

# TYPES OF TRUSTS– THE ULTIMATE GUIDE

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## **Introduction:**

Trusts can be confusing, if not down-right intimidating. That's because there are so many different types of trusts, with so many different purposes, and with so many different names. If you didn't know better, you'd think there were a million different types of trusts, with each one having its own rules and regulations. But, that's not the case at all! As intimidating as trusts appear to be, there is a relative simplicity that runs through them. That simplicity gives order and meaning to the various types of trusts that exist today, which, in turn, allows all of us to understand and appreciate the seemingly endless array of trusts before us.

## **Basic Concept of a Trust**

In order to understand the nature of trusts and the many different types of trusts that exist, it is important to understand the basic concept of a trust. In a general sense, a trust is nothing more than an arrangement whereby one person agrees to hold property for the benefit of another. We create trusts all the time without even thinking about it.

For example, how many times have you given money to a babysitter in case he or she needed something for the kids? In a strictly legal sense, your babysitter accepted the money and agreed to hold it and use it for their benefit. That is the essence of a trust - someone agrees to hold money or property for the benefit of someone else. In a pragmatic sense, you trusted your babysitter to hold on to the money and use it for the benefit of your kids. And, there probably was an implied understanding that whatever wasn't spent on the kids would be returned to you.

Every type of trust you'll ever confront - regardless of the name given to it - must have the same basic components as our babysitter example; i.e.:

- Someone must create the trust. We call this person the "grantor." Other people call the creator of a trust the "donor," or the "settlor," or the "trustor." All these terms are used interchangeably. In our baby sitter example, you were the grantor because you created the trust between yourself and your babysitter.
- Some other person or entity must agree to hold money and/or property for the benefit of someone else. We call this person the "trustee." There may be more than one trustee and the trustee need not be a person. It may be a corporation with trust powers, such as a bank.

In our babysitter example, your babysitter agreed to serve as the trustee.

- Some money and/or property must actually be held by the trustee for the benefit of someone else. We call this money or other property the "principal" of the trust. Some people also call this money or other property the "corpus" of the trust. The principal (or corpus) of the trust never stays the same; some is spent by the trustee, some is invested - earning dividends and interest, and some of the principal appreciates and/or depreciates in value. Collectively, we call all of this money and property the "trust fund."
- Someone else must benefit from the trust. We call this person the "beneficiary" of the trust. There may be more than one beneficiary. In that case, they are collectively called the "beneficiaries." In our babysitter example above, your children were the beneficiaries of the trust.

All types of trusts must have these four basic components.

## **Common Classifications of Trusts**

While all types of trusts must have the four basic components discussed above, they all don't have to contain the same property, they all don't have to have the same purpose, and they all don't have to be created in the same manner. It is these differences that give rise to the seemingly endless types of trusts that exist today.

This is actually a good thing. Since all types of trusts have the same four basic components, then the only distinguishing features are the manner in which they are created and the purpose for which they are created. It is these distinguishing features that allow us to differentiate the various types of trusts that exist today. In our babysitter example above, we know that the trust was created by a parent or guardian with minor children; that the trust was to exist for only a short time; that only a small amount of cash was involved; and that the sole purpose of the trust was to provide treats for the minor children while the parent or guardian was away. We could easily call this type of trust a "babysitter trust" and everyone would know what kind of trust it was simply by its name.

Today, trusts tend to be classified - or named - in one of three ways, although you may find other classifications as well. These three classifications are described below.

### **1. Living Trusts vs. Testamentary Trusts**

One of the most basic classifications of trusts is whether they become effective during the grantor's lifetime or whether they become effective only after the grantor's death.

A trust that becomes effective during the grantor's lifetime is called a "living trust" or an "inter-vivos trust." The term "inter-vivos" is a Latin term meaning "during life." Most living trusts, except informal trusts such as our babysitting trust discussed above, are generally created by a written instrument, which can be either a trust agreement or a declaration of trust. If the trust has a trustee other than the

grantor, then the trust instrument is called a "trust agreement" because both the grantor and the trustee must agree to the terms of the trust. However, if the grantor is the sole trustee, then the trust instrument is simply called a "declaration of trust," since the grantor is the only party to the trust.

On the other hand, a trust that is created under a Last Will and Testament is called a "testamentary trust." A testamentary trust, by definition, can only become effective after the testator's death because the Last Will and Testament does not become effective until that event occurs. Even then, the Last Will and Testament must be admitted to probate before it - and the testamentary trust created therein - becomes effective.

So, what's the significance of a living trust versus a testamentary trust? Other than the fact that a living trust becomes effective during the creator's lifetime and a testamentary trust becomes effective only after the creator's death, they both have the four basic components discussed above. Of course, there are differences that may be significant in certain circumstances, depending upon the specific objectives that one is trying to achieve. For example, testamentary trusts do not avoid probate because they become effective only after the grantor's death. Living trusts do avoid probate if properly funded during the grantor's lifetime. Because testamentary trusts are created under a Last Will and Testament, there are more formalities to creating - and changing - a testamentary trust than a living trust. Testamentary trusts are also more public than a living trust because a testamentary trust is part of a Last Will and Testament, which is a public document. Costs can also be a factor because a living trust requires a separate document, whereas a testamentary trust is part of a Last Will and Testament.

## 2. Revocable Trusts vs. Irrevocable Trusts

Another very basic classification of trusts is whether they are revocable or irrevocable. If the grantor reserves the right to revoke the trust after it becomes effective, including the right to change any of the terms or provisions of the trust, then the trust is said to be a "revocable trust." If the grantor gives up the right to revoke the trust after it becomes effective, including the right to change any of the terms or provisions of the trust, then the trust is said to be an "irrevocable trust."

Before we go any further, it is important to note that this classification only applies to living trusts. A testamentary trust is always revocable during a testator's lifetime because a Last Will and Testament cannot become effective until after the testator's death and after it has been admitted to

Probate. Once a testator has died and his or her Last Will and Testament has been admitted to probate, the underlying testamentary trust becomes irrevocable because the only person who could revoke it or terminate it is no longer living. So, when we talk about revocable trusts and irrevocable trusts, we're not talking about testamentary trusts - we're only talking about living trusts.

So, what's the difference between a revocable living trust and an irrevocable living trust? Well, to state the obvious once more, a revocable trust can be amended, revoked, terminated or changed at any time by the grantor. An irrevocable trust cannot be amended, revoked, terminated or changed by the grantor or anyone else once it becomes effective.

That seems rather obvious. But, just what is the significance of all that? Simply put, if you put some or all of your property into a revocable trust, you can get the property back any time you want. You can also change the terms and conditions upon which some or all of the beneficiaries will receive benefits under the trust. In short, when you create a revocable living trust and transfer some or all of your property to it, you still retain all the "incidents of ownership" to that property. You can sell it; you can give it away, you can change the beneficiaries of that property upon your death; and, you can determine how the property will be managed and invested while it's in the trust. In fact, if you really think about it, you don't give up any rights to your property when you transfer it to a revocable living trust. That's why you're still treated as the owner of the property for tax purposes.

Here's a descriptive analogy. Suppose you have an apple tree in your back yard. If you decide to dig it up and move it to another part of your back yard, have you changed your ownership of the tree? Of course not. You can still eat the apples or sell them if you wish. You can even cut down the tree and use it for firewood if you choose. That's the essence of transferring property to a revocable living trust.

An irrevocable living trust is a different story. If you transfer some or all of your property to an irrevocable living trust, you are giving up all your rights to that property. That's because an irrevocable trust is, by definition, one that you no longer have the right to amend, revoke, terminate or change. In other words, you give up all your rights to any property you transfer to an irrevocable living trust. It's the same as giving the property to another person with no strings attached.

Going back to our apple tree analogy above, let's suppose that, instead of moving the tree to another part of your back yard, you move it over to your neighbor's property. Whether you like it or not, the tree now belongs to your neighbor and you can't go over there and get it back - at least not without your neighbor's permission. And, guess who owns the apples growing on the tree?

Staying with this analogy for one more minute, who do you think the IRS will go after in each of these scenarios? If you simply move your apple tree to another part of your back yard (i.e., to a revocable trust), the IRS will come after you for its share of the apples. But, if you move the apple tree to your neighbor's yard, the IRS will be calling on your neighbors.

If you no longer own the property transferred to an irrevocable trust, why would anyone ever create one? Actually, there are many reasons for doing so. One common reason is to satisfy a property settlement as a result of a divorce or some other court decree. Many property settlements mandate that certain property be placed in trust, especially when minor children are the intended beneficiaries.

Many elderly persons, who are concerned about the high cost of nursing homes, also transfer their property to an irrevocable trust before they apply for Medicaid (Title XIX) benefits. In order to qualify, the property must be transferred to an irrevocable trust at least 5 years prior to filing the application and certain other requirements must be met as well. But irrevocable trusts are frequently used by elderly persons in an effort to avoid paying the high cost of a nursing home stay.

Many high-net-worth individuals also use irrevocable trusts to protect their property from the claims of creditors. Entertainers, professional athletes, doctors, and other high income people are particularly

vulnerable to law suits that result in high monetary judgments, and irrevocable trusts (particularly off-shore trusts or other types of asset protection trusts) are often used as a means of insulating property from these types of claims.

Perhaps one of the most common uses for an irrevocable living trust is the avoidance of federal estate taxes. In past years, individuals with large estates were subject to federal estate taxes as high as 55%. Even today, despite a personal exemption of \$2 million and tax rates reduced to 46%, the federal estate tax can be one of the largest expenses incurred by a decedent's estate.

One of the more common techniques to reduce the federal estate tax is to transfer property to an irrevocable trust. Transferring property to an irrevocable trust is the equivalent of making a complete gift of the property, since you don't have any right to get the property back or to alter or affect its use in any way once the transfer is made. Upon the grantor's death, the property is not subject to federal estate tax because the grantor no longer owns it.

We should mention, however, that the federal government treats a transfer of property to an irrevocable trust as a gift for federal gift tax purposes. Since the federal gift tax rates are substantially the same as the estate tax rates, it would seem that there is little to be gained by transferring property to an irrevocable trust. But, that is not necessarily the case. For example, property that is appreciating in value is often a good candidate for this type of transfer because the appreciation in value from the date of transfer to the date of death will be exempt from both the federal gift tax and the federal estate tax.

With this concept in mind, there is one type of property that is often placed into an irrevocable trust; i.e., a life insurance policy on the grantor's life. The death benefit payable upon the death of an insured is subject to federal estate taxes. If your estate is large enough to be subject to the federal estate tax, then owning a life insurance policy on your life will cause the death benefit payable to your designated beneficiaries to be taxed at rates as high as 35%. For example, if you have a \$1,000,000 insurance policy on your life and you die owning the policy, then the estate tax payable on that

\$1,000,000 death benefit will be approximately \$350,000 - leaving only \$650,000 for your beneficiaries. Of course, this assumes that your estate is larger than the applicable exclusion amount in the year of your death (THIS BENEFIT LIMIT CHANGES ANNUALLY)

This result can be avoided entirely by purchasing the life insurance policy through an irrevocable living trust or by transferring the policy to an irrevocable trust after the trust has been established. Yes, the value of the life insurance policy is considered to be a gift to the trust at the time of the transfer and that value is subject to the federal gift tax. But, what is the value of the policy at the time of the transfer? If it's a term policy, the value is absolutely zero! If it's a whole-life policy or any type of policy that builds a cash value, the value of the policy is the cash surrender value (or, more technically, the "interpolated terminal reserve" value) at the time of the transfer. In either case, there will probably be no gift taxes paid on the transfer. Then, upon your death, the entire death proceeds will be estate-tax free because you don't own the policy. Using our example above, if the \$1,000,000 insurance policy on your life is transferred to an irrevocable trust prior to your death, then the entire \$1,000,000 would be

payable to your beneficiaries and nothing would be payable to the U.S. Treasury - a savings of approximately \$460,000.

### 3. Classification of Trusts by Purpose

While the two basic classifications of trusts (i.e., living vs. testamentary and revocable vs. irrevocable) cover the various types of trusts in existence today, there is still one other form of classification that is used to distinguish one type of trust from another - that is, the purpose of the trust.

Every trust is established for a specific purpose, and that purpose will dictate the form and the basic provisions of the trust. For example, let's return to our babysitter trust discussed above. We just coined that name for the trust because it is descriptive of all trusts established for the benefit of minor children when their parents go out for the evening. So, what does the term "babysitter trust" tell us? First, we know that the trust is certainly a living trust. Second, we know that the trust is almost certainly a revocable trust. Third, we know that it is probably funded with a small amount of cash. Fourth, we know that it will probably last for only a few hours or, at most, a few days. Fifth, we know that the beneficiaries are most likely the grantor's minor children. Sixth, we can assume that the trust was probably created by an oral agreement between the parents and the babysitter.

You see how much information is conveyed by a descriptive title? Just knowing the purpose of the trust will give you a vast amount of information about the trust itself. Furthermore, the purpose of a trust is most often reflected in the name of the trust. For example, if the Smiths were creating the babysitter trust described above, they would probably call it "The Smith Babysitter Trust."

There is one further reason why different types of trusts are classified according to their purpose. Whether we like it or not, just about every trust has certain income tax and/or estate tax consequences associated with it. In fact, many trusts are established primarily to take advantage of certain income or estate tax benefits that are provided under the tax laws. In order to get those benefits, however, the tax laws require that certain terms and provisions be included in the trust instrument. As a result, all trusts that seek a particular tax benefit will be very similar to one another. Therefore, knowing the purpose of the trust will give you almost all the information you need about that trust without ever having to look at the trust instrument.

### Some Common Types of Trusts by Purpose

Here, then, is a short list of the more common types of trusts according to their purpose. In each case, we have included a brief description of the types of trust and some of the more common elements associated with their purpose. Though not all inclusive, this short list should provide a good basis for an understanding of all types of trusts that you may come across.

## **A/B Trusts**

An A/B Trust is any type of trust that splits into two separate and distinct trusts upon the death of the grantor. One of the separate and distinct trusts is a Credit Shelter Trust, which is designed to hold as much of the grantor's property as is sheltered from the federal estate tax by virtue of the unified credit i.e., \$2,000,000 for decedent's dying in years 2006, 2007, and 2008, and \$3,500,000 for decedent's dying in the year 2009. The other separate and distinct trust is a Marital Trust, which is designed to hold the remainder of the decedent's property, which is sheltered from the federal estate tax by virtue of the unlimited marital deduction. These separate and distinct trusts are designed to eliminate or reduce the federal estate tax liability of a married couple over the deaths of both spouses. An A/B Trust arrangement can be created under a living trust or a testamentary trust, since these provisions do not take effect until after the grantor's death. See "Credit Shelter Trusts" and "Marital Trusts." See also "Family Trusts" and "By-Pass Trusts."

## **Asset Protection Trusts**

An "Asset Protection Trust" is a type of trust that is designed to protect assets from the claims of creditors. There are two types of Asset Protection Trusts - a Domestic Asset Protection Trust (also known as an "Onshore Trust" or "DAPT") and a Foreign Asset Protection Trust (also known as an "Offshore Trust"). Both types of trusts are also referred to as "Self-Settled Spendthrift Trusts." Asset Protection Trusts are always irrevocable living trusts.

Both types of Asset Protection Trusts have come under considerable scrutiny from federal and state governments of late, especially since the passage of the Bankruptcy Reform Act, as it is popularly called. Accordingly, the continued viability of Asset Protection Trusts is the subject of considerable debate.

## **By-Pass Trusts**

A "By-Pass Trust" is another name for a Credit Shelter Trust. This type of trust is often called a "Credit Shelter Trust" because it shelters property from federal estate taxation by virtue of the unified credit. For the amount of property that can be placed in this type of trust and sheltered from federal estate taxation by virtue of the unified credit. Many people also refer to this type of trust as a "By-pass Trust" because the property placed in this trust is not subject to federal estate tax in the surviving spouse's estate. In other words, it "by-passes" the surviving spouse for federal estate tax purposes. The net result is that property placed in this type of trust (whether you call it a "Credit Shelter Trust" or a "By-Pass Trust" or a "Family Trust") is not subject to federal estate taxation in either spouse's estate.

A By-Pass Trust can be created under a living trust or a testamentary trust, since these provisions do not take effect until after the grantor's death.

## **Credit Shelter Trusts**

A Credit Shelter Trust is a type of trust that is used by married couples with large estates in order to avoid federal estate taxes upon the death of the first spouse to die. This type of trust is structured so



that, upon the death of the first spouse to die, the maximum amount of property sheltered from the federal estate tax (by virtue of the unified credit) is transferred to this trust. The trust is designed so that the assets in this trust will not be subject to the federal estate tax in the surviving spouse's estate upon his or her subsequent death. As a result, the assets placed in this trust upon the death of the first spouse to die will not be subject to federal estate taxes in either spouse's estate and will be transferred to other beneficiaries (normally the children) free of any estate taxes.

Even though the assets in a Credit Shelter Trust will not be taxed in the estate of the surviving spouse, the trust is designed in such a way that the surviving spouse can enjoy the benefits of the assets placed in this trust. For example, the surviving spouse can have the right to receive all the income of the trust during his or her lifetime. Although the surviving spouse cannot be given the right to demand any of the principal of the trust (an exception is the so-called "5 and 5 power"), the trustee can have the discretion to distribute principal to the surviving spouse for specified purposes.

This type of trust is also referred to as a "By-Pass Trust" because the assets placed in this trust effectively by-pass the surviving spouse for federal estate tax purposes. Some people also refer to this type of trust as a "Family Trust" in order to distinguish it from a "Marital Trust," which is established for the sole benefit of a surviving spouse.

A Credit Shelter Trust can be created under a living trust or a testamentary trust, since these provisions do not take effect until after the grantor's death.

## **Charitable Trusts**

A "Charitable Trust" is a type of trust that has one or more charitable beneficiaries. If properly established under federal tax laws, a charitable trust will entitle a grantor to deduct a portion of the amount contributed to the charitable trust as a current charitable income tax deduction. There are other tax benefits as well, depending upon the type of charitable trust established. For example, the amount passing to charity under a charitable remainder trust qualifies for a charitable estate tax deduction upon the death of the grantor. There are four types of charitable trusts; i.e., the charitable lead annuity trust (CLAT), the charitable lead unitrust (CLUT), the charitable remainder annuity trust (CRAT), and the charitable remainder unitrust (CRUT). In charitable lead trusts, one or more charities are paid a certain amount each year for a fixed number of years, with the remainder passing to non-charitable beneficiaries. In charitable remainder trusts, one or more non-charitable beneficiaries are paid a certain amount each year for a fixed number of years or for life, with the remainder passing to one or more charities.

A Charitable Trust can be created under a living trust or a testamentary trust; however, if any distributions are to be made during the grantor's lifetime, then the Charitable Trust must be an irrevocable living trust. See "split-interest trusts" below. See also "charitable lead trusts" and "charitable remainder trusts" above.

## **Charitable Split-Interest Trusts**

A "Charitable Split-Interest Trust" is a charitable trust that has both charitable and non-charitable beneficiaries. Since the interest of the charitable beneficiaries is separate from the interest of the non-charitable beneficiaries, these types of trusts are collectively referred to as a "Split- Interest Trust." In addition, there are different types of split-interest trusts, and each type is given a name that reflects the nature of the split interest. See, for example, Charitable Lead Trusts and Charitable Remainder Trusts. Charitable Split-Interest Trusts that meet the requirements of the federal tax laws are tax-exempt and irrevocable.

A Charitable Trust can be created under a living trust or a testamentary trust; however, if any distributions are to be made during the grantor's lifetime, then the Charitable Trust must be an irrevocable living trust. See "split-interest trusts" below. See also "charitable lead trusts" and "charitable remainder trusts" above.

## **Charitable Lead Trusts**

A "charitable lead trust" is a trust that provides for payments to one or more charities for a fixed number of years (lead interest). At the end of the charitable interest, the remainder of the trust assets passes to non-charitable beneficiaries (remainder interest). This is an example of a so-called "split-interest trust" whereby the present interest (lead interest) goes to one or more charities and the remainder interest goes to one or more non-charities. These trusts must comply with strict federal tax laws in order to receive favorable tax treatment (tax deductions for charitable contributions). However, a simple example of a charitable lead trust is as follows: Sam gives \$10,000 to a charitable lead trust he established. The trust instrument provides that 8% of the value of the trust is to be given to the American Heart Association each year for 10 years. After the 10 years, the trust terminates and the trust assets (the remainder interest) pass to Sam's children who are then living. See "split interest trusts" below.

## **Charitable Remainder Trusts**

A "Charitable Remainder Trust" is a trust that provides for payments of income and/or principal to one or more non-charitable beneficiaries for a fixed number of years or for life (lead interest). At the end of the lead interest, the remainder of the trust assets passes to one or more qualified charities (remainder interest). This is an example of a so-called "split-interest trust" whereby the present interest (lead interest) goes to non-charities and the remainder interest goes to charities. These trusts must comply with strict federal tax laws in order to receive favorable tax treatment (both income tax and estate tax deductions for charitable contributions). However, a simple example of a charitable remainder trust is as follows: Sam gives \$10,000 to a charitable remainder trust he established. The trust instrument provides that 5% of the value of the trust is to be given to Sam's son, Jim, during Jim's lifetime. Upon Jim's death, the trust will terminate and all the trust assets (the remainder interest) will pass to the American Heart Association. See "split interest trusts" below.

## **Charitable Remainder Annuity Trusts ("CRATs")**

A "Charitable Remainder Annuity Trust" ("CRAT") is a charitable remainder trust that pays a fixed dollar amount each year to the non-charitable (lead interest) beneficiaries. See "charitable remainder trusts" above. See also "charitable remainder unitrusts" below.

## **Charitable Remainder Unitrusts ("CRUTs")**

A "Charitable Remainder Unitrust" or "CRUT" is a charitable remainder trust that pays a fixed percentage of the value of the trust each year to the non-charitable (lead interest) beneficiaries. See "charitable remainder trusts" above. See also "charitable remainder annuity trusts" above.

## **Charitable Remainder Unitrusts with Net Income Make-up Provisions ("NIMCRUTs")**

A "Nimcrut" is a type of Charitable Remainder Unitrust that provides a net income make-up provision. A Charitable Remainder Unitrust generally provides an annual distribution of income to the non-charitable beneficiaries equal to a fixed percentage of the trust fund, say 5%. However, if the net income of the trust is less than the fixed payout percentage, then the trust payout is limited to the net income. A net income make-up provision allows the trust to "make-up" any such deficiencies during any year in which the net income of the trust exceeds the fixed payout percentage.

For example, assume that a charitable remainder unitrust is required to pay 5% of the value of the trust fund each year. In year 1, the trust has net income equal to 3% of the value of the trust fund. Its distribution to non-charitable beneficiaries during that year is limited to 3%. In year 2, the charitable remainder unitrust has net income equal to 9% of the value of the trust fund. In year 2, the trust can pay 5% to the non-income beneficiaries (which is its normal payout amount each year), plus it can pay an additional 2% to the non-charitable beneficiaries to "make-up" for the deficiency in year 1. Without the make-up provision, the payout to non-charitable beneficiaries in year 2 would be limited to 5% despite the deficiency in year 1.

## **Complex Trusts**

For federal income tax purposes, all trusts are classified as Simple Trusts or as Complex Trusts. A "Complex Trust" is any trust that is not classified as a Simple Trust. For the definition of a "Simple Trust," please see Simple Trusts below.

## **Constructive Trusts**

A "Constructive Trust" is a trust created by a court when no formal trust actually exists. For example, if a person has title to certain property and/or takes possession of certain property when the property rightfully belongs to another person, then the court may rule that the holder of the title is actually holding it as a constructive trustee for the benefit of the rightful owner. This can occur whenever a person acquires title to property through fraud, breach of faith, ignorance or inadvertence.

## **Crummey Trusts**

A "Crummey Trust" is a life insurance trust with certain provisions that allow gifts to the trust to qualify for the annual gift tax exclusion.

Initially, the IRS ruled that gifts of money to a Life Insurance Trust, which were used to pay premiums on life insurance policies held in the trust, did not qualify for the annual gift tax exclusion because the beneficiaries did not have a present interest in those gifts. The only interest they had was a future interest; i.e., when the insured died and the death proceeds were paid into the trust. Under the gift tax rules, the annual gift tax exclusion only applies to gifts of a present interest.

In order to get around this problem, a Mr. D. Clifford Crummey created a life insurance trust that prohibited the trustee from using any money gifted to the trust for at least 30 to 60 days after the gift was made. During that 30 to 60 day period, the beneficiaries were given the right to withdraw the money if they wished. If they didn't withdraw the money during the 30 to 60 day period, their withdrawal rights terminated and the money could then be used to pay the premiums that were due. Of course, the grantor never intended to have any of the money withdrawn from the trust during that 30 to 60 day period. That right was given to them solely to qualify the gift for the annual gift tax exclusion.

The IRS challenged these provisions in court, claiming that the right to withdraw the money was a sham because everyone knew that the money was needed for payment of the insurance premiums. Nonetheless, the IRS lost. The court stated that whether the beneficiaries actually withdrew the money or not, they had the right to do so - and that right is all that's needed to give the beneficiaries a present interest in the gift.

Today, an irrevocable life insurance trust that gives the beneficiaries the right to withdraw a gift for a pre-determined period of time in order to qualify it for the annual gift tax exclusion is called a "crummey trust."

## **Dynasty Trusts**

A "Dynasty Trust" is a type of trust that is designed to last beyond the time permitted by the Rule Against Perpetuities (</estate-planning-center/last-will-and-testament/what-the-experts-say/understanding-the-rule-against-perpetuities.html>), which is generally the lifetime of any beneficiary living at the time of the creation of the trust, plus 21 years. Dynasty Trusts are often designed to last forever, with generation after generation receiving distributions from the trust. A Dynasty Trust may be created under a revocable or irrevocable living trust or even a testamentary trust.

## **Generation Skipping Trusts**

A "Generation-Skipping Trust" is a type of trust that is specifically designed to hold the amount of property that is exempt from the generation-skipping tax (</resources/glossary-of-terms/glossary-of-terms-g.html>) under the federal estate tax laws.

A Generation-Skipping Trust may be created under a revocable or irrevocable living trust or even a testamentary trust.

## **Grantor Trusts**

A "Grantor Trust" is a trust under which the grantor or someone other than the grantor is treated as the "owner" for federal income tax purposes. As the owner of the trust for tax purposes, the grantor is required to report all income of the trust on his or her own income tax return each year and pay the income taxes on such income. A Grantor Trust does not file its own income tax return (Form 1041).

A grantor (or someone other than the grantor) is treated as the "owner" of a trust for federal income tax purposes if he or she retains certain interests in the trust or retains certain powers over the trust fund, as set forth in Sections 671-679 of the Internal Revenue Code including the following:

The right to a reversionary interest in either the trust property or the income of the trust.

The right to control the beneficial enjoyment of either the trust property or the income of the trust.

The power to make decisions respecting the trust property, including the right to vote stock, etc.

The power to amend or revoke the trust and take back the trust property.

Most revocable living trusts established for the purpose of avoiding probate or to provide for the management of assets in the event of incompetency are Grantor Trusts because the grantor generally

retains the right to amend or revoke the trust. In addition, the grantor is often the sole trustee, which gives the grantor the right and power to make decisions respecting the trust property.

A Grantor Trust is most often a revocable living trust, but can be an irrevocable trust under some circumstances. It is never a testamentary trust.

### **Grantor Retained Income Trusts ("GRITs")**

A "Grantor Retained Income Trust" ("GRIT") is a Grantor Trust in which the grantor transfers property in trust, but retains the right to receive the trust income for life or for a term certain. There are three types of GRITs in use today; the Qualified Personal Residence Trust ("QPRT"), the Grantor Retained Annuity Trust ("GRAT"), and the Grantor Retained Income Trust ("GRIT").

All three are similar in that the objective behind them is to reduce the valuation of property for federal estate tax purposes upon the death of the grantor. In all three, the federal estate tax laws require only that the income interest retained by the grantor be included in the grantor's estate upon his or her death for federal estate tax purposes. This generally represents a substantial discount from the full value of the property. GRITs, GRATs and QPRTs are irrevocable trusts that are heavily regulated by the federal income tax laws. A Grantor Retained Income Trust is always an irrevocable living trust.

### **Life Insurance Trusts**

A "Life Insurance Trust" is a type of irrevocable trust that is designed to hold life insurance on the life of the grantor or another person. The objective of a Life Insurance Trust is to exclude the life insurance proceeds payable on the death of the grantor from federal estate taxation. If a life insurance policy is owned by a grantor, the death benefits are included in the grantor's estate for federal estate tax purposes because the grantor has the power (among other things) to designate the beneficiary or beneficiaries to receive the death benefits under the policy upon his or her death. Life Insurance Trusts are attractive to individuals and couples with estates large enough to be concerned with federal estate taxes. A Life Insurance Trust is always an irrevocable living trust.

### **Qualified Personal Residence Trusts ("QPRTs")**

A "Qualified Personal Residence Trust" or "QPRT" is a type of irrevocable living trust that is designed to reduce the value of a personal residence for federal estate tax purposes upon the death of the grantor. A QPRT allows a grantor to transfer his or her home to an irrevocable living trust and still continue living in the home, while reducing the value for federal estate tax purposes. A QPRT is a form of a Grantor Retained Income Trust ("GRIT"). See Grantor Retained Income Trust above.

A Qualified Personal Residence Trust ("QPRT") is always an irrevocable living trust.

## **Qualified Terminable Interest Property Trusts ("QTIP Trusts")**

A "Qualified Terminable Interest Property Trust" or "QTIP Trust" is a type of Marital Trust that is designed for use by a grantor when a second marriage is involved. It allows the grantor to transfer property in trust for his or her surviving spouse estate-tax free by virtue of the unlimited marital deduction, even though the surviving spouse is not given the right to determine the beneficiaries of the property upon his or her subsequent death. A QTIP Trust is an ideal vehicle to provide for a surviving spouse while insuring that the property is ultimately distributed to your children upon the surviving spouse's death. A Qualified Terminable Interest Property Trust ("QTIP") can be created under a revocable or irrevocable living trust or a testamentary trust, since this type of trust does not become effective until the grantor's death.

## **Resulting Trusts**

A "Resulting Trust" is a type of implied trust that is created through operation of law, where the actions of the parties involved and the nature of the transaction implies an intention to create a trust. A resulting trust and an express trust are similar in that both require an intent to create a trust. A resulting trust often occurs when someone fails to give up his or her beneficial interest in property, which can be intentional or simply by accident.

## **Revocable Trusts**

A "Revocable Trust" is a type of living trust in which the grantor retains the right, during his or her lifetime, to amend, change, revoke or terminate the trust within his or her sole discretion. A Revocable Trust is the type of living trust that is generally created when the objective is to avoid probate or to provide for continuity of management of one's assets in the event of incompetence.

## **Simple Trusts**

For federal income tax purposes, all trusts are classified as Simple Trusts or as Complex Trusts. To be classified as a "Simple Trust," the following requirements must be met:

- The trust instrument must require that all income be distributed currently (i.e., in the tax year in which it is earned;
- The trust instrument must provide that no amounts are to be paid, permanently set aside, or used for charitable purposes; and,

- The trust must not distribute any amounts that are allocated to the corpus (principal) of the trust.

Both Living Trusts and Testamentary Trusts can qualify as Simple Trusts.

### **Special Needs Trusts**

A "Special Needs Trust" (also called a "Supplemental Needs Trust" or "SNT") is a trust that is established for a person who is receiving government benefits. The intent of a Special Needs Trust is to provide a source of funds for such person without disqualifying such person from such government benefits. Ordinarily when a person is receiving government benefits, an inheritance or a gift or even the receipt of a sum of money for damages in a personal injury law suit could reduce or eliminate the person's eligibility for such benefits. With a Special Needs Trust, a beneficiary can obtain certain luxuries and other benefits without defeating his or her eligibility for government benefits. Often a Special Needs Trust will include a provision that terminates the Trust if it makes the beneficiary ineligible for government benefits. A Special Needs Trust may be created under a revocable or irrevocable living trust, or a testamentary trust.

### **Spendthrift Trusts**

A "Spendthrift Trust" is any kind of trust that includes certain language giving the trustee wide latitude to avoid making distributions to beneficiaries when the distribution would go to a creditor, or when the trustee fears that the distribution would be wasted by the beneficiary. An example of a spendthrift provision is as follows:

"Spendthrift Provision. Except as otherwise provided by law, no power of appointment created hereunder shall be subject to involuntary exercise, and no interest of any beneficiary in the income or principal of any trust created hereunder shall be subject to assignment, alienation, pledge, attachment, or claims of creditors, including claims for alimony or support, until the same is distributed to such beneficiary or beneficiaries." A Spendthrift Trust may be created under a revocable or irrevocable living trust, or a testamentary trust.

### **Testamentary Trusts**

A "Testamentary Trust" is a trust created under a Last Will and Testament. As such, a Testamentary Trust is amendable and revocable at any time during the testator's lifetime, but becomes irrevocable upon the testator's death. Unlike a Living Trust, a Testamentary Trust does not come into existence until the testator's death and, accordingly, cannot be used to avoid probate or to provide continuity of management of the testator's property in the event of his or her incapacity.



## **Totten Trusts**

A "Totten Trust" is an informal type of trust that is created during the lifetime of the grantor by depositing money into an account at a bank or other financial institution in the grantor's name as the Trustee for another person. Money deposited into this type of bank account is not considered a completed gift until the grantor's death, or the happening of some other event that unequivocally reflects the gift during the grantor's lifetime.