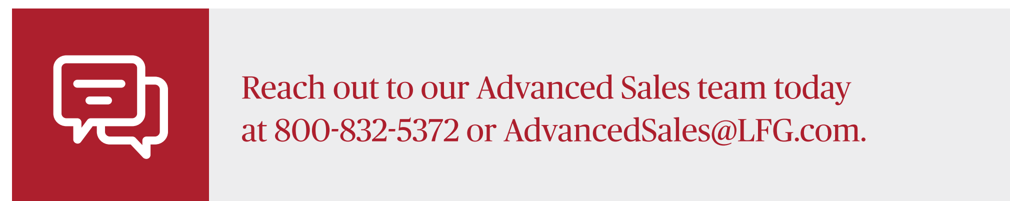
Thomas F. Commito is an Advanced Sales consultant for Lincoln Financial Distributors. A graduate of Cornell University, he earned a Juris Doctor degree, cum laude, from Boston College Law School and a Master of Laws degree in taxation from Boston University School of Law. Tom is admitted to practice law in Massachusetts and Vermont, and is also Series 7 and Series 24 licensed.

He is the author of two books, "Working with LLCs: A Practitioner's Guide to Limited Liability Companies" and "Comprehensive Buy-Sell Agreements," both published by the National Underwriter Company. He writes the column "Accounting and Taxation" in the *Journal of Financial Services Professionals*, and was formerly an assistant editor for *The American Alpine Journal*.

He has been elected to the Estate Planning Hall of Fame, and has been awarded the Distinguished AEP certification by the National Association of Estate Planners and Councils. He is a frequent speaker to, and a member of, several insurance and legal associations.



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