



## Advanced Sales

# "It's called a WHAT?" Interpreting Estate Planning Trusts

Trusts bring life to estate planning, but understanding how one trust differs from another is not easy. And those names! They are amalgams of words and initials that only bring questions and scowls from clients.

Making trusts fulfill estate planning goals and dreams can be science and art. By understanding the practical science of trusts, a planner can understand why a trust may be appropriate, how a trust functions, and how to offer the best trust solution.

Following is a review of the fundamental elements of trusts and characterizations of popular estate planning trusts. Using these fundamental elements can be a great help in deciphering the purpose, strategy, and tax treatment of different trust arrangements.

### Trust Fundamentals

#### Parties

Trusts have three parties known as the grantor, the trustee, and the beneficiary.

The **grantor**, also known as the creator or settlor, is the person that creates the trust, names the other parties, selects the trust's provisions and initially funds the trust. A grantor may be an adult individual or an organization.

The **trustee** is the person empowered to administer the trust, manage trust assets, and act for the benefit of the trust beneficiaries. The trustee's powers are listed in the trust document and in state law. A trustee may be an adult individual or an organization, such as a bank or trust company.

The **beneficiary** is the person that receives the benefits from the trust. Often, the trust will name multiple beneficiaries. Sometimes these beneficiaries are divided between income beneficiaries and remainder beneficiaries. Income beneficiaries typically receive the income and possibly small amounts of principal, for a stated period of time or for life. Remainder beneficiaries typically receive the principal, any accumulated income, and all remaining assets of the trust at the end of the term.

#### Creation

Trusts can be created at two times: during the grantor's life, known as an "inter vivos" trust or a living trust, and at the grantor's death, known as a testamentary trust. Grantors typically draft trust documents (known as trust agreements, Deeds of Trust, or Declarations of trust) with an attorney and sign them at the end with any required seal or witness. Testamentary trusts are created in a Will.

#### Funding

The trust becomes a separate legal entity when the terms are established in the trust document and the trust is funded with assets that are delivered to the trustee. Often, trusts are nominally funded with \$10 or \$100, and then are subsequently funded with larger amounts of assets, life insurance proceeds, or by will.

#### Tax Treatment

What makes trusts complicated are the tax laws associated with them. Trusts can be classified differently

for income tax and transfer tax purposes, so we'll look at each of these separately.

**Federal Income Tax:** The income tax on trust income must be reported and paid by one of the three trust parties: the grantor, the beneficiary or the trustee. To determine who pays the tax, income tax law classifies trusts as a grantor trust, a simple trust, or a complex trust.

A *grantor-type trust* is treated for income tax purposes as if the grantor owns the trust property. The grantor is subject to tax on the income of the trust. A simple trust is a trust that distributes all of its income every year to a trust beneficiary. The income tax on the income also goes to the trust beneficiary. The trust is treated as a pass-through entity, receiving income and passing it through to the beneficiary. The trust will report the distribution, the taxable portion, and the type of income (such as capital gains, dividends, and ordinary income), to the IRS and to the beneficiary.

A *complex trust* may accumulate income. If it receives income and distributes it in the same year, then the beneficiary pays the tax as described above for a simple trust (as a pass-through). However, if the trust accumulates income, it must pay the tax on the income that accumulates. The trust is generally subject to the same rules as individual taxpayers, except that it has a very small exemption amount and is almost immediately in the top tax bracket of 35%. A trust's income tax rates on dividends and long-term capital gains are currently 15%.

**Federal Gift and Estate Tax:** Although a trust is a separate legal entity, it may or may not be treated as a separate entity for transfer tax purposes. The distinction is often based on whether the trust is revocable or irrevocable.

A revocable trust is treated as owned by the grantor for transfer tax purposes and is included in the grantor's taxable estate when he dies. Transfers from the grantor to a revocable trust will not be considered a gift or bequest. However, any transfer from the trust to another person will be treated as a gift or bequest from the grantor at the time of distribution. If a revocable trust becomes irrevocable, then a gift or estate transfer occurs at the time it becomes irrevocable.

An irrevocable trust is a separate legal entity and, unless the grantor has retained certain powers over those assets, the assets in the trust are not included in the grantor's estate. Transfers to the trust are treated as gifts (transfers during life) or bequests (transfers made upon death). Gifts to an irrevocable trust are treated as gifts to the trust beneficiaries.

**Combining Advantageous Tax Treatment:** Because the income tax and transfer tax are two separate tax regimes, it is often possible to combine the preferred income tax treatment into a well-drafted irrevocable trust. For example, an irrevocable trust may be drafted so that income tax is paid by the grantor, the trustee, or the beneficiary. Examples may be found in the trust descriptions below. However, revocable trusts are, by definition, grantor-type trusts for income tax purposes; no other income tax treatment is available until the trust becomes irrevocable.

The tax identification number used by the trust usually depends on whether it is a grantor-type trust for income tax purposes. A grantor-type trust may use the grantor's Social Security number or may obtain its own Employer Identification Number from the IRS. Any other type of trust must obtain and use an EIN. Trustees may obtain EINs from the IRS immediately by phone or website.

## Using the Fundamentals to Understand Estate Planning Trusts

Working from these trust basics, it is possible to understand more complex trust arrangements by identifying the parties, tax treatment and possible uses for life insurance. Here are some of the most popular estate planning trust arrangements. Note: The trusts described below are generic and must comply with the applicable state laws.

### Living trust or revocable living trust

Purpose: To avoid probate and to name a successor trustee to manage trust assets if the grantor

	becomes disabled. May also create A and B trusts upon grantor's death.
Parties:	Grantor may also be named as the trustee and/or beneficiary.
Income tax:	Grantor-type trust, so trust income is taxed to the grantor.
TIN	Usually uses grantor's SSN, but may use EIN.
Estate tax:	Revocable by the grantor, so trust assets are taxable in the grantor's estate at death.
Life Insurance:	May be owned inside or outside of trust; a policyowner may name the trust as life insurance beneficiary.

### **Irrevocable life insurance trust (ILIT)**

Purpose:	To keep life insurance proceeds out of the grantor's estate while providing benefits to the grantor's heirs.
Parties:	Grantor may not be the trustee or beneficiary. Trustee must not be the grantor or an insured of a trust-owned policy. Beneficiary: spouse may be income beneficiary if not an insured of a trust-owned policy.
Income tax:	May be structured as a grantor-type, simple, or complex, depending on needs..
TIN	Grantor's SSN if a grantor-type trust; usually EIN.
Estate tax:	Irrevocable by the grantor, so trust assets are generally not taxable in the grantor's estate at death.
Life Insurance:	Provisions differ for single life and survivorship life policies: trusts owning single life policies may provide income to a surviving spouse; trusts owning survivorship policies should not name either spouse as trustee or beneficiary.

### **Spendthrift trusts, asset protection trusts and special trust**

Purpose:	To keep trust assets out of reach of the creditors of the trust beneficiaries, while providing the trustee with the ability and discretion to benefit the trust beneficiaries. Special needs trusts provide certain benefits to individuals who, due to age or disability, have special needs and qualify for certain government or charitable benefits. Special needs trusts are designed to continue such benefits without reducing or eliminating available government or charitable benefits.
Parties:	Grantor may not be the beneficiary (except in certain states).
Income tax:	Structured as a complex trust, so income is taxed to the trust unless it is distributed to the beneficiaries..
TIN	EIN
Estate tax:	When funded at the grantor's death, the transfer may be taxable in the grantor's estate. However, trust assets are generally inaccessible to trust beneficiaries and their creditors; likewise, trust assets are not taxable in a beneficiary's estate at death.
Life Insurance:	These trusts may be funded with proceeds from life insurance on the grantor. Once funded, they may purchase and own life insurance on a spouse or other beneficiary, so long as an insured is not also a trustee.

### **Intentionally defective grantor trust (IDGT) or intentionally defective irrevocable trust (IDIT)**

Purpose:	To keep trust assets out of the grantor's estate while allowing the grantor to be treated as the owner of the assets and income for income tax purposes only.
Parties:	Grantor may not be the trustee or beneficiary. Trustee must not be the grantor. Beneficiary: spouse may be income beneficiary if not insured.
Income tax:	A grantor-type trust, so income is taxable to grantor.
TIN	Grantor's choice of grantor's SSN or EIN.
Estate tax:	Irrevocable by the grantor, so trust assets are not taxable in the grantor's estate at death.

Life Insurance: May purchase and own life insurance; insured should not be a trustee.

### **Marital trust, also known as an "A" trust; similar to a QTIP trust**

**Purpose:** Usually these are created by will upon grantor's death when grantor is the first spouse to die. They are designed to provide income and principal to a surviving spouse for life, then remainder to children. These are designed to qualify for the estate tax unlimited marital deduction, so that trust assets are not subject to estate tax until the surviving spouse dies. The QTIP trust differs by restricting the spouse's access as much as possible while still qualifying for the marital deduction.

**Parties:** Grantor or spouse may be the trustee or beneficiary; others are the remainder beneficiaries.

**Income tax:** Grantor-type trust, so income is taxed to the spouse.

**TIN** Spouse's SSN or EIN

**Estate tax:** May be revocable or irrevocable by the grantor's spouse, but is taxable in the spouse's estate at death.

**Life Insurance:** Generally these trusts do not own, and are not funded with, life insurance.

### **Credit shelter trust, also known as a "B" trust, Family Trust, Exemption Trust**

**Purpose:** Usually these are created by will upon grantor's death. If the grantor is the first spouse to die, then the trust provides income to a surviving spouse for life. When no spouse survives, trust assets pass to children.

**Parties:** Spouse is generally the income beneficiary; others are remainder beneficiaries. Spouse may be the trustee.

**Income tax:** Grantor-type trust, so income is taxed to the spouse.

**TIN** Spouse's SSN or EIN

**Estate tax:** Irrevocable, so it is taxable in the grantor's estate at death and uses the decedent's estate tax exemption (i.e., not subject to estate tax when the surviving spouse dies).

**Life Insurance:** These trusts may be funded with proceeds from life insurance on the grantor. Once funded, and with careful drafting, they may purchase and own life insurance on a spouse or other beneficiary, so long as an insured is not also a trustee.

### **Spousal Lifetime Access Trust (SLAT)**

**Purpose:** To provide income to grantor's spouse, both during the grantor's life and after the grantor's death, then to pass assets to children. The trust is funded with gifts from the grantor and the trust is not subject to estate tax when the surviving spouse dies. Similar to a Credit shelter trust or "B" trust. Usually funded upon death by the first spouse to die.

**Parties:** Spouse may be the trustee and income beneficiary.

**Income tax:** Grantor-type trust, so income is taxed to the grantor and/or spouse..

**TIN** Spouse's SSN or EIN, depending on income tax structure.

**Estate tax:** Irrevocable, and is generally designed not to be taxable in the grantor's estate at death.

**Life Insurance:** These trusts may purchase life insurance on the grantor and may purchase survivorship life on grantor and spouse, only if neither spouse is trustee.

### **Charitable remainder trust (CRT), Charitable remainder annuity trust (CRAT) and Charitable remainder unitrust (CRUT)**

**Purpose:** To provide a grantor, spouse or others with income, then pass the remainder interest to charity. It is usually funded during life, but may be funded upon grantor's death. The income interest may continue for the life of the income beneficiaries or for a specified number of years.

Parties:	Income beneficiary is usually the grantor and spouse; the remainder beneficiary must be a charity.
Income tax:	Income interest is subject to specific tax accounting rules. Grantor's lifetime gifts to fund the trust may be partially deductible for income tax purposes.
TIN	EIN
Estate tax:	Usually the grantor has no interest upon death, so no trust value is included in taxable in the grantor's estate. If the CRT is funded upon grantor's death, then it may be partially deductible for estate tax purposes.
Life Insurance:	Usually life insurance is used within a separate ILIT to replace the value of the charitable gift for the family.

### **Grantor retained annuity trust (GRAT), Grantor retained unitrust (GRUT), Qualified Personal Residence Trust (QPRT)**

Purpose:	To provide a grantor, spouse or others with income, then pass the remainder interest to others. It is funded during grantor's life. The income interest may continue for the life of the income beneficiaries or for a specified number of years. In a QPRT, the income interest is the use of the property.
Parties:	Income beneficiary is usually the grantor, possibly a spouse; the remainder beneficiary is typically children or a trust for children.
Income tax:	A grantor-type trust, so income is taxable to grantor..
TIN	Grantor's choice of grantor's SSN or EIN.
Estate tax:	If the grantor dies during the term of the trust, then the trust assets are included in the grantor's estate. If the grantor survives the term, then no trust value is taxable in the grantor's estate. Transfers by the grantor to the trust are treated as gifts equal to the present value of the remainder interest.
Life Insurance:	Usually life insurance is owned separately from a GRAT, GRUT or QPRT. However, a grantor may name an ILIT as the remainder beneficiary of a GRAT or GRUT, with the proceeds used to pay life insurance premiums or to repay loans incurred in split dollar or premium-finance arrangements.

### **Employer-sponsored retirement plan trusts for qualified plans (pension trusts) and non-qualified plans (Rabbi trusts)**

Purpose:	To keep trust assets out of common funds of the employer and available for employee retirement benefits. Assets in a pension trust are beyond the reach of creditors, while assets in a rabbi trust are subject to claims of the employer's creditors.
Parties:	The grantor is the employer. The trustee is the employer or third-party administrator. The beneficiaries are the covered employees.
Income tax:	Pension trusts are designated as income tax-free; rabbi trusts are treated as grantor type trusts and income is taxable to the employer.
TIN	EIN
Estate tax:	When a covered employee dies, his taxable estate includes the value of the benefits payable under the retirement plan.
Life Insurance:	These trusts may purchase life insurance on covered employees. Rules and taxation are governed by tax law, ERISA, and federal regulation.

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