The Irrevocable Trust

in depth

Northwestern Mutual®

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Including Sample Trust Agreements
by

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A Study Prepared for
The Northwestern Mutual Life Insurance Company

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THE IRREVOCABLE TRUST

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I. INTRODUCTION

Our country taxes the transfer of wealth at death. This tax is, of course, known as the estate tax. For some people, the estate tax is not a concern, because the property they transfer at their deaths is not valuable enough to be subject to the estate tax system. For others, the value of their property does subject them to estate taxes, but they are comfortable letting beneficiaries pay the tax out of their bequests. These people do not worry about funding their estate tax liability.

But other taxpayers do have these worries. Their estates contain assets that are both valuable and illiquid. A common example is the stock of a closely held business. This valuable stock may trigger a large estate tax liability at the owner's death. The personal representative could liquidate the stock to pay this liability, but the client may want the stock retained for the family. Further, there may be practical limitations on the personal representative's ability to find a willing and able buyer for the shares.

So what does the estate need? Cash to pay the estate taxes. When does it need the cash? At the owner's death when the liability is triggered. What pays cash at the owner's death? A life insurance policy that insures the owner's life. For that reason, life insurance is a perfect fit for providing estate liquidity.

If the taxpayer purchases insurance to fund the eventual estate tax liability, who should own the insurance? The natural choice is the taxpayer. But if the taxpayer owns the insurance, the death benefit will be included in the gross estate. The result is that up to half of the proceeds could be lost in additional estate taxes. If the spouse owns the policy, the death benefit (to the extent not expended during the spouse's life) is in the spouse's gross estate. If the spouse predeceases the insured, the policy's cash value is in the spouse's gross estate. Finally, if there is a divorce, the spouse could very easily walk away owning the policy, and it may not be available for its intended use: estate liquidity. Children could own the policy, but there are practical problems with that ownership structure as well: the children's creditors, divorce, premature death, or vagaries like substance abuse.

That's where the irrevocable trust comes in. The trust can be easily designed to own the policy, provide the appropriate estate with liquidity, and avoid inclusion of the trust property in either spouse's gross estate. At the same time, the trust can give the non-insured spouse virtually unlimited access to cash values during the insured spouse's lifetime, and to the death benefit proceeds after the insured's death.

While the irrevocable trust has planning advantages, it is not without drawbacks. The primary disadvantage is the grantor does not own the policy, so the grantor has no right to make decisions regarding the policy, including accessing the cash values. This does not mean the grantor, or the grantor's family unit, loses access to these values; rather the grantor personally gives up this authority. Another disadvantage is the trust is irrevocable. Once the grantor establishes the trust, the grantor gives up the power to make changes to the trust's terms. The grantor may alleviate some of these circumstances by drafting the trust with flexible provisions that allow the trustee, or another trusted individual, to react to changing circumstances.

II. GETTING THE POLICY IN THE TRUST

The client has determined the need for life insurance and wants an irrevocable trust to own the insurance. The client and advisors need to determine how the trust will come to own the policy.

A. Trustee Applies for the Policy

From an estate and gift tax perspective, the preferable timeline is:

1. The attorney completes the trust and the grantor and trustee sign the trust.

2. The trustee applies and pays for the policy.

3. The policy is issued to the trust as owner. [1]

Unfortunately, this "perfect" timeline is often not practical.

B. Trust Not Yet in Existence or Existing Policy

1. In General

The insured might want immediate life insurance coverage, but cannot get the trust drafted that quickly. Or perhaps the insured refuses to incur the necessary legal fees to draft the trust until insurability is determined. Another possibility is that the insured wants to transfer an existing policy to the trust.

2. Gift Tax Consequences

If the insurance is issued before the trust is executed, the policyowner will have to transfer the policy to the trust. If the owner gives the policy to the trust, the transfer is a gift to the trust and might trigger gift tax liability. If the trust gives beneficiaries a withdrawal right equal to the annual gift tax exclusion amount (colloquially known as a Crummey power),[2] then to the extent the value of the policy is less than those withdrawal rights, the transfer will not result in a taxable gift. If the value of the policy exceeds the withdrawal rights, the excess is a taxable gift.[3]

The value of a life insurance policy is established by examining the sale of that particular contract by the insurance company, or by looking at the sale of comparable contracts: in other words the contract's replacement cost.[4] The replacement cost of a single premium policy or a paid-up policy can be determined by the amount the company would charge for a single premium contract of that same amount on a person the insured's age.[5] The replacement cost of a new policy is the premiums paid (what the company would charge for a policy of that amount on an insured the same age). Finally, replacement cost is not readily ascertainable when the policy has been in force for some time and further premiums are payable. In that case, the policy's value can be approximated by adding the policy's interpolated terminal

[1] Backdating is an administrative procedure allowed by many insurance companies to "save age" for the insured. The policy is backdated to a date prior to the insured's age change to require a lower premium. Even though the "policy date" may predate the existence of the trust, backdating the policy purchased by the trust should not result in any adverse estate tax consequences. There may, however, be adverse gift tax consequences if the second annual premium comes due in the same calendar year.
[2] See Section III.A.3. *infra*.
[3] But the gift would not necessarily trigger gift tax liability because of the grantor's lifetime gift tax exemption. I.R.C. §2505.
[4] Treas. Reg. §25.2512-6(a).
[5] Treas. Reg. §25.2512-6(a); Example 3.

reserve to its unused premium and then subtracting any outstanding policy loans.[6] The policyowner can determine this value by requesting a Form 712 from the insurer. The policyowner should request the form to determine the policy's value prior to giving the policy away to avoid unpleasant gift tax surprises.

3. Estate Tax Consequences: The §2035 Issue

An individual's gross estate includes property owned at death, and property in which the individual has retained certain interests. If someone gives away an interest in property or relinquishes a power over property within three years of death, and if the property would have been included in the decedent's gross estate under Sections 2036, 2037, 2038 or 2042 if the transfer had not been made (or the power had not been relinquished) the decedent's gross estate will include the value of that property.[7]

For example, Dad is the grantor of a revocable trust. Because of his power to revoke the trust, Dad realizes that if he dies, the trust property is included in his gross estate.[8] Therefore, Dad amends the trust to make it irrevocable. Dad dies two years later. The trust's date of death value is in Dad's estate under §2035(a)(2), because Dad (1) relinquished a power (the right to revoke) within three years of death and (2) if he had not relinquished that power, the trust property would have been included in Dad's gross estate under §2038.

Another example. If someone:

a. Owns a policy of insurance on his life (or has any incidents of ownership in that policy),

b. Gives that insurance policy away (or relinquishes the incidents of ownership),

c. Dies within three years of that gift, and

d. A death benefit is collected on that policy,

then the death benefit is included in the insured's gross estate. So if Mom owns a policy on her life, transfers it to an irrevocable trust and dies two years later, through §2035, the entire death benefit is included in Mom's estate.

4. Potential Solutions for the "Three Year Problem"

a. Accept the §2035 Risk

The simplest, and perhaps most practical, way of getting the policy into the trust is to have the insured own the policy initially and then give the policy to the trust. If the transfer is within the policy's first year, the gift tax consequences are the same as if the trust had originally owned the policy. If the insured/grantor dies within three years from the date of transfer, however, the death benefit will be included in the insured's gross estate under §2035(a)(2). This is a fact but is it, in fact, a problem?

The benefit of applying for the insurance policy on a prepaid basis as soon as possible is that if the insured dies after the application is submitted, a death benefit will be paid (presuming the client was insurable). Coupled with the benefits of getting insurance protection in place immediately is that if the

[6] Treas. Reg. §25.2512-6(a); Example 4.
[7] I.R.C. §2035(a)(2).
[8] I.R.C. §2038. See Section III.B.2.d. *infra* for a more complete discussion of inclusion of property in the decedent's gross estate under I.R.C. §2038.

insured is, say, forty years old, and has just qualified for life insurance, the probability is low that he or she will die in the next three years. Even if the insured is seventy, the insured more likely than not will outlive the three-year window.

Even if the grantor does not live three years beyond the date the policy is transferred, there might not be an *immediate* estate tax liability, because of the unlimited marital deduction. The grantor can design the irrevocable trust with a "marital deduction savings clause." Under this clause, if the death benefit is included in the grantor's gross estate, the trust property is distributed either directly to the spouse or to a trust that will qualify for the marital deduction. The trust should not require the proceeds to be paid to the decedent's probate estate or a revocable trust, because that could cause the entire death benefit to be included in the insured's gross estate even if he lives beyond three years from the date of transfer (in other words the proceeds should be paid to or for the benefit of the spouse pursuant to the irrevocable trust.)[9] If the proceeds are paid to the spouse or a marital trust, the ultimate goal of keeping the proceeds out of both spouses' estates will be defeated, but at least the potential estate tax liability will be deferred until the surviving spouse's death.

What if the grantor is not married? Assume the insured purchases a policy with a $2,000,000 death benefit and a $40,000 annual premium. The insured transfers the policy to an irrevocable trust in year one and dies in year two. The trust receives a $2,000,000 death benefit, but because of §2035 the death benefit is included in the insured's estate. Presuming a 50% estate tax rate and a tax sharing clause that places liability for the estate tax on the trust (the recipient of the death benefit), the trust will be left with $1,000,000. Given a total premium outlay of $80,000, the economic rate of return to the trust is roughly 353%. Even a novice investor recognizes that this rate of return cannot be practically achieved with any investment. Therefore, from an economic perspective, simply accepting the §2035 risk is not an unsound choice considering the alternative might be that no life insurance proceeds are payable at all (e.g., the client becomes uninsurable or dies before the policy is in force).

b. Apply for a Non-prepaid Policy

If the insured wants to determine insurability before incurring legal fees to have the trust drafted, the insured can apply for the policy on a non-prepaid basis. The insurance company will gather underwriting information, then provide an informal opinion on the insured's risk classification. If the insured receives a favorable opinion, the trust can be drafted, executed, and can then apply for the insurance.

Even though a non-prepaid application starts the underwriting process, the insured owns no specific policy rights. The right to apply for insurance is not an incident of ownership. Therefore, if the insured dies within three years of the policy's issue date, the death benefit is not included in the insured's estate.[10]

The disadvantage of using this method is that no insurance coverage exists until a premium is paid.[11] If the insured dies, no death benefit will be payable. If the insured's risk classification changes before that

[9] Treas. Reg. §20.2042-1(c)(3) provides that an incident of ownership in a policy includes a reversionary interest in the policy or its proceeds if the value of that reversionary interest, immediately before the insured's death, exceeds 5% of the policy's value. A reversionary interest includes the possibility that the policy or its proceeds may return to the decedent or his estate or be subject to a power of disposition by him. A trust provision that potentially pays the death benefit to the insured's gross estate or revocable trust is a reversionary interest and, if sufficient in value, an incident of ownership. That incident of ownership lapses when three years have passed from the date the policy is given away. This might trigger a new three year period from the lapse of that incident of ownership. Basically, due to the fact that the reversion itself is an incident of ownership, the three year problem might never go away. Therefore, having the proceeds payable to the decedent's gross estate or a revocable trust should be avoided, to prevent any risk of inclusion in the decedent's gross estate after the three year period has expired.

[10] Rev. Ruling 76-421, 1976-2; Priv. Ltr. Rul. 93-23-002 (February 24, 1993).

time, the trust could be saddled with higher premiums than if the insured had "locked-in" the premiums with a prepaid application. Even worse, the client may become uninsurable.

To protect family members during this interim period, the insured can purchase term insurance. When the trust obtains permanent coverage, the owner can allow the term policy to lapse. To avoid the three-year rule, the insured should not, however, convert the term policy to a permanent policy. The insured should also take steps to avoid the appearance that "in substance" the lapse of the term policy and the issuance of the permanent policy is a conversion.[12] Two practical tips to avoid a "deemed conversion:" have different amounts for the two policies and do not exactly coincide the dates of lapse and issuance of the new policy (have some overlap).

c. Have a Third Party Apply for the Policy and Transfer it to the Trust

The insured does not have to own the policy. If the insured wants immediate insurance coverage, someone else with an insurable interest, such as the spouse or an adult child, can own the policy. When the trust is executed, that person can transfer the policy to the trust. If the insured dies before the trust is executed, and the third party still owns the policy, the death benefit will not be included in the insured's gross estate. Further, if the insured dies within three years of the transfer, the proceeds will not be included in the insured's gross estate, because the insured never possessed any incidents of ownership.[13]

There can be serious problems with this plan. First, if the insured dies before the policy is transferred to the trust, to the extent any policy beneficiaries are not policyowners, the proceeds are a taxable gift from the policyowner to the beneficiaries.[14] This can be avoided by making the owner(s) the beneficiary(ies).

Second, when the policyowner transfers the policy to the trust, that owner becomes a trust grantor. If that owner also has an interest in the trust, part or even all of the trust value can be included in his or her gross estate.[15] Of course, this is not an issue if the trust terminates before the beneficiary's death, but could be an issue if the trust is designed to be in force for more than one generation (for example, a generation-skipping or dynasty trust).

d. Have the Trust Surrender the Policy in a §1035 Exchange

A viable, but untested, solution is to have the insured apply for and own the policy. When the trust is executed, the insured transfers the policy to the trust. The trustee exchanges the policy for a new policy in a §1035 tax-free exchange.

A tax-free exchange is a surrender of the old policy, with a contribution of the surrender proceeds into a new life insurance policy. Section 1035 makes that otherwise taxable event (a policy surrender) non-taxable. Section 1035 does not, however, alter what has legally happened; the policy that the grantor possessed incidents of ownership in (the old policy) no longer exists, and the policy that does exist is one in which the grantor never possessed any incidents of ownership.[16]

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[11] At which time, the insured is covered on a contingent basis. That is, if the insured dies between the prepaid application and the policy issue date, the insurance company will pay the death benefit if, based on the company's underwriting standards, it would have issued the policy.
[12] Priv. Ltr. Rul. 91-47-007 (June 19, 1991).
[13] I.R.C. §2035(a)(2).
[14] *Goodman v. Comm'r*, 156 F.2d 218 (2nd Cir. 1946).
[15] I.R.C. §§2036 and 2038.
[16] It is now clear that for the policy proceeds to be included in the grantor/insured's estate under §2035, the grantor must have actually possessed an incident of ownership *in that policy* within three years of his death. *Estate of Leder v. Comm'r*, 893 F.2d 237 (10th Cir. 1989); *Estate of Perry v. Comm'r*, 927 F.2d 209 (5th Cir. 1991); A.O.D. 1991-012 (July 3, 1991).

e. Sell the Policy to the Trust

Finally, the three-year rule only applies when the transfer is not a bona fide sale for adequate consideration.[17] The three-year rule will be avoided if the grantor sells the policy to the trust for its fair market value.

To do this, the grantor can make a gift to the trust equal to the policy's value (the premiums paid to date in the first policy year). The trustee uses that money to purchase the policy from the grantor. This approach raises two income tax issues.

First, because the policy is being sold, if the sale price exceeds the grantor's basis in the policy, the grantor may recognize taxable income. Second, because a life insurance policy is being transferred "for valuable consideration," the transfer for value rule might apply.[18] Under that rule, if a life insurance policy is transferred for valuable consideration, the death benefit is taxable to the extent it exceeds the consideration paid plus subsequent premiums.[19] The death benefit, however, will not be taxed if the transfer fits within an exception to the transfer for value rule.[20]

Both problems can potentially be avoided by designing the trust as a "grantor trust" for income tax purposes.[21] The grantor trust rules are contained in §§671-679. Section 671 provides that if the grantor (or another person) is treated as the owner of a trust, or any portion of a trust, the income of that trust (or portion of that trust) is included in the grantor's taxable income.[22] Sections 673 through 679 contain rules to determine whether the grantor "owns" the trust for income tax purposes.

The trust can be designed as a grantor trust for income tax purposes, but still avoid inclusion in grantor's estate. For example, if the trust authorizes the trustee (without the consent of an adverse party) to use trust income to pay life insurance premiums on policies insuring the life of the grantor and/or his spouse, the trust is a grantor trust.[23] That provision, by itself, will not cause the trust corpus to be included in the grantor's estate. The problem with relying solely on this provision in designing the trust is that courts have held that, despite the statutory language, the grantor may be the owner of only part of the trust if the trust income is not actually used to pay premiums or if the trust generates more income than is necessary to pay premiums.[24] To insure that the grantor is the owner of the entire trust for income tax purposes, the practitioner may want to grant the insured (or some other individual), acting in a non-fiduciary capacity, the right to substitute property of an equivalent value.[25]

By designing the trust as a grantor trust, sometimes known as an "intentionally defective grantor trust,"[26] the sale of the policy to the trust will not result in taxable income to the grantor.[27] For income tax purposes, the owner of the grantor trust's property is the grantor; therefore, a sale is not recognized when

[17] I.R.C. §2035(d).
[18] I.R.C. §101(a)(2).
[19] *Id*.
[20] I.R.C. §§101(a)(2)(A) and (B).
[21] I.R.C. §§671-677.
[22] I.R.C. §671.
[23] I.R.C. §677(a)(3).
[24] *Iversen v. Comm'r.*, 3 T.C. 756 (1944); *Moore v. Comm'r*, 39 B.T.A. 808 (1939), but see also LAFA 2006-27-01F (July 7, 2006).
[25] I.R.C. §675(4)(C); *Jordahl v. Comm'r*, 65 T.C. 92 (1975).
[26] "Defective" because the trust is a grantor trust, so it has a "defect" for income tax purposes. "Intentional" because the taxpayer seeks precisely this result.
[27] Rev. Rul. 85-13, 1985-1 C.B. 184; Priv. Ltr. Rul. 2002-28-019 (July 12, 2002).

the grantor transfers property to himself.[28] This can be particularly helpful when the grantor wants to transfer a policy that has been in existence for some time. While the grantor can take policy loans to drive the gift tax value of the policy down, the gain from an income tax perspective is not reduced, because the gain is, in effect, measured by the *gross* cash value minus basis. Using a grantor trust allows the grantor to avoid recognizing the gain.

A sale to a grantor trust should also avoid transfer for value concerns. The transfer for value rules do not apply if the transferee is the insured[29] or if the transferee's basis in the policy is determined, in whole or in part, by reference to the transferor's basis.[30] The Eighth Circuit has held that a sale to a grantor trust is a transfer to the insured for purposes of the transfer for value rule.[31] Much has been made, however, about the risk of relying on the *Swanson* decision, particularly because (1) the Eighth Circuit's reasoning places a strong focus on the grantor/trustee's control over the policy's incidents of ownership once the policy was in the trust and (2) the IRS has never acquiesced in the *Swanson* decision.

The policy-selling grantor does not have to rely on *Swanson* for an exception to the transfer for value rule. The IRS has ruled that the sale of property between a grantor and grantor trust is not recognized for income tax purposes.[32] Even though there is, in fact, a transfer, because it is ignored for income tax purposes, there is no transfer for value.[33] Additionally, because the transfer is disregarded, the grantor's basis in the policy carries over to the trust and the so-called carryover basis exception (often referred to as the "gift" exception) will exempt the sale from the transfer for value rules, and the trust will receive the death benefit income tax-free.[34]

A transfer to a partner of the insured is also an exception to the rule.[35] If the insured owns interests in a partnership, limited partnership, or a limited liability company (taxed as a partnership), a portion of those interests can be transferred to the trust prior to the sale of the policy. The trust will be a partner of the insured at the time of the sale, and the transfer for value rule will not apply.[36] To avoid giving the trust management authority and burdening it with joint and several liability, if possible, the trust's interest should be a limited partner interest or a limited liability company interest (particularly in a manager managed limited liability company).[37]

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[28] Rev. Rul. 77-402, 1977-2 C.B. 222.
[29] I.R.C. §101(a)(2)(B).
[30] I.R.C. §101(a)(2)(A).
[31] *Swanson v. Comm'r*, 518 F.2d 59 (8th Cir. 1975).
[32] Rev. Rul. 85-13, 1985-1 C.B. 184.
[33] Priv. Ltr. Ruls. 2006-36-086 (September 8, 2006); 2006-06-027 (February 10, 2006); 2005-18-061 (May 6, 2005); 2005-14-001 and 002 (April 8, 2005); 2002-47-006 (November 22, 2002), and 2002-28-019 (April 10, 2002).
[34] I.R.C. §101(a)(2)(A).
[35] I.R.C. §101(a)(2)(B).
[36] I.R.C. §101(a)(2)(B).
[37] Priv. Ltr. Rul. 1999-05-010 (February 8, 1999); Priv. Ltr. Rul. 97-25-007 (June 20, 1997).

III. TRUST OPERATION AND ADMINISTRATION

A. Paying Premiums

1. In General

The trustee has now agreed to have the trust own the insurance on the grantor's life. How is the trustee going to pay for the insurance? To answer that question completely, it is best to break this situation down into its fundamentals. A person decides to purchase an asset. How does that person pay for it?

First, that person can use ready funds to purchase the asset. If those funds are not sufficient to purchase the asset, someone can make a gift to our purchaser. If no one is willing to make that gift, the purchaser may be able to borrow the funds to buy the asset.

The trustee is no different. The trustee can use the assets in the trust to pay premiums. If there are insufficient assets in the trust, the grantor can make gifts to the trust. The grantor can make a single gift of property with the hope that the income from that property will be sufficient to pay premiums. Or the grantor can make annual gifts to the trustee as premiums come due. Finally, the trustee can borrow money to pay premiums, from a bank, the insured's business, or directly from the insured. Let's look at these possibilities.

2. Fund the Trust to Pay Premiums

Not every person wants to make annual gifts and give family members the annual right (and perhaps a lingering right with hanging powers) to withdraw the gift. Some would rather make one large initial gift to the trust, and then let the trustee use that property and its earnings to pay premiums.[38]

For example, let's assume that Dad has determined that he wants the trust to own a policy on his life with a death benefit of $5,000,000. Assume that based on Dad's age and health, the policy will have a $100,000 annual premium. Dad wants to transfer sufficient property so the trustee can use the earnings to pay premiums.[39] If Dad transfers assets that have a 10% annual rate of return, he will have to transfer assets with a $1,000,000 value to have sufficient earnings to pay the premiums. He can use Crummey powers to qualify part of that $1,000,000 transfer for the annual exclusion, and allocate some of his $1,000,000 lifetime gift tax exemption to the rest. If the asset continues to perform at the expected rate of return, Dad will never have to make another gift to the trust to pay premiums.

Of course, if the trust is funded, the trust generally will generate taxable income. If the trust is liable for the tax this reduces the earnings available to the trustee to pay premiums. With a funded trust, however, the trust generally will not be liable for the taxes, because most of the time the trust will be a grantor trust for income tax purposes.[40] The grantor, rather than the trust, will be responsible for the income tax liability generated by the trust's assets.[41]

Funded trusts can be a good fit with owners of a family business organized as an S corporation. Let's say Mom is a widow and sole owner of an S corporation. The S corporation has been recently valued at

[38] In some cases it may not be possible to make an upfront gift to the trust. Instead, the grantor may be able to sell assets to the trust in exchange for a promissory note. The trustee can then use income from the property sold to pay interest on the note and the premiums. The trust will need to repay the note principal at some point in the future.
[39] The trust could also use the principal to make premium payments as long as the trustee determined that sufficient assets would continue to be available to pay premiums.
[40] I.R.C. §677(a)(3).
[41] I.R.C. §671.

$9,000,000, and has a historic 8% internal rate of growth. Mom wants to insure her life for $5,000,000, leave the business to her three children who all work in the business, and have that insurance owned by an irrevocable trust.

When she dies, the trust can buy assets from the estate (primarily S corporation stock), leaving the estate with $5,000,000 in cash to meet Mom's anticipated estate tax liability.

After running the life insurance illustration, Mom's life insurance agent informs her that the premium will be $100,000 annually. Mom has three children and seven grandchildren; all are trust beneficiaries. So Mom can make a $100,000 annual gift to the trust, give all ten beneficiaries a $10,000 withdrawal right and qualify the entire gift for the annual exclusion. But Mom is already using her annual exclusion to make gifts of S corporation stock to her children, and has used her next five years of annual exclusion gifts to make contributions to a §529 plan for her grandchildren.

Mom does have her entire $1,000,000 lifetime gift tax exemption intact. She can transfer $1,000,000 in cash to the trust. The trustee can use the income to pay premiums. The problem is that under current market conditions, the trustee is unsure of obtaining an asset that has the requisite 10% annual rate of return.

But Mom does not have to make a gift of cash to the trust; she can give the trust S corporation stock instead. The problem appears to be that the stock's rate of return is insufficient. Because the stock is returning 8% a year, Mom must give the trust stock with a value of $1,250,000 for the trust to return $100,000 a year to pay premiums. But the S corporation is worth $9,000,000, so stock that represents $1,250,000 in liquidation value constitutes a minority of the Company's overall shares (specifically 13.89%). Therefore, when Mom gives these shares to the trust, she is entitled to take some discounts, such as for lack of marketability and control.

Taking a conservative discount of 30%, shares with a liquidation value of $1,250,000 have a fair market value of $875,000. In fact, if Mom is willing to use her entire $1,000,000 gift tax exemption, she can transfer stock with a $1,428,000 liquidation value to the trust. The stock can return a little more than 7% in a year and still be able to meet the premium obligation, giving the trustee some buffer if the business underperforms.

3. Have the Grantor Make Annual Gifts to Pay Premiums

Many grantors do not own assets that they are willing or able to contribute to a trust in one lump sum to allow the trustee to pay premiums. It is much more common for the grantor to make annual gifts to the trust to provide the trustee money to pay the annual premiums as they come due.

A gift to a trust is a gift to the trust beneficiaries.[42] Because a gift to a trust does not qualify as a present interest gift, the grantor will not get the benefit of the annual gift tax exclusion under §2503(b).[43] The gift can qualify, however, for the annual gift tax exclusion if the beneficiaries are given an immediate right to withdraw ascertainable amounts cumulatively equal to the value of the gift to the trust.[44] This right has

[42] Treas. Reg. §25.2503-2(a).
[43] Treas. Reg. §25.2503-3(c).
[44] Rev. Rul. 80-261, 1980-2 C.B. 279. Of course, each beneficiary's withdrawal right should be limited to the grantor's annual exclusion or if it is expected that the grantor's spouse will elect to split gifts, to an amount double the annual exclusion. If the grantor is married and gift-splitting is anticipated, the withdrawal right should be drafted to presume gift-splitting, and not be dependent on the grantor's spouse consenting to gift-splitting. By definition, the spouse cannot elect to split gifts at the time of the gift, but rather must wait until the gift tax return is filed. This delay could place the annual exclusion at jeopardy, because a Court could hold the withdrawal right is not immediately exercisable.

become known as a Crummey power, named after the case upholding the use of a withdrawal right to qualify a gift to the trust for the annual gift tax exclusion.[45]

a. The *Crummey* Case, its Progeny, and the Real Legal Standard

In *Crummey*, the Ninth Circuit had to choose which legal standard to apply in determining whether a gift to a trust coupled with a withdrawal right qualifies as a present interest gift. The IRS argued that the Court should focus on the likelihood of withdrawal: if the facts and circumstances indicate that the beneficiary will not withdraw the gift, the gift is one of a future interest.

But the Ninth Circuit did not accept the IRS's fact-dependent test. Instead, the Court adopted the taxpayer's argument: if the beneficiary has the right to demand withdrawal of the gift that cannot be legally resisted by the trustee, the gift is a present interest qualifying for the annual exclusion. Since *Crummey,* the Tax Court has consistently applied this standard.

For example, in *Estate of Cristofani*,[46] the Tax Court held that likelihood of exercise is not the test for determining whether the beneficiary receives a present interest. Rather, if the beneficiary has the power to withdraw trust corpus, and the trustee cannot legally resist a beneficiary's demand for payment, the gift is one of a present interest.[47] Again, the Tax Court held in *Estate of Kohlsaat*[48] that gifts to a trust are present interest gifts where the beneficiaries have unrestricted rights to demand immediate distributions of trust property.[49] Once more, in *Estate of Holland*,[50] the Tax Court confirmed that the correct test is whether the beneficiary's demand right can be legally resisted.[51]

Courts have uniformly held that there are only two factors in determining whether a gift to a trust qualifies as a present interest:

i. Does the beneficiary have the immediate right to withdraw an ascertainable amount?

ii. Can the trustee legally resist that right?

If the answer to 1. is yes and to 2. is no, the gift will qualify for the annual exclusion, and the likelihood of a beneficiary exercising the right is disregarded.[52]

b. Contingent Beneficiaries

i. In General and The IRS Position

While courts have consistently held that a present interest gift exists when the beneficiary has a demand right that cannot be legally resisted, the IRS continues to focus on particular facts to determine the likelihood of exercise. A factor the IRS finds dispositive is whether the beneficiary has a vested interest

[45] *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).
[46] *Estate of Cristofani v. Comm'r*, 97 T.C. 74 (1991).
[47] *Cristofani*, 97 T.C. at 83.
[48] *Estate of Kohlsaat v. Comm'r*, 73 T.C.M 2732 (1997).
[49] *Kohlsaat*, 73 T.C.M at 2734.
[50] *Estate of Holland v. Comm'r*, 73T.C.M. 3236 (1997).
[51] *Holland*, 73 T.C.M. at 3236-37.
[52] While the Tax Court has not strayed from this legal standard, language in a recent case could give the IRS hope that the Tax Court may be amenable to a facts and circumstances test in the future. *Estate of Trotter v. Comm'r*, 82 T.C.M. 633 (2001). In language unnecessary to its holding (i.e., dicta), the Tax Court does seem to question the viability of a Crummey power when its exercise is unlikely. The dicta is unfortunate since it could be read to challenge the long standing position of not only the Tax Court but a higher court (the Court of Appeals) in a case where the language had no bearing on the Court's opinion.

in the trust. If not, the IRS believes there is no rational reason the beneficiary would not exercise the withdrawal right and that the beneficiary must have agreed prior to receiving the withdrawal right not to exercise it. Result? Denial of the annual exclusion.

The IRS's position is well documented in three private letter rulings.[53] In each ruling, Mom and Dad establish a trust for the benefit of children, with contingent interests for grandchildren. All children and grandchildren are given Crummey powers. Mom and Dad make annual gifts equaling the maximum total withdrawal powers of the Crummey beneficiaries. For example, taking the current annual exclusion amount of $12,000 per beneficiary per year, if Mom and Dad have three children and seven grandchildren, they can make $240,000 of annual exclusion gifts every year. ($24,000 x 10 Crummey beneficiaries)

In all three rulings, the IRS rejected the annual exclusion for gifts to the grandchildren. The IRS's position is simple (and simplistic): no person in his right mind turns his back on $12,000 (or whatever the actual amount is) when the money ends up in a trust in which that person has no vested rights.

In fact, the IRS has held "there is no imaginable reason why one of them (the grandchildren) would not have exercised his withdrawal rights unless there existed some kind of an understanding with the Donors that no one would do so, or they knew that doing so would result in undesirable consequences."[54]

The IRS's position on this issue is as practically unsound as it is legally wrong. There are a variety of reasons why grandchildren might turn their back on a mere $12,000. Suppose the $12,000, if left in the trust, will pay premiums on a life insurance policy that will explode into millions of dollars of income and estate tax-free wealth (maybe to replace millions of dollars lost to estate taxes in the grandparent's estate or to keep a family business running). These grandchildren are most likely the beneficiaries of their parents' estates, so any act they take that increases the value of that wealth will eventually benefit them.

The grandchildren may also feel a moral (but not legal) obligation to the grandparents and parents to help effectuate the grandparents' estate plan. This moral obligation does not impede their legal right to withdraw.

ii. The IRS Loses: Cristofani

The Tax Court was not persuaded by the IRS's position either. The IRS first litigated its contingent beneficiary theory in *Cristofani*.[55] The facts in *Cristofani* were identical, in pertinent part, to the facts in the IRS's contingent beneficiary private letter rulings. Maria Cristofani created a trust for the primary benefit of her two children, but she gave Crummey withdrawal powers to her five grandchildren as well (a total of seven annual exclusion gifts). The grandchildren were contingent beneficiaries of the trust; they would only receive trust distributions if their parent predeceased them before the trust terminated.

The IRS invoked the same tired "nobody in their right mind" litany and denied the annual exclusion gifts to the grandchildren. The Tax Court, however, rejected the IRS's argument. The Tax Court reminded the IRS of the legal standard from *Crummey*: "Is there a power to withdraw that cannot be legally resisted by the trustee?"[56] The Tax Court found that each grandchild had such a right. The Tax Court granted the annual exclusions.

[53] Priv. Ltr. Ruls. 87-27-003 (March 16, 1987); 90-45-002 (July 27, 1990) and 91-41-008 (June 24, 1991).
[54] Priv. Ltr. Rul. 90-45-002 (July 27, 1990).
[55] *Estate of Cristofani*, 97 T.C. at 82.
[56] *Id*.

iii. The IRS's Non-Acceptance

After *Cristofani,* the IRS stubbornly held its position denying the annual exclusion when withdrawal powers are given to contingent beneficiaries.[57] The IRS warned that it would "litigate other cases whose facts indicate a greater abuse of the Crummey Power than those of *Cristofani*." The IRS expressed disagreement with the Tax Court's "sweeping interpretation" of the *Crummey* case, and implicitly criticized *Crummey* itself for finding that a "mere legal right" to demand a distribution was sufficient for a present interest gift.

Then, just to show it was really serious, four years later the IRS issued another, almost identical, Action on Decision.[58] The IRS again disagreed with the Tax Court's "sweeping interpretation of *Crummey*." The IRS stated, "to extend the benefit of the annual exclusion to illusory gifts of present interests would undermine significantly the unified system of estate and gift taxation." The IRS warned that it would litigate cases where facts indicate that the substance of the transfer was merely to obtain annual exclusions, and that no bona fide gift of a present interest is intended.

Why the second Action on Decision? It's possible the IRS was seeing a rash of situations where Crummey powers were being given to contingent beneficiaries, and wanted to reissue its warning. Another possibility is that the IRS wanted to issue a broader warning to taxpayers in the 1996 Action on Decision, and not limit its warning to just contingent beneficiary situations, but to cases where "no bona fide gift of a present interest was intended."

iv. The IRS Loses Again - Kohlsaat

In 1997, the IRS yet again litigated its denial of the annual exclusion where Crummey powers were given to contingent beneficiaries, and again it lost.[59] Lieselotte Kohlsaat created a trust primarily to benefit her two children. Ms. Kohlsaat made a gift to the trust, and gave Crummey withdrawal rights not only to her two children, but also to her daughter-in-law, her seven grandchildren and her eight great-grandchildren. The IRS denied the annual exclusion on these sixteen gifts because the donees were only contingent trust beneficiaries.

Once again, the Tax Court reminded the IRS that the applicable standard is whether the beneficiaries have a legal right to withdraw, not whether they are likely to exercise the right. Again, the Tax Court upheld the annual exclusion.

v. Practical Tips

As a two-year old might say, the IRS is "wrong, wrong, wrong." All that is required for the annual exclusion is (1) the right to make a demand (2) that cannot legally be resisted. Simply put, the right to withdraw trust property is an unrestricted right to the immediate use, possession or enjoyment of that property. That makes the right a present interest gift.[60] Further, the withdrawal right is a general power of appointment. Is there any question that the IRS would include the property in the beneficiary's gross estate if the beneficiary died while the right was still in force?[61] The point the IRS keeps missing is that the grantor's intent, or the beneficiary's intent for that matter, is irrelevant. If the beneficiary has the legal right to present enjoyment of the property, the transfer is a complete, present interest gift and the annual exclusion applies.

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[57] A.O.D. 1992-009 (April 6, 1992).
[58] A.O.D. 1996-010, 1996-29 I.R.B. (July 15, 1996).
[59] *Estate of Kohlsaat v. Comm'r*, 73 T.C.M. 2732 (1997).
[60] Treas. Reg. §25.2503-3(b).
[61] I.R.C. §2041.

But why fight the IRS? The grantor wants to make a gift to the trust so the trustee can pay premiums on a life insurance policy. The premium is greater than the annual exclusion amount multiplied by the grantor's children (the primary trust beneficiaries). To qualify the entire gift for the annual exclusion, the grantor must give Crummey powers to the grandchildren. But the IRS may disallow the annual exclusion if the grandchildren are contingent trust beneficiaries. While the grantor will ultimately win if the IRS litigated, the cost of battling the IRS could eat up some or all of the tax savings.

The simple solution to this problem is found in the IRS's own words in the 1996 Action on Decision:

"Current income beneficiaries and persons with vested remainder interests have a continuing economic interest in the trust and must weigh the benefit of a present withdrawal against their long term interests. Generally, the Service will not contest annual gift tax exclusions for Crummey powers held by these beneficiaries."

The grantor can simply make the grandchildren current beneficiaries during the grantor/insured's life. The grandchildren can be given the right (on either a mandatory or a discretionary basis) to the trust's income and principal. If the right is discretionary, the grandchildren do not have to receive any distributions. The trustee can, however, decide to make distributions to the grandchildren, in accordance with the trust's objectives.[62]

c. Notice and Duration

i. The IRS Position

Must the beneficiary receive notice of the withdrawal right for the grantor to obtain the benefit of the annual exclusion? Is there a minimum period of time the beneficiary must be given to exercise this right? The IRS's position is that to qualify for the annual exclusion, the beneficiary must get adequate notice of the withdrawal right and sufficient time to exercise it. The IRS announced its position in Revenue Ruling 81-7.[63] The grantor made a gift to a trust "shortly" before the beneficiary's withdrawal right was to lapse. The grantor did not inform the beneficiary of his withdrawal right. The IRS said "in failing to communicate the existence of the demand right and narrowly restricting the time for its exercise, G (the grantor) did not give A (the beneficiary) a reasonable opportunity to learn of and to exercise the demand right. G's conduct made the demand right "illusory and effectively deprived A of the power."

The IRS's position is that the beneficiary does not have the immediate use, possession or enjoyment of the property without knowledge of both the gift and the withdrawal right.[64] Without current notice of the gift and the right to withdraw, the gift will not qualify for the annual exclusion.[65]

The IRS also requires the beneficiary to have a sufficient amount of time to exercise the withdrawal right. The IRS has informally ruled that 30 days is a sufficient amount of time,[66] and 4 days is insufficient.[67] The IRS has also acquiesced in the result in *Cristofani* which upheld a 15-day withdrawal period.[68]

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[62] If the trustee does make a distribution to a grandchild, it would be a taxable distribution for generation skipping tax purposes and should be handled accordingly. See Section IV.B.3. *infra* for a more in-depth discussion of this issue.
[63] Rev. Rul. 81-7, 1981-1 C.B. 474.
[64] Tech. Adv. Mem. 95-32-001 (August 11, 1995).
[65] *Id*.
[66] Priv. Ltr. Ruls. 93-11-021 (December 18, 1982); 92-32-013 (May 4, 1992) and 92-18-040 (January 30, 1992).
[67] Tech. Adv. Memo. 96-28-004 (July 12, 1996).
[68] A.O.D. 1996-010, 1996-29 I.R.B. (July 15, 1996).

ii. The Courts' Position

Most tax experts consider *Crummey* the seminal case for determining when withdrawal rights qualify as present interest gifts. Therefore, it is interesting to look at how the Ninth Circuit views notice in *Crummey*.

The Ninth Circuit holds:

> "As a practical matter, it is likely that some, if not all, of the beneficiaries did not even know that they had any right to demand funds from the trust. They probably did not know when contributions were made to the trust or in what amounts. Even had they known, the substantial contributions were made toward the end of the year so that the time to make a demand was severely limited."[69]

Yet, even with all of these "flaws," the Ninth Circuit found that the withdrawal rights were present interest gifts. Clearly, the Ninth Circuit held that notice was irrelevant. The Ninth Circuit implicitly found that a "reasonable exercise period" was irrelevant as well.

The Tax Court dealt with notice in *Holland* where the trust required the trustee to give written notice to beneficiaries of any gifts to the trust and of their withdrawal rights.[70] The trustees never provided written notice of the contributions or the right to withdraw. The Tax Court found the gifts were still present interest gifts.[71] The Court held that notice goes only to the likelihood that the right will be exercised. The Court reiterated that the applicable test for a present interest is not the likelihood of exercise but rather the legal right to demand payment from the trustee.

One disconcerting feature of the Tax Court's position on notice is that it seems ambiguous. For example, in *Kohlsaat*, the Tax Court made clear that the beneficiaries had actual knowledge of their withdrawal rights.[72] Further, in *Holland*, after the Tax Court says notice is irrelevant, it goes to great pains to point out that adult beneficiaries and parents of the minor beneficiaries had actual knowledge of the gift and the right to withdraw.

Why does the Tax Court even get into this issue? *Crummey* certainly did not. *Crummey* acknowledged that the minor beneficiaries never received notice nor did they know they had withdrawal rights. The Ninth Circuit made it clear that notice simply does not matter.

The Tax Court says notice does not matter, but then goes through the tedious process of finding evidence of actual knowledge. This extraneous and potentially troubling dictum leads to some doubt on the Tax Court's position. What will the Tax Court hold when the beneficiaries do not have actual knowledge? Will the Tax Court firmly hold that notice and knowledge are irrelevant? Or will it adopt some sort of actual knowledge requirement?

While this issue may appear less than settled, it should be remembered that Tax Court cases are appealable to the Courts of Appeal. These Courts' positions in *Crummey* is very clear: neither notice nor actual knowledge are legally relevant factors in determining whether a withdrawal right qualifies for the annual exclusion.

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[69] *Crummey*, 397 F.2d at 88.
[70] *Holland*, 73 T.C.M. at 3237.
[71] *Id*.
[72] *Kohlsaat*, 73 T.C.M. at 2734.

iii. Practical Tips

To avoid a potential dispute with the IRS, practitioners should ensure that notice is given, even though it does not appear to be legally required. Every time the grantor makes a trust contribution, notice should be given to the beneficiaries. The notice should include the amount they can withdraw, the procedure for exercising the right, and a deadline for exercise.

The trust itself should not *require* that the trustee provide notice. It is not required, so why place additional burdens on the trustee that are not imposed under the law? If notice is not required, and if the trustee fails to provide notice, a beneficiary will not have claim for breach of trust. The practitioner should advise the trustee to provide notice to beneficiaries to satisfy the IRS, but the trust need not require the trustee to do so.[73]

d. Other Issues Involving Crummey Powers

i. Minor Beneficiaries

Crummey says that a withdrawal power held by a minor beneficiary qualifies as a present interest gift, even though a guardian must be appointed to make the demand.[74] The IRS has attempted to expand the requirements of *Crummey* to allow the annual exclusion for a withdrawal right given to a minor beneficiary only if the trust *expressly permits* the minor to exercise the power through a legal guardian.[75] This position has led some commentators to suggest that the trust have a provision expressly permitting the beneficiary to make a demand through his or her guardian.

Who should that guardian be? The IRS has privately ruled that it cannot be the grantor or the grantor's spouse because the minor's power is then illusory.[76] Without explanation, years later the IRS altered its position with respect to the non-grantor spouse.[77]

In response to the 1983 technical advice memorandum, many practitioners began drafting trusts to "appoint" a guardian with the power to exercise a minor beneficiary's withdrawal right--someone other than the beneficiary's parent. For example, donor creates a trust, gives his minor daughter a withdrawal right, and "appoints" his brother as guardian with respect to the withdrawal right.

The problem with this approach is it might result in the loss of the annual exclusion for the gift to that child. The grantor can give anyone he chooses the power to withdraw money on behalf of another. That power is legally enforceable.

But, the legal standard in *Crummey* says that the *donee* must have the power to make the withdrawal. When that donee is legally incompetent (for example, a minor), the law provides that the incompetent act through a guardian. There are legal processes through which a guardian is appointed; the grantor cannot unilaterally appoint someone to act in this role. So giving "Uncle Bob" the right to withdraw on the child's behalf may not be the same as giving the power to the child (or to the child's true legal guardian--a parent). If a Court holds it is not the same, the annual exclusion will be lost.

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[73] Or the practitioner could handle it in a way recommended by the great William Lynch: have the grantor (the donor for gift tax purposes) give notice to the donees.
[74] *Crummey*, 397 F.2d at 87.
[75] *Normoff v. Comm'r*, T.C. Memo. 1983-435 (1983).
[76] Tech. Adv. Memo. 83-30-005 (March 29, 1983).
[77] Priv. Ltr. Rul. 87-12-014 (December 18, 1986).

So what should the client do? Simply rely on *Crummey*, and give the beneficiaries withdrawal rights. If it turns out some of the beneficiaries are legally disabled because they are minors, then under state law the beneficiary's guardian will have the power to exercise the withdrawal right on the beneficiary's behalf. Or the client could avoid giving notice at all because it is better to, under the worst case scenario, use part of the client's gift tax exemption than to lose one hundred percent on the dollar if the guardian (say an ex-spouse) exercises the withdrawal right on behalf of the child.

ii. Rights Should Not Be Subordinate

The beneficiary's withdrawal right should be absolute. If the trustee has the discretion to diminish the trust assets, such as a power to terminate the trust or to distribute trust principal, that discretion should be subordinate to the beneficiaries' withdrawal rights. Otherwise, the gifts may be ineligible for the annual exclusion.[78]

iii. Flexible Crummey Powers

Once a beneficiary has been given a withdrawal right, the right must be absolute and not legally resistible.[79] If a beneficiary decides to exercise the withdrawal right, there is nothing the grantor or the trustee can do legally to prevent the withdrawal. The trust can, however, give the grantor, at the time of making the gift, the right to specify withdrawal rights for any one or all of the beneficiaries and still obtain the annual gift tax exclusion for the beneficiaries who do have the right to withdraw.[80] The IRS has also confirmed that giving this power to the grantor does not cause inclusion of the trust assets in the grantor's estate.[81]

iv. Trustee's Ability to Satisfy Withdrawal Rights

A trust may have insufficient cash to meet the beneficiaries' withdrawal demands. This circumstance can arise when the grantor makes a gift to pay premiums on a life insurance policy and the trustee pays the premiums prior to the lapse of the Crummey power. Therefore, the trust should provide that withdrawal rights can be satisfied with any trust asset, including the policy itself.[82]

What if trust values are insufficient to meet the withdrawal rights? This is a common concern if the trust owns only life insurance, due to the economics of a life insurance policy in its early years. For example, presume that a policy's annual premium is $20,000. Grantor transfers $20,000 to the trustee who pays the premium immediately. The trust has two beneficiaries; each has the right to withdraw $10,000 for the next thirty days. Because of mortality costs and other expenses, the cash surrender value of the policy following the premium payment is $15,000. Does the annual exclusion only extend to $7,500 per beneficiary? These concerns cause many practitioners to draft the trust to require the trustee hold the cash until the withdrawal rights terminate.

Is this necessary? Not in the first policy year. The value of a newly issued life insurance policy is equal to the premiums paid.[83] The trustee has an asset worth $20,000 (the policy) it can transfer to the beneficiaries if they both exercise their withdrawal right.

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[78] Priv. Ltr. Ruls. 92-51-004 (September 4, 1992); 82-13-074 (December 30, 1981), and 81-07-009 (October 31, 1980).
[79] *Crummey*, 397 F.2d at 88.
[80] Tech. Adv. Memo. 95-32-001 (August 11, 1995); Priv. Ltr. Ruls. 90-30-005 (April 19, 1990) and 81-03-074 (October 23, 1980).
[81] Priv. Ltr. Rul. 98-34-004 (August 21, 1998).
[82] Priv. Ltr. Rul. 81-03-074 (October 23, 1980).
[83] Treas. Reg. §25-2512-6(a), Example 1.

In later years the premiums paid are no longer the measure of the policy's value. Instead, the policy is valued at its interpolated terminal reserve, plus the unused portion of that year's premium minus outstanding policy loans.[84] If that value is less than the cumulative demand rights, is the grantor's annual exclusion in jeopardy?

No. Under the trust, the beneficiary has the legal right to withdraw a certain sum (usually a proportionate amount of the total gift). If the beneficiary exercises that right, the trustee must deliver property with that value to the beneficiary. That right is not affected or reduced by the trustee's investment decision. But why should that decision affect the present interest nature of the *grantor's* gift? What if the trustee invested in IBM stock that decreased in value during the "30 day window?" Or what if the trustee lost the money at the track? Clearly, the beneficiary in all three cases may have an action against the trustee to meet the demand right, but such action should not affect the present interest nature of the gift.

For practical purposes, the safest route is to have the trustee hold onto the cash during the "30 day window." When that is not possible, the trust should have a provision that gives the trustee the right to borrow funds (including from the grantor) up to a reasonable amount at market (arm's length) terms and conditions.[85]

v. The 5 x 5 Problem: Lapsing of Withdrawal Rights

When a beneficiary is given a Crummey power, the beneficiary has a general power of appointment over the property subject to the power. If the beneficiary fails to withdraw the property before the right expires (the most common scenario), the general power of appointment lapses. A *release* of a general power of appointment is a transfer of property by the powerholder, in other words a gift.[86] On the other hand, the *lapse* of a general power of appointment is treated as a release of the power (i.e., a gift by the power-holding beneficiary to the trust), only to the extent the value of the withdrawal power (oftentimes equal to twice the annual exclusion) exceeds the greater of $5,000 or 5% of the value of the assets out of which the power can be satisfied (generally, all of the trust assets).[87] In other words, if the value of the withdrawal right exceeds the greater of $5,000 or 5% of the trust's assets, the beneficiary has made or will make a taxable transfer. In essence granting a Crummey power that exceeds the "5 x 5" amount replaces the grantor's gift tax problem with the beneficiary's gift tax problem. There are some solutions: (1) hanging powers, (2) testamentary powers of appointment and (3) additional beneficiaries. Each has its own positives and negatives, and each may be appropriate depending on the circumstances.

a) Hanging Power

One solution to the 5 x 5 limitation is the use of a cumulative lifetime general power of appointment, otherwise known as a "hanging power." The hanging power provides that the withdrawal rights do not lapse, but rather "accumulate" until they (1) are exercised or (2) lapse in later years when 5% of the trust assets is not only large enough to lapse that year's gift, but previous years' contributions as well. This concept can work well when life insurance is the primary trust asset, and based on the insurance illustration, it is anticipated that the policy's dividend will be used in the near future to pay the annual premium. In later years if the grantor does not have to make gifts to pay premiums, the 5 x 5 lapse will begin to exhaust "hanging" amounts.

[84] Treas. Reg. §25.2512-6(a), Example 4.
[85] Priv. Ltr. Rul. 98-09-032 (February 27. 1998).
[86] I.R.C. §2514(b).
[87] I.R.C. §2514(e).

Here is an example. Father creates an irrevocable life insurance trust for the benefit of his two children. Mother and Father make $40,000 annual gifts to the trust. The children have the right to withdraw a pro rata share of each annual gift, or $20,000, which enables the parents to utilize the full annual exclusion for split gifts. If the withdrawal right is not exercised, it lapses to the extent of the greater of $5,000 or 5% of the value of the trust corpus. Any amount that does not lapse in a given year will continue to be subject to withdrawal until such time as it can lapse without incurring a gift tax liability. The "5% of the trust assets" amount will be determined by looking at the fair market value of the trust, which is the sum of current gifts and the fair market value of the policy while the insured is living, and the death proceeds at the insured's death.

Let's look at how the hanging power can wither away:

	(1)	(2)	(3)	(4)	(5)
Yr.	Total Gift to Trust	Beneficiary's Share of Gift	FMV of The Trust*	Greater of $5,000 or 5% of Trust	Cumulative Amount Hanging Per Beneficiary
1	$40,000	$20,000	$ 40,000	$ 5,000	$15,000
2	$40,000	$20,000	$ 43,000	$ 5,000	$30,000
3	$40,000	$20,000	$ 76,000	$ 5,000	$45,000
4	$40,000	$20,000	$112,000	$ 5,600	$59,400
5	$40,000	$20,000	$153,000	$ 7,650	$71,750
6	$40,000	$20,000	$199,000	$ 9,950	$81,800
7	$40,000	$20,000	$250,000	$12,500	$89,300
8			$243,000	$12,150	$77,150
9			$260,000	$13,000	$64,150
10			$1,445,000	$75,250	0

*All numbers are hypothetical. At death of insured, FMV equals policy death proceeds. Illustration assumes death of insured in year 10.

The primary drawbacks of the hanging power are that (1) the amount subject to the power can be withdrawn by the beneficiary at any time and used for any purpose, and (2) it is cumulative. This means that the withdrawal right may become very large, and the temptation for the beneficiary to exercise the power can become too great to resist. To illustrate this point, look at year 7 in the example above. The beneficiary can withdraw almost $90,000 from the trust by simply exercising the power. Even if the beneficiary resists the temptation to exercise, if the beneficiary dies prior to the lapse of the hanging power, the value of the withdrawal right on the beneficiary's date of death will be included in his gross estate.[88]

b) Testamentary Power of Appointment

What if instead of giving the beneficiary the cumulative right to *withdraw* amounts in excess of the 5 x 5 limit, the trust gives the beneficiary a testamentary power to *appoint* this property? When someone retains power over property's ultimate disposition, the transfer of that property is an incomplete gift.[89] If

[88] I.R.C. §2041.
[89] Treas. Reg. §25.2511-2(b).

the beneficiary has a testamentary power of appointment over trust property, the lapse of that beneficiary's Crummey power is also an incomplete gift.[90] The gift becomes complete when the power is exercised at the beneficiary's death.[91]

This result extends to a limited power of appointment as well.[92] So, this power can be designed to allow the beneficiary to appoint the property only at death, and then to only a limited subset of people, such as the other trust beneficiaries.

This solution will insure that the annual lapse of the Crummey power will not result in immediate gift tax consequences to the beneficiary. Also, in contrast to the hanging power, the beneficiary will not be tempted to withdraw the ever growing pot of money subject to the power. The only way the testamentary power can be *voluntarily* exercised is through the beneficiary's suicide--not a likely strategy. The cumulative amount subject to the power will, however, be included in the beneficiary's estate.[93] Of course, this is not a problem if the trust terminates prior to the beneficiary's death or if the beneficiary's estate is not big enough to attract a transfer tax.

Concerns about inclusion in the beneficiaries' gross estates may be alleviated when life insurance is a primary trust asset. The way the limited power of appointment concept works is that each year each beneficiary is given a withdrawal power up to the annual exclusion (or twice that amount if gift-splitting is elected). Each year those withdrawal powers lapse to the extent of the greater of $5,000 or 5% of trust assets. In years where the contributions exceed this 5 x 5 amount, the amount subject to a beneficiary's limited power of appointment will increase. In years when contributions are less than the 5 x 5 amount (either because no contributions are made or 5% of the trust assets exceed the amount contributed), the amount subject to the power will decrease. Eventually, it is possible that the limited testamentary power will go away, resulting in nothing being included in a trust beneficiary's gross estate.

c) Additional Crummey Beneficiaries

Of course, a lapse of a Crummey power will not create transfer tax problems for beneficiaries if the withdrawal right is limited to the greater of $5,000 or 5% of trust assets. But frequently the premium exceeds the number of primary beneficiaries multiplied by the 5 x 5 amount (most likely $5,000 in the early years of the trust). In that case, remember that withdrawal rights can be given to other beneficiaries, as discussed in Section II. C. above. If the annual premium payment is less than $5,000 multiplied by all trust beneficiaries given 5 x 5 withdrawal powers, the lapse of the withdrawal rights will not cause any transfer tax concerns for the beneficiaries.

d) Combining Strategies

Each beneficiary does not have to be given the same type of withdrawal right. The grantor has the flexibility to use different "5 x 5" solutions consistent with the trust's purpose and the beneficiaries' personalities.

For example, differing withdrawal rights can be a useful tool in a generation skipping trust. Grandma and Grandpa may have a sizable estate that they want to get to the grandchildren without estate taxation at their children's deaths. But Grandpa and Grandma may not want to "disinherit" the children. Grandma and Grandpa can avoid estate tax at their children's deaths, but still give the children access to their estate.

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[90] Treas. Reg. §25.2511-2(f).
[91] *Id*.
[92] Priv. Ltr. Rul. 90-30-005 (April 14, 1990).
[93] Treas. Reg. §20.2041-3(d)(1); I.R.C. §2036(a)(2).

They would give their property to a trust designed identically to the credit shelter trust used in marital situations except that the trust would be for the benefit of the children rather than the surviving spouse. In other words, the trust is designed to give the child virtually unlimited access to the trust assets (make the child trustee, give the child the right to income and principal limited by ascertainable standards and give the child a limited power of appointment), yet limit the access just enough to keep the trust assets out of the child's estate.
If the child's annual power of withdrawal is not limited to the greater of $5,000 or 5% of the trust assets, then a significant portion of the trust can be included in the child's estate.[94] This prevents achieving a primary purpose of the trust. On the other hand, if the child's withdrawal power is limited to $5,000 or 5% of the trust assets, the annual tax-free gift that can be made to the trust is limited, in most cases, to $5,000 rather than the entire annual gift tax exclusion amount (or double that amount for gift-splitting). This might not be enough to qualify anticipated gifts to the trust (equal to the annual policy premium) for the annual gift tax exclusion.

In contrast to concerns about trust property being included in the children's gross estates, there may be no concerns about the trust property being included in a grandchild's estate. For example, the trust may be designed to distribute assets to the grandchildren. If the premiums are too large to qualify for the annual exclusion by giving all beneficiaries a Crummey power limited to the 5 x 5 amount, the grandchildren can be given withdrawal rights equal to the full annual gift tax exclusion amount (double that amount with gift-splitting). To avoid giving the grandchild the temptation to withdraw an accumulating balance, the grandchild can be given a testamentary power of appointment, rather than a hanging power.

e) The Income Tax Consequences of Withdrawal Rights

If the trust only owns a life insurance policy, the trust does not generate taxable income during the life of the grantor because of the tax-deferred growth of policy values. A trust funded with other assets will likely generate taxable income. Who is responsible for the tax liability?

The answer depends on whether the trust is a grantor trust.[95] With a grantor trust, the grantor is treated as the owner of the underlying trust assets for income tax purposes.[96] For example, a trust will be a grantor trust if it provides that trust income may be used, without the consent of an adverse party, to pay premiums on a policy insuring the grantor's life.[97] If the trust is not a grantor trust, the trust, rather than the grantor, will be liable for the income tax unless it distributes the income to a beneficiary.[98] In that case, the beneficiary is responsible for the tax liability.[99]

These general rules are complicated when the trust provides beneficiaries with Crummey withdrawal rights. The Code treats a person as a partial grantor of a trust when that person has a power to vest the corpus or income in himself.[100] This is the essence of a Crummey power. During the time the power is outstanding (in other words before it is exercised, released or allowed to lapse) the Crummey beneficiary is responsible for a portion of the trust's income tax liability.[101]

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94 I.R.C. §2036(a)(2); Treas. Reg. §20.2041-3(d)(1).
95 I.R.C. §§671-678.
96 I.R.C. §671.
97 Treas. Reg. §1.677(b)-2(iii).
98 I.R.C. §641.
99 I.R.C. §662.
100 I.R.C. §678(a)(1).
101 Rev. Rul. 67-241, 1967-2 C.B. 225; Priv. Ltr. Ruls. 2000-22-035 (June 5, 2000), 90-34-004 (May 17, 1990).

This rule does not apply, however, with respect to a power over income if another person is treated as a trust grantor.[102] While the Code language seems to limit the §678(b) exception to powers over income, the IRS's rulings have extended it to powers over corpus: in other words, Crummey powers.[103] If the grantor has a power that causes the trust to be a grantor trust, then the grantor is treated as the only trust owner for income tax purposes. If the trust does not qualify as a grantor trust or is no longer a grantor trust because the trust's grantor dies (or otherwise relinquishes powers that cause him or her to be taxed on trust income under the grantor trust rules), the Crummey powerholders will be taxed on a proportionate amount of trust income.[104] The IRS's position is that the Crummey powerholder is also taxed on income proportionate to amounts lapsed in excess of the 5 x 5 amount.[105]

4. Finance the Premiums

Up to now, this section has focused on the grantor making gifts to the trust to provide the trustee sufficient funds to purchase trust assets (including, of course, paying premiums on a life insurance policy). The trustee has ways it can finance the purchase of trust assets other than gifts.

a. Loans in General[106]

The trustee can borrow money. In our economy, people borrow money to make a variety of purchases such as homes, cars, and college education. Presumably, the reasons they have borrowed the money is (1) they do not have it, (2) no one is willing to give it to them, or (3) they do not want to use their money, even though they could.

The trustee borrows money for the same reasons. There might not be any money in the trust to pay the premiums (in other words, the grantor did not fund the trust with income-producing assets). Or, the grantor is not willing to make sufficient gifts to pay the premiums. With a trust, the grantor usually has sufficient funds to make the gift. The reason the grantor is unwilling to make the gift has to do with the gift tax ramifications.

b. Gift Tax Leverage Achieved By Financing

Let's say Dad is the owner of a corporation worth approximately $10,000,000 and has determined that he needs $5,000,000 of life insurance. To avoid losing half of the insurance proceeds to the government in estate taxes, Dad has decided to have the insurance owned by a trust. Based on Dad's health and age, the policy will have a $100,000 annual premium. Dad's two children each have Crummey withdrawal powers. If Dad and Mom elect to split gifts in 2007 (the year the trust is created), $48,000 qualifies for the annual exclusion. Dad and/or Mom will have to use a total of $52,000 of their lifetime gift tax exemption in making a total gift of $100,000.

Instead of making a taxable gift of $52,000 annually, Dad can lend the trust the $100,000. Dad will want to keep the trust's cost of borrowing as low as possible. What interest rate must Dad charge the trust?

Dad can make a loan to the trust that charges no interest. The problem with doing that is the Code will impute a rate of interest on the loan, and that imputed interest will be an annual gift from Dad to the

[102] I.R.C. §678(b).
[103] Priv. Ltr. Rul. 91-41-027 (July 11, 1991).
[104] Priv. Ltr. Ruls. 2000-22-035 (June 5, 2000), 90-34-004 (May 17, 1990) and 81-42-061 (July 21, 1981).
[105] Priv. Ltr. Ruls. 2000-22-035 (June 2, 2000) and 90-34-004 (May 17, 1990).
[106] This section focuses on the use of loans to finance premiums, but there are other viable financing techniques such as non-equity split-dollar.

trust.[107] That same imputed interest is deemed to be paid by the trust to Dad and is income to Dad unless the trust is a grantor trust.[108] The interest rate is equal to the applicable federal rate ("AFR"), compounded semiannually.[109] That rate will change annually, leading to uncertainty about future gift tax consequences.

The key to planning with loans is to avoid §7872 altogether. Section 7872 only applies to below-market loans.[110] A below-market interest loan is a loan that charges a rate less than the AFR.[111] When Dad lends money to the trust, Dad should charge an interest rate equal to the AFR. Dad can make gifts to the trust sufficient to allow the trustee to make the interest payments to Dad. Dad reduces the amount of the gift to the trust, in the first year, from $100,000 to the interest on that sum ($6,000 assuming a 6% current AFR).

When the premium is due the next year, Dad can again make a loan, at the appropriate AFR, to the trustee to pay premiums. Of course, as loans continue to be made, the gift becomes larger due to the ever accumulating loan balance. Given that loans were used to resolve Dad's gift tax concerns in the first place, it is important that the cost of the solution not exceed that of the original problem.

c. Lending to Finance Premiums: A Small Business Owner

Let's go through an example of how this can be done. Our client is George, an owner of a closely held C corporation and father of 3 (his children are Hal, Isabella, and Jordan). George wants to pass his $5,000,000 business to the children, who are all actively employed by the company. To do so, he decides he needs life insurance owned by an irrevocable trust to provide estate tax liquidity at the death of the survivor of he and his wife, Kate. Based on George's age and health, the premiums on that policy will be $100,000. George can use his and Kate's annual exclusion to give the trust $72,000 gift tax-free, but he and Kate would have to use $28,000 of their combined or individual gift tax exemption every year. More troublesome to George and Kate is that they would like to use their annual exclusions and gift tax exemptions to pass ownership of the business on to the children.

George can lend the $100,000 premium to the trust. Let's say the AFR at the time of the loan is 5%. That means that the interest in year one is $5,000, so George can make a $5,000 gift to the trustee to pay that interest. George and Kate can still make $67,000 of annual exclusion gifts of stock to the children directly or to the trust. Under the terms of the trust, the children (perhaps as trustees) can still be allowed to vote the stock and benefit from any distributions. More importantly, if the stock grows faster than the interest rate, the stock provides another alternative for paying off the loan.

d. A Powerful Combination: Discounted Giving and Loans

Suppose George's company does not generally pay dividends. It retains its earnings to reinvest in the business. That model will cause the business to grow at a 10% internal rate of return. George's gifts of minority interests in the Company qualify for a valuation discount. Presume that an appraiser has determined the appropriate combined discounts on the shares are 40%. George and Kate can give away stock worth $67,000 today that would be worth $111,667 if it was part of a controlling block.

If the stock continues to grow at or around a 10% annual rate of return, if the AFR stays consistent at or around 5%, and if the policy continues to perform adequately, by the time the policy dividend is large enough to pay the premium, no loans will have to be made to pay premiums. The trust can then use the

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[107] I.R.C. §§7872(a)(1), 7872(c)(1)(A), 7872(f)(3).
[108] I.R.C. §7872(a)(1)(B).
[109] I.R.C. §7872(a)(1).
[110] I.R.C. §7872(a)(1).
[111] I.R.C. §7872(e)(1).

stock to repay the loan. The trustee does not have to place the policy at risk by reducing its cash values. Of course, if the growth does not match assumptions, the trustee may very well have to use policy values to repay the loan.

B. Trust Design

1. Background: Estate Tax Consequences of Trust Ownership

A couple of primary factors enter into the design of the irrevocable trust. First, practically speaking, what does the insured want to accomplish: provide family income, avoid creditors, preserve a family business, provide for those with special needs, or just preserve hard-earned wealth? Who should benefit from the arrangement, and how and when? Is the trust's primary beneficiary the surviving spouse, the children, or maybe even the grandchildren? Once those decisions are made, the distribution, management and dispositive provisions can be drafted accordingly.

Second, how can the goals be accomplished while still achieving the primary tax goal of avoiding inclusion of the trust property in either spouse's estate?

The objective then, is to design the trust to achieve the client's goals while avoiding inclusion in the gross estate.

2. Avoiding Inclusion in The Gross Estate: The Odyssey of the Six Million Dollar Man

To understand the impact of the estate tax system on the average American (well, at least the average wealthy American) let's go through an example. Our client is Steve Austin, a man worth roughly $6,000,000. His estate consists primarily of his business, an incorporated manufacturer worth $4,000,000. The rest of his estate is in publicly traded securities ($1.5 million) and his home and personal effects (roughly half a million). Steve Austin has been married to his wife, Jamie, for twenty years and their three children are Audrey, Brett and Cassidy.

a. Property Owned At Death: §2033

Steve Austin, like many self-made millionaires, wants to control the assets he has accumulated over his lifetime. He does not want to give away any of his hard-earned assets, especially not the business he built from the ground up. While this is understandable, this particular estate plan may result in estate tax liability for our client. All of the property Steve Austin owns at his death will be part of his gross estate.[112] This does not mean it necessarily will all be part of his taxable estate and subject to estate taxes. For example, if Steve Austin leaves everything to his wife, Jamie, none of the property will be part of his taxable estate due to the unlimited marital deduction.[113] And Steve Austin can give an amount equal to his remaining estate tax exemption equivalent to anyone without estate tax liability.[114] Of course, if Steve Austin leaves everything to Jamie, unless Jamie exhausts the entire estate during her lifetime, the property she leaves to the children (at least in excess of her estate tax exemption) will be subject to estate tax at her death.[115]

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[112] The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death. I.R.C. §2033.

[113] I.R.C. §2056.

[114] I.R.C. §2010(c).

[115] I.R.C. §2033.

b. Income Interests and the Right to Possession or Enjoyment: §2036(a)(1)

Steve Austin does not like the idea of this large estate tax bill at his or Jamie's death. So he is going to give away the property during his lifetime. The problem is that Steve Austin relies on the income from that property to provide for the basic necessities of life.

To avoid losing this income stream, Steve Austin is going to transfer his property to a trust. The trustee will be Jamie (a natural choice to maintain some level of practical control) and the trust will distribute all of the income to Steve Austin for his lifetime.

A logical conclusion is that nothing is included in Steve Austin's estate because his trust interest, a lifetime income interest, dies with him. He owns nothing he can transfer at death, so nothing should be in his gross estate, right?[116]

Wrong. The entire value of the trust on the date of Steve Austin's death is included in his gross estate even though he has given the property away.[117] And what if Steve Austin drafts the trust so that all of the trust income does not have to be distributed to him, knowing that Jamie as trustee will in fact distribute income regularly as needed or desired? The trust property may be included in Steve Austin's estate if a court finds that Steve Austin has in fact retained possession and enjoyment of the trust property.[118]

c. Retaining Control: §§2036(a)(2) and 2038

Steve Austin now understands that to keep the property out of his estate he cannot own it and he cannot give it away if he either retains the right to the income or if he actually receives the income. So Steve Austin is going to retain sufficient assets to provide for his needs. His advisors have run financial projections and determined that he can give away a substantial portion of assets and still have sufficient income to meet his lifestyle.

Steve Austin does not want to deal with minority shareholders (even family members), so he is not willing to give away his stock. He is willing to transfer his other assets to a trust designed to benefit his family. Steve Austin still wants to control how the trust invests the assets and when the children (the trust beneficiaries) receive distributions. So Steve Austin names himself as trustee. Will this cause estate inclusion? The answer is "maybe."[119] The retention of investment control will not cause estate inclusion, but if Steve Austin retains (as trustee) discretion to control the timing of trust distributions, the trust property will be part of his gross estate.[120]

d. Reversionary Interests and Powers to Revoke: §§2037 and 2038

So Steve Austin decides he will transfer some of his assets to a trust. Because he wants the trustee to have completion discretion regarding distributions, he will name Jamie, rather than himself, as trustee.

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[116] This was in fact the Supreme Court's holding in *May v. Heiner*, 281 U.S. 239 (1930), the case that resulted in Congress enacting the precursor to current I.R.C. §2036.

[117] The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer under which decedent has retained either (1) for his life, (2) for any period not ascertainable without reference to his death, or (3) any period which does not in fact end before his death--the possession or enjoyment of, or the right to income from, the property. I.R.C. §2036(a)(1).

[118] I.R.C. §2036(a)(1); *Nicol v. Comm'r*, 56 T.C. 179 (1971). See section III.B.3.b. *infra* for a complete discussion of this issue.

[119] See section III.B.3.a *infra* for a complete discussion of this issue.

[120] I.R.C. §§2036(a)(2) and 2038; *Lober v. United States*, 346 U.S. 335 (1953). Also, see section III.B.3.a.ii *infra* for a more complete discussion of this issue.

Jamie and the three children will be beneficiaries. What if Jamie and the kids predecease him? Where should the trust property go?

Steve Austin wants the trust property to come back to him, but only if he is the surviving family member (actuarially a very unlikely event). If Steve Austin predeceases some or all of his family members, nothing is in his gross estate, right? Not so fast. The entire trust value may be in his gross estate, depending on the value of his reversionary interest.[121]

So Steve Austin will not retain any right to the trust property under any set of circumstances. What if he simply wants to retain the right to terminate or revoke the trust at which time everything would go pro rata to the trust beneficiaries? That right to revoke or terminate also results in the trust property being included in his gross estate.[122]

e. General Powers of Appointment: §2041

Steve Austin has resigned himself to the fact that to get property out of his estate he will give it to a trust. He will not have any beneficial interest in the trust, he will not be trustee, and he will not have the right to revoke, terminate or amend the trust. Steve Austin will name Jamie as the trustee. This should clearly keep the trust property out of his estate.

This is not Steve Austin's only estate planning goal, however. We know that he can accomplish that goal without giving the property away by simply leaving everything to Jamie.

So not only must he design the trust to keep its property out of his estate, but Jamie's as well. The key to keeping property out of Jamie's estate is to avoid giving her a general power of appointment over the trust property.[123] Jamie will have a general power of appointment if she can transfer trust property to herself, her creditors, her estate, or the creditors of her estate.[124]

Jamie, as trustee, has the power to distribute trust property to herself, as beneficiary. The trust property will be in her estate, unless Steve Austin limits her distributions to an ascertainable standard relating to her health, education, maintenance and support.[125]

3. Casting the Trust Roles

a. Grantor as Trustee

i. Background

If estate taxes were not a concern, people might not transfer assets to irrevocable trusts. Instead, they would own and control all of their property until their deaths. Estate taxes provide a sufficient incentive for many people to give away their property during their lifetimes, frequently to a trust. Given a choice, people want trust roles that empower them to control and enjoy this property. What role(s) can the

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[121] The decedent's gross estate includes property the decedent has transferred, when (1) someone else can only possess or enjoy the property by surviving the decedent and (2) the decedent retains a reversionary interest valued at more than 5% of the property's value. I.R.C. §2037(a). If Steve Austin's reversionary interest is valued (based on actuarial principles) at more than 5% of the trust's value at the death of Steve Austin's death, the entire trust is included in his estate.
[122] I.R.C. §2038(a)(1).
[123] I.R.C. §2041.
[124] I.R.C. §2041(b)(1).
[125] I.R.C. §2041(b)(1)(A). See section III.B.3.c. *infra* for a complete discussion of the spouse as trustee.

grantor have in the trust without estate inclusion? To answer that question, it is best to start by removing life insurance from the analysis. Generally speaking, can the grantor be the trustee?

It depends on the trustee's rights and powers. If the grantor as trustee has the right to designate who receives corpus or income, the right to accumulate trust income, the right to control the timing or manner of enjoyment, or any similar rights, the trust property will be included in the grantor's estate.[126] On the other hand, if the grantor as trustee has solely administrative, non-discretionary powers over the trust property, then the trust will not be included in the grantor's estate.[127] Where this line is drawn, of course, is the tricky part.

ii. Discretion Over Investment Policy and Accounting

If the trustee has the power to choose trust investments, the trustee has some power to control who receives trust income and corpus, and when they receive it. This is true even if the trustee retains no discretion over trust distributions. For example, assume the trust has one income beneficiary and one remainder beneficiary. The trust provides that the income beneficiary will receive all trust income quarterly, but has no rights to trust corpus. The remainder beneficiary will receive trust corpus upon the income beneficiary's death.

If the trustee invests in bonds or other income producing assets, the income beneficiary may receive a generous stream of income, and the remainder beneficiary may receive little or no growth on the corpus.[128] On the other hand, if the trustee invests in growth stock, the income beneficiary may receive nothing, and the remainder beneficiary will receive all of the stock's growth. Further, if the trustee has the power to allocate receipts between principal and income, the trustee also has the power to affect who enjoys the property.

The courts have consistently distinguished between an administrative power given to the trustee and the right to control enjoyment in determining whether property is included in the gross estate. The courts have held that investment control and accounting discretion are "administrative" *powers*, rather than the *right* to designate who enjoys trust property or the right to alter enjoyment.[129] Courts have stated that administrative powers are only equivalent to a right to control enjoyment if the trustee's power is beyond a court's control.[130] Courts have uniformly found that state law requires the trustee to exercise these powers impartially, and that the court has jurisdiction to oversee the trustee's actions.[131]

It is clear under the case law that the grantor can be the trustee without concern of property being included in the gross estate if the trustee's only role is limited to deciding how to invest trust property and to "administrative responsibilities." If the grantor retains these rights as trustee, the practitioner should insure that the trustee's powers are subject to court supervision under state law.

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[126] I.R.C. §§2036(a)(2) and 2038. Treas. Reg. §§20.2036-1(b)(3) and 20.2038-1(a)(3).

[127] *Old Colony Trust v. U.S.*, 423 F.2d 601 (1st Cir. 1970); *U.S. v. Powell*, 307 F.2d 821 (10th Cir. 1962); *Budd v. Comm'r*, 49 T.C. 468 (1968).

[128] In fact, given the time value of money and the impact of inflation, the remainder beneficiary's interest may be declining in value.

[129] *Budd v. Comm'r*, 49 T.C. 468 (1968); *U.S. v. Powell*, 307 F.2d 821, 824-25 (10th Cir. 1962); *Old Colony Trust v. U.S.*, 423 F.2d 601, 603 (1st Cir. 1970). One court held that investment and accounting powers constituted the power to affect enjoyment was subsequently overruled. *State Street Trust v. U.S.*, 263 F.2d. 635 (1st Cir. 1959), overruled on this issue by *Old Colony Trust*, 423 F.2d at 603.

[130] *Old Colony Trust*, 423 F.2d at 603.

[131] *Old Colony Trust*, 423 F.2d at 603; *Powell*, 307 F.2d at 825; *Budd*, 49 T.C. at 475-76.

iii. Discretion Over Distributions

What if the trust goes one step further and empowers the grantor as trustee to make distributions? The power to distribute seems to be the power to affect enjoyment of principal and income, and the power to alter enjoyment. Retention of these powers will seemingly result in the transferred property being included in the gross estate under §§2036(a)(2) and 2038(a)(1).

That result does not necessarily follow, however. If the trust provides a beneficiary with a mandatory income interest, the trustee has no discretion over who gets the income or principal, and the trustee cannot control the timing or manner of enjoyment. Similarly, if the trust requires all income be accumulated, the trustee has no discretion to control enjoyment.

What if the trustee has discretion to control who gets trust income and/or property, and when they get it? That would seem to lead to inclusion under §§2036(a)(2) and 2038. But it is not so simple. If the beneficiaries' rights to income or principal are governed by a standard that can be enforced by a court, the grantor/trustee has not retained the right to control who enjoys the property.[132] So what constitutes a judicially enforceable standard?

It is clear that a standard limited to health, education, maintenance and support qualifies.[133] Also, if the trustee is empowered to make distributions that maintain the beneficiaries in their current standard of living, the courts have found a judicially enforceable standard.[134] But a standard is not judicially enforceable if it refers to the beneficiaries' pleasure or happiness.[135]

Taking life insurance out of the equation, it is clear that the grantor can act as trustee without estate inclusion under either §§2036(a)(2) or 2038 so long as the trustee has only administrative powers under the trust or the trustee has dispositive powers limited to a judicially enforceable standard. A point of caution, or maybe practicality: while case law allows the grantor to act as trustee, it is an idea the IRS has failed to embrace. To avoid risk of IRS challenge, unless there is a compelling need to make the grantor the trustee, the grantor should name someone else to act in that role. Even if the grantor can serve without the trust property being included in his gross estate, the trust's flexibility will be severely limited.

iv. Adding Life Insurance to the Equation

How does the analysis change if the trust owns insurance on the grantor's life? Stated another way, can the grantor who is also the insured, be the trustee?

If the insured possesses incidents of ownership in a life insurance policy, the death benefit is included in the insured's gross estate.[136] An insured possesses incidents of ownership when the insured or his estate has the right to any economic benefits of the policy.[137] An insured possesses incidents of ownership in a trust-owned policy when the decedent has the power (including the power as a trustee) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment, even though the

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132 *Jennings v. Smith*, 161 F.2d 74 (2nd Cir. 1947); *Michigan Trust v. Kavanagh*, 284 F.2d 502 (6th Cir. 1960); *Budd. v. Com'r.*, 49 T.C. 468 (1968); *U.S. v. Powell*, 307 F.2d. 821 (10th Cir. 1962).
133 *Wier v. Comm'r*, 17 T.C. 409 (1951); *Budd v. Comm'r*, 49 T.C. 468 (1968).
134 *Jennings*, 161 F.2d at 75-76; *Ithaca Trust Company v. U.S.*, 279 U.S. 151 (1929).
135 *Old Colony Trust Company v. U.S.*, 423 F.2d 601 (1st Cir. 1970); *Merchant's National Bank v. Comm'r*, 404 F.2d 927 (10th Cir. 1968). One court, however, in a somewhat strained opinion, held that the ability to make distributions for a beneficiary's "happiness" did create a judicially enforceable standard. *U.S. v. Powell*, 307 F.2d 821, 827-28 (10th Cir. 1962).
136 I.R.C. §2042(2).
137 Treas. Reg. §20.2042-1(c)(2).

decedent has no beneficial interest in the trust.[138] These two regulations create a problem when trust owns a policy, even though the trust does not provide the insured or the insured's estate with any of the policy's economic benefits.

The Circuits have not been consistent in resolving this conflict. The Fifth Circuit has held that if the insured is the trustee, and as trustee may exercise the incidents of ownership in a life insurance policy, the death benefit is included in the insured's gross estate.[139] The Fifth Circuit does not distinguish between "personal" incidents of ownership, and those that can only be exercised in a fiduciary capacity.

In contrast, a variety of circuits have held that if the insured, as trustee, can only exercise the incidents of ownership in a fiduciary capacity, the death benefit is not included in the insured's gross estate.[140] The IRS eventually acquiesced in this line of cases, albeit in an extremely limited fashion.[141] The IRS has ruled that the insured does not possess incidents of ownership if the insured (1) holds those incidents solely in a fiduciary capacity, (2) has not retained these powers (in other words, the insured did not transfer the policies to a trust that is created by the insured and that names the insured as trustee), and (3) the insured/trustee cannot exercise the incidents of ownership for his own benefit.[142] So if the insured is the person who has created the trust, and is the person who is making gifts to the trust, the insured cannot be the trustee without inviting a dispute with the IRS.

But if someone other than the insured is the grantor, the insured can be the trustee without estate inclusion, as long as the insured/trustee cannot exercise the incidents of ownership for his own personal benefit.[143] It seems likely that the IRS will scrutinize this situation to determine whether the insured has been named as trustee through a prearranged plan. If so, the IRS may attempt to include the death benefit in the insured's estate.[144] Finally, it is clear that if the non-insured spouse is the grantor and the insured spouse is the trustee, there are risks of estate inclusion in naming either spouse a beneficiary.[145]

These issues are not raised if the insured spouse is the grantor and the non-insured spouse is the trustee and beneficiary. This is the more common trust design.

b. Grantor as Beneficiary

The conventional wisdom is simple: the grantor should never be the beneficiary of an irrevocable trust because that mere *status* will cause estate inclusion. But an analysis of the Code, the regulations, rulings and case law indicates that this issue is much less settled and much more complex. In fact, there is no doubt that if the trust is structured correctly, and circumstances play out in a certain way, the grantor can be a beneficiary without inclusion of the trust property in the gross estate.

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[138] Treas. Reg. §20.2042-1(c)(4). See, however, Priv. Ltr. Rul. 2004-04-013 (January 25, 2004) where the Service found no estate inclusion for an insured trustee who was neither a grantor nor beneficiary.
[139] *Rose v. U.S.*, 511 F.2d 259 (5th Cir. 1975); *Terriberry v. U.S.*, 517 F.2d 286 (5th Cir. 1975).
[140] *Skifter v. Comm'r*, 468 F.2d 699 (2nd Cir. 1972); *Hunter v. U.S.*, 624 F.2d 833 (8th Cir. 1980); *Bloch v. Comm'r*, 78 T.C. 850 (1982). The Sixth Circuit also held that an insured as trustee can exercise incidents of ownership in a fiduciary capacity without estate inclusion, but included the death benefit in the insured/trustee's estate because he was also an income beneficiary of the trust. *Fruehauf v. Comm'r*, 427 F.2d 80 (6th Cir. 1970).
[141] Rev. Rul. 84-179, 1984-2 C.B. 195.
[142] *Id*.
[143] *Id*.; *Estate of Fruehauf v. Comm'r,* 427 F.2d 80 (6th Cir. 1970); *Estate of Skifter v. Comm'r*, 468 F.2d 699 (2nd Cir. 1972).
[144] Rev. Rul 84-179, 1984-2 C.B. 195; G.C.M. 39333 (Jan. 29, 1985).
[145] See Subsection III.B.3.b. *infra* for grantor as beneficiary, and Rev. Rul. 84-179 for non-grantor insured as trustee and beneficiary.

The first issue that needs to be addressed is what code section or sections can cause trust property to be included in a beneficiary's gross estate. Simple drafting can immediately dispose of §§2037, 2038, 2041 and 2042 as concerns.[146]

The code section that creates the most concern is §2036, specifically subsection (a)(1). Trust property is included in the grantor's gross estate if the grantor retains the right to income from the property or the possession or enjoyment of the property.[147] A key to avoiding inclusion in the grantor's gross estate is to place the grantor's beneficial rights completely within the trustee's discretion.[148] In other words, the trust should not give the grantor rights to trust property within a judicially ascertainable and enforceable standard.

But avoiding inclusion in the grantor's gross estate does not end there. The trust property will also be included in the gross estate when the grantor retains possession or enjoyment.[149] Courts have found that this standard is not limited to a legally enforceable right to the trust property, but extends to whether the grantor *in fact* retained possession or enjoyment of the trust property.[150]

Generally, the IRS has prevailed in two circumstances where the grantor retained possession or enjoyment of the trust property, even though the grantor's beneficial interest is completely discretionary. The first is where state law provides that the grantor's creditors have the right to all of the trust property when the grantor (1) creates a trust and (2) retains any beneficial interest. Courts have included the trust property in the grantor's estate because even though the grantor's interest in trust property is nominally discretionary, the grantor can access all of the trust property by running up large bills and then allowing the creditors to seize trust property in repayment.

On the other hand, if state creditor law provides that the creditor can only "step into the shoes" of the grantor/beneficiary, courts have not included trust property in the grantor's estate.[151] This is logical, because a truly discretionary right to trust property is really a right to nothing. Rather, it is a mere possibility to receive property. If the grantor is to be a discretionary beneficiary, the practitioner should insure that local law does not allow creditors unfettered access to the corpus of the trust.

The other circumstance where property is included in the grantor's estate is when the court, based on the facts and circumstances, determines that the grantor and trustee have a "prearranged understanding" that the trustee will distribute trust property to the grantor/beneficiary.[152] In fact, if the grantor actually receives trust distributions, the grantor has the unenviable legal burden of disproving the existence of a

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[146] Section 2037 (revisionary interests) and its regulations clearly provide that it does not apply to rights to receive income. Further, §2037 only applies to a reserved reversionary *right*. Treas. Reg. §§20.2037-1(c)(1) and (2). Section 2038 only applies if the grantor has the *power* to amend, alter, terminate or revoke. Section 2041 only applies to a *power*. Section 2042 applies to incidents of ownership. Avoiding these sections simply requires giving the grantor a beneficial interest that is completely discretionary (i.e., the grantor retains no rights to the trust property) and, of course, not naming the grantor as trustee (i.e., not giving the grantor any powers over trust property). Some practitioners may be concerned that making a grantor a beneficiary of a trust that owns a policy on the grantor/insured's life provides the grantor with an economic benefit in the policy and, therefore, an incident of ownership. Treas. Reg. §20.2042-1(c)(2). But that regulation section also speaks of rights and powers, and should not be read to apply if the grantor's interest is completely discretionary.

[147] I.R.C. §2036(a)(1).

[148] *Estate of Wells v. Comm'r*, T.C. Memo 1981-574; Rev. Rul. 2004-64, 2004-27 I.R.B. 7 (July 6, 2004) (Service rules that the existence of a discretionary power of the Trustee to reimburse the grantor for taxes paid on trust income does not result in estate inclusion.

[149] I.R.C. §2036(a)(1).

[150] *Estate of McNichol v. Comm'r.*, 265 F.2d 667, 670-71 (3rd Cir. 1959).

[151] *German v. U.S.*, 7 C1. Ct. 641 (1985) (applying Maryland creditor law); *Estate of Uhl v. Comm'r*, 241 F.2d 867 (7th Cir. 1957) (applying Indiana creditor law); *Herzog v. Comm'r*, 116 F.2d 591 (2nd Cir. 1941) (applying New York creditor law).

[152] *Nicol v. Comm'r*, 56 T.C. 179 (1971); *McNicol v. Comm'r.*, 265 F.2d 667 (3rd Cir. 1959); *Green v. Comm'r*, 64 T.C. 1049 (1975); *Skinner v. U.S.*, 316 F.2d 517 (3rd Cir. 1963).

prearranged understanding.[153] While that burden is a "heavy one," it can be met.[154] In one case, the grantor/beneficiary received all of the trust income, and yet the court held that, based on the facts and circumstances, there was no pre-arrangement.[155] The court focused on the fact that the trust income was not economically necessary for the grantor's support, and that the grantor never intended to retain the income. Rather the transfer of the income was solely the trustee's choice.

On the other hand, there are certain facts that generally result in the court finding that a pre-arrangement exists. For example, (and not withstanding the previous paragraph) if the beneficiary actually receives <u>all</u> of the income, courts usually find retention of the possession and enjoyment.[156] There also are cases where the grantor has communicated to the trustee an intention to retain the income. Even if that "understanding" is legally unenforceable, courts will find that the grantor retained the enjoyment of the trust property.[157] Finally, there are cases where the grantor files a gift tax return upon the creation of the trust and deducts from the value of the gift a "retained life estate." When the grantor's estate later argues that the grantor did not retain enjoyment over the property, the estate is unsuccessful.[158]

If the grantor wants to retain a beneficial interest in the trust, what should the practitioner do? First, the safest course of action is to resist giving the grantor any interest in the trust. If the grantor has a strong marriage, give the spouse the beneficial interest, knowing that the spouse can use the distributed property for marital needs and can even make gifts to the grantor.

What if the grantor is not married or is not comfortable giving the spouse this interest? Again, because the burden will be on the grantor to disprove retained enjoyment, the safest course is to try to convince the grantor to avoid any beneficial interest in the trust. Explain that if a need for money arises, the trustee can be permitted (but not required) to lend money to the grantor at commercially reasonable terms.

If the grantor still insists on a beneficial interest, the practitioner should structure the interest to avoid inclusion of the property in the grantor's gross estate. First, make sure the interest is completely discretionary; there must not be a legally enforceable standard. Second, be sure that the state law governing the trust does not subject trust assets to the claims of the grantor's creditors.

Third, structure the facts so that the IRS will have a difficult time proving implied retention. Advise the trustee and the grantor to avoid any distribution to the grantor unless truly necessary, and, in any case, to avoid distributing all of the trust income to the grantor. Also, the grantor's gift tax return should treat the entire trust contribution as a gift. All parties involved (i.e., all potential witnesses) should be informed that the grantor does not expect any distributions from the trust; those decisions are completely within the trustee's discretion. Finally, the grantor should be able to show that no additional income from the trust is necessary to maintain his standard of living.

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[153] *Wells v. Comm'r*, T.C. Memo 1981-574.
[154] *Id*.
[155] *Id*. In *Wells*, Mrs. Wells placed $30,000 in trust for her two grandchildren. She named her son as trustee. Her CPA also convinced her to name herself as beneficiary in case she "incurred a medical tragedy of some kind where additional money was needed." Her son, as trustee, transferred all of the trust income to his mother because he knew how much she always wanted to travel and knew she would not spend her own money to do so. The court found no pre-arrangement. The facts of *Wells* lay out a pretty good blueprint on how to overcome the burden on the taxpayer to disprove pre-arrangement.
[156] *Estate of Skinner v. U.S.*, 316 F.2d 517, 519 (3rd Cir. 1963). But see *Wells*, T.C. Memo 1981-574.
[157] *McNichol v. Comm'r,* 265 F.2d 667, 672-73 (3rd Cir. 1959).
[158] *Estate of Green v. Comm'r*, 64 T.C. 1049, 1059, (1975); *Estate of Skinner v. U.S.*, 316 F.2d 517, 519 (3rd Cir. 1963).

c. Grantor's Spouse as Trustee

After learning of the risks of being the trustee and beneficiary, the grantor decides not to act in either role. But the grantor would like some practical access to decision-making and/or trust assets. One way to maintain practical access is to name the spouse as trustee and beneficiary. The spouse is free (but of course not required) to solicit the grantor's advice on administering and distributing trust property. Further, if the spouse, as beneficiary, receives a trust distribution, the grantor may indirectly receive some benefit from that property. So in many situations, naming the spouse as trustee and beneficiary is the "next best thing." Can the spouse act as trustee and be beneficiary without inclusion of the trust property in either spouse's gross estate?

The grantor can name the spouse as trustee without any concerns about the property being included in the grantor's estate.[159] The key is preventing the property from being included in the spouse's estate. Because the spouse has not created, or made transfers to, the trust the spouse has not retained an interest.[160] Therefore, the "string" sections (2035-2038) do not apply. Also, because the spouse is not the insured, §2042 does not apply. The section that causes concern is §2041; the trustee spouse cannot be given a general power of appointment over the trust property. Whether the spouse has a general power of appointment in the capacity of trustee depends primarily on the identity of the trust beneficiaries and the extent of the trustee's discretion to make distributions.

d. Spouse and Minor Children as Trust Beneficiaries

The trust property is included in the spouse's estate if the spouse, as trustee, can make distributions to himself, his creditors, his estate or the creditors of his estate (a general power of appointment).[161] If neither the spouse nor minor children are trust beneficiaries, there are generally no concerns with property being included in the spouse's gross estate. What if the spouse or minor children are beneficiaries?

i. Spouse as a Beneficiary

a). If the spouse is both trustee and beneficiary, then the spouse has the power as trustee to transfer trust property to himself as beneficiary. That ability is a power of appointment.[162] Property subject to a *general* power of appointment is included in the powerholder's gross estate. A power is not a general power of appointment if distributions are limited to an ascertainable standard related to the powerholder's health, education, maintenance and support.[163] The solution is to limit spousal distributions to this "ascertainable standard."

This standard does not limit distributions to the bare necessities of life.[164] In fact, courts often equate this standard to the beneficiary's current standard of living.[165]

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[159] But see, *McCabe v. U.S.*, 475 F.2d 1142 (Ct. C1. 1973) where decedent created a trust that gave his wife a retained life interest and named a trust company as trustee. The wife unwittingly signed a series of documents directing the trustee to make payments to the husband's (the grantor) bank account. The court held this was part of a pre-arrangement between the grantor, the spouse and the trustee, and the prearrangement was that the grantor would retain the trust income for his lifetime. The court included the trust property in the grantor's estate under I.R.C. §2036(a)(1). If the non-grantor trustee spouse consistently transfers trust property, directly or indirectly, back to the grantor spouse, the IRS could use the reasoning of *McCabe* to argue that grantor retained an income interest causing inclusion under I.R.C. §2036(a)(1).
[160] As long as only the grantor's property is transferred to the trust, the spouse's consent to split gifts with the grantor does not make the spouse a grantor. See Priv. Ltr. Rul. 2001-30-030 (July 30, 2001).
[161] I.R.C. §2041.
[162] I.RC. §2041(b)(1).
[163] I.R.C. §2041(b)(1)(A).
[164] Treas. Reg. §20.2041-1(c)(2).
[165] *Jennings v. Smith*, 161 F.2d 74 (2nd Cir. 1947); *Ithaca Trust Co.v. U.S.*, 279 U.S. 151 (1929).

More significantly, any "close-call" distributions made by the spouse to himself are challengeable only by the other trust beneficiaries--generally the spouse's children or maybe grandchildren.[166] Absent egregious overreaching by the spouse, it is hard to fathom a family member going through the expense and personal anguish to challenge a distribution.

If the spouse is concerned about any potential restrictions this standard places on distributions, the trust can allow an independent trustee to make unlimited distributions to the spouse without risking inclusion in the spouse's gross estate. To summarize, the trust can provide that distributions within the ascertainable standard can be made by the spouse as trustee; distributions over and above those necessary for the spouse's health, education, maintenance and support can be placed within the sole discretion of an independent trustee.

The independent trustee can be a family member, friend, or anyone who is "sympathetic" to the spouse's needs. If in drafting this provision, the practitioner wants to use a non-adverse person (a person who does not have a substantial interest in the trust that would be adversely affected by the exercise of the power in favor of the spouse), the trust should provide that any distribution above the ascertainable standard is to be made solely by the independent trustee, not jointly by the independent trustee and the spouse. If the grantor wants to have the power exercised jointly by the spouse and the co-trustee, then the co-trustee has to be an adverse party to avoid inclusion in the spouse's estate.[167]

ii. Minor Children as Beneficiaries

So what if the spouse as trustee has the power to distribute trust property to the couple's minor children? A power to transfer trust property to one's creditors is a general power of appointment.[168] If a power can be exercised to discharge a legal obligation, the power is exercisable in favor of the powerholder's creditors.[169] Because the trustee/spouse has the legal duty to support his minor children under state law, and his ability (as trustee) to make distributions to these children (as beneficiaries) can alleviate his personal support obligation, the spouse has a general power of appointment over the trust property.[170] In that situation, some or all of the trust property is included in the spouse's gross estate.

The solution to this problem is actually quite simple. The trust should prohibit the spouse, as trustee, from making distributions to the children that satisfy the spouse's duty to support them under state law. A different trustee (again, someone sympathetic to the family's wishes) can be given the sole authority to make distributions to the children within the spouse's support obligation.[171] Of course, if the grantor parent is still alive, no one should be allowed to make distributions to fulfill that parent's support obligation.[172]

iii. Removing the Spouse as Trustee and Beneficiary and Adding Children born after the Trust is Executed: Acts of Independent Significance

While naming the spouse as trustee and beneficiary is a wonderful idea to allow the household access to trust property, having the spouse in these roles is generally undesirable when the couple is experiencing marital problems. The grantor can draft the trust to remove the spouse from these roles upon the

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[166] *Scott's Law of Trusts,* Section 187.6 (2000 Aspen Publishers 4th Ed.).
[167] I.R.C. §2041(b)(1)(C)(ii); *Cox v. Comm'r*, 59 T.C. 825 (1973).
[168] I.R.C. §2041(b)(1).
[169] Treas. Reg. §20.2041-1(c)(1).
[170] Rev. Rul. 79-154, 1979-1 C.B. 301.
[171] See generally Priv. Ltr. Rul. 90-36-048 (June 13, 1990).
[172] I.R.C. §2036(a)(1); Treas. Reg. §20.2036-1(b)(2).

occurrence of a specific event. For example, the trust can provide that the spouse shall be treated as deceased at the time a decree of divorce is entered or even at the time one of the spouses files for legal separation.

The practical effect of this provision appears to give the grantor the power to change beneficiaries and the power to amend or alter the trust through a legal separation; however, this power does not cause inclusion of the trust property in the grantor's gross estate under either I.R.C. §§2036(a)(2) or 2038(a)(1). The reason is that legally separating from one's spouse is an act of independent significance the effect of which on the trust is merely incidental or collateral.[173]

The Court of Claims put it best in *Tully*: "In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd."[174] Equally absurd is the possibility that someone would go through the emotional pain, the legal cost, and the burden of legal support obligations surrounding a legal separation simply to remove the spouse as trustee and beneficiary. This possibility is so *de minimis* and speculative that it does not rise to the level of a §2036(a)(2) or 2038(a)(1) power.[175]

For the same reason, if the trust provides that all of the grantor's children are beneficiaries, the grantor does not retain a power to affect beneficial enjoyment under §§2036(a)(2) or 2038(a)(1) simply because of the grantor's ability to have or adopt more children.[176] The Service has ruled that the act of bearing or adopting children is an act of independent significance, the incidental consequence of which is adding a beneficiary to the trust.[177] The Service concluded that a trust provision that adds after-born or after-adopted children as beneficiaries is not equivalent to a retained power to designate or change beneficial interests under either §2036(a)(2) or §2038(a)(1).[178]

e. Independent Trustee

If the grantor selects an independent trustee and retains no beneficial trust interests, there generally will not be a concern of the trust property being included in either spouse's gross estate.[179] The grantor should not be given the power to remove the trustee and then become the trustee.[180] If the grantor wants the power to remove and replace the trustee with some other person or entity, the grantor should be limited to choosing a successor who is not related or subordinate.[181] Other advantages of using an independent trustee may be money management expertise and continuity of administration (particularly with a corporate trustee).

The concerns with appointing an independent trustee are practical rather than tax-related. For example: trustee compensation; whether the trustee's exercise of discretion will comport with the grantor's thinking as far as investment philosophy and distribution strategy; and the trustee's availability. These concerns cause many grantors to choose a spouse or an adult child as trustee.

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[173] Rev. Rul. 80-255, 1980-2 C.B. 272; *Estate of Kurz*, 101 T.C. 44, 60 (1993); *Estate of Tully*, 528 F.2d 1401 (Ct. C1. 1976).
[174] *Estate of Tully*, 528 F.2d at 604-605.
[175] *Id*. at 605.
[176] Rev. Rul. 80-255; 1980-2 C.B. 272.
[177] *Id*.
[178] *Id*.
[179] However, the trustee must act independently of the grantor and not merely as the grantor's agent. *Estate of Kurihara v. Comm'r*, 82 T.C. 51 (1984).
[180] Treas. Reg. §20.2038-1(a)(3).
[181] Rev. Rul. 95-58, 1995-2 C.B. 191. The Tax Court has held that if the grantor has the right to replace a trustee with an *independent* trustee, this power does not cause the trust property to be included in the grantor's gross estate. *Estate of Wall v. Comm'r*, 101 T.C. 300 (1993). The Tax Court's standard seems broader, but using it invites potential IRS challenge.

4. Trust Provisions

a. Distributions During the Grantor's Life

Frequently, practitioners draft irrevocable life insurance trusts that do not allow the trustee to make distributions during the grantor's life. While there may be several valid reasons to have that provision in any trust, a frequently cited reason is that any reduction in cash value reduces the death benefit and the performance of the policy. Given that the death benefit is usually needed to fund estate liquidity, this provision avoids placing the death benefit at risk.

Of course, this presumes the potential estate tax liability stays the same or goes up. But what if it goes down? Asset values have been known to go down, especially in under-performing equity markets. Or, maybe the grantor's assets continue to perform well, but the grantor does an effective job of giving away a large percentage of the assets during life. There is the possibility that estate tax reform or repeal could lower or eliminate the estate tax bill. And: we might just need the money.

Irrevocable trusts should generally allow the trustee to make distributions during the grantor's life. If the estate tax bill stays the same or increases, the trustee may decide never to exercise this power. If the estate tax bill goes down for whatever reason, the trustee has the power to access cash values (through partial surrenders or policy loans) and to make distributions to trust beneficiaries, including the grantor's spouse and children.

b. Dispositive Provisions

In trust planning, there is frequently too little thought given to how and when the trust terminates. Practitioners place a lot of focus on solving their clients' problems at the time the trust is executed, but little focus on how the trust operates thereafter. The creation seems the highlight and the rest formulaic. For example, how many irrevocable trusts in effect today provide that the trust property is divided equally among the children, who then get one-third of their shares at ages 25, 30 and 35? How do all these grantors have the exact same family situation?

They do not, and the dispositive provisions should be well thought out to match the grantor's purpose. For example, does the grantor want the trust divided into separate trusts for the children, or are the grantor's needs better met by having a large "pot trust" that the trustee can use to meet emerging individual needs? The answer to this question depends on the grantor's philosophy on helping the children. If the grantor always treats the kids equally, regardless of need, separate trusts accomplish that goal. But if the grantor wants to provide for the needs of the children as they arise, a "pot trust" should be used because the needs of the children will not necessarily be equal.

The grantor should also determine when property should be distributed from the trust to the children. Not all children are ready to receive substantial distributions of trust corpus when they are 25; others are mature enough to handle this distribution at an even younger age.

Finally, the grantor should consider giving the trustee the discretion to withhold an otherwise scheduled distribution to the child. Again, there is not a magical maturity switch that is activated on a certain birthday; the trustee can be given discretion to analyze whether the beneficiary can adequately handle the distribution. The beneficiary may have substance abuse problems, marital problems, creditor problems or other issues that make a significant distribution unwise. If the trustee determines that the distribution is not in the best interests of the beneficiary, the trustee should have the discretion to hold the property in trust or distribute the property to a new trust for the benefit of that beneficiary.

c. Limited Power of Appointment

Another way to build flexibility into an irrevocable trust is to give someone, generally the spouse or maybe the children, the right to transfer the trust property to others.[182] This is another way to transfer trust property, including a life insurance policy, when the trust no longer meets its intended purpose. That might be because the trust was drafted poorly, family circumstances change, or external circumstances (such as the estate tax laws) change. In those situations, the powerholder can transfer the trust property to a different trust, to the beneficiaries directly (as long as the transfer does not reduce the powerholder's support obligation to dependents),[183] or even to the trust grantor. A primary example of where this type of power provides flexibility is helping clients deal with uncertainties surrounding their estate tax liability.

Practitioners do not know when their clients will die, what their estates will look like at that time or what the law will say. People are reluctant to put assets, such as life insurance, in an irrevocable trust when this uncertainty exists. But let's just say, based on changing circumstances, that the client no longer needs the life insurance in the trust. It then makes more sense for the client to own the policy outright. While the client cannot be given the right to demand that the policy be returned to him without having that policy's value included in his gross estate,[184] the spouse can use a power of appointment to transfer the policy (trust property) to the insured. The power to make this transfer does not cause inclusion in the spouse's estate nor does the exercise of this limited power of appointment result in gift tax consequences.[185]

d. Trust Protector/Collapse Provisions

When the 2001 Tax Act[186] passed, and permanent estate tax repeal became a more realistic possibility,[187] practitioners began to devise ways to protect their clients from an estate tax while providing for trust asset exit strategies.

A popular method is to include a collapse provision in the trust; if some particular event takes place, such as estate tax repeal, the trust is terminated. At that time, the trust assets are distributed to the beneficiaries. A problem is that the trust is terminated automatically upon the happening of specific, objective events. Even if those events take place, it may still be in the beneficiaries' best interests to keep the property in the trust. The beneficiaries might have creditors, substance addiction, or disabilities that would entitle them to federal aid but for their newly acquired trust distributions.

Grantors may want to add an element of reasoning and logic as to whether to terminate the trust. A popular device is to give some person, often called a "trust protector," the power to terminate the trust. This person can be given unfettered discretion to act at any time, or upon specific events (such as estate

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182 Of course, to avoid inclusion in the powerholder's estate, the transfer cannot be made to the powerholder, his estate, his creditors or the creditors of his estate. I.R.C. §2041(b)(1).

183 See Section III.B.3.d.ii, *supra*.

184 I.R.C. §§2036, 2038, 2041 and 2042.

185 Treas. Reg. §§20.2041-1(c)(1), 25.2514-1(c)(1). Of course, if the spouse exercises the power of appointment and transfers the trust property back to the insured/grantor, it is in the insured's estate. I.R.C. §§2033, 2042. Further it is possible that the IRS will argue this limited power of appointment given to the spouse will cause inclusion in the grantor/insured's estate if the IRS can show that the spouses had a prearranged understanding that the spouse *would* make the transfer back to the grantor/spouse under certain circumstances. I.R.C. §2036. Therefore, it is important that the couple not have a documented prearrangement, but rather the powerholder spouse simply understands that the transfer is one of many options that exist with respect to the power.

186 Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

187 Essentially, at the time this act passed, the estate tax repeal was only effective in the year 2010 due to the Act's "Sunset Provision." Act §901. Repealing the sunset provision to make the estate tax repeal permanent requires both a majority vote in the House and an affirmative vote of 60 senators.

tax repeal). The advantage of the trust protector is that someone can decide if the trust's termination is actually in the beneficiaries' best interests. A disadvantage is that the trust protector may not exercise the discretion in a way the grantor finds acceptable.

This prompts a somewhat snide observation. The trustee is charged to "protect" the trust in the best interests of the beneficiaries. If the trust protector is so great, why not make that person the trustee? If the trustee is the right person to protect the trust, simply give the trustee these powers rather than this separate Solomon-like "Trust Protector."

e. Life Insurance Provisions

The trust should include three specific trust provisions related to life insurance. First, authorize the trustee to purchase life insurance on the grantor, the grantor's spouse, a beneficiary or on anyone in whom the beneficiary or the trustee has an insurable interest.

Second, authorize the trustee to exercise any legal rights the owner of the policy has, such as surrendering the policy, taking loans, allowing the dividend to pay the premium, and the like. This is boot strapping, but nonetheless useful.

Third, if the trust purchases a policy on the on the life of the trustee, the trustee is prohibited from exercising any incidents of ownership in that policy; rather, an independent co-trustee shall have the sole authority to exercise those incidents of ownership. Here's an example. Dad creates an irrevocable trust which purchases a $3 million insurance policy on his life. Dad names Mom as the trustee. The purpose of the $3 million death benefit is to give Mom some survivor income, and to fund an estimated $2 million estate tax liability at Mom's death.

Dad dies. Mom does a great job managing her assets, and their value goes up dramatically. Now Mom's estimated estate tax liability is no longer $2 million but $4 million. How is Mom going to provide liquidity to pay her estate tax? She needs cash when she dies: life insurance! Who is going to own the life insurance? Mom doesn't want to own it; her beneficiaries will lose half the death benefit in estate taxes. Therefore, a trust is going to own the policy.

How is the trustee going to pay the premiums? Generally the answer, as laid out in Section II above, is Mom will make gifts to the trust. She will use Crummey powers to qualify at least part of the gift for the annual exclusion. To the extent the gifts exceed the annual exclusion(s) available, Mom may have to use her gift tax exemption.

But Mom can use the trust created by Dad. That trust has $3 million in cash, more than enough to pay the premiums on the policy. Mom may never have to make any gifts to pay premiums. The key is to make sure that Mom, in her role as trustee, does not control the incidents of ownership in the policy. The provision that prevents a trustee from having incidents of ownership in a policy insuring his life accomplishes this objective. This authority can reside in another trustee appointed for this purpose.

f. Tax Reporting

The trust is a separate legal entity. Does this mean that it has to file its own separate income tax return? The answer depends on two factors: (1) has the trust generated taxable income, and (2) is the trust a grantor trust? If the trust has not generated taxable income it need not file an income tax return. If it does generate taxable income, that trust's income must be reported, but not necessarily on the trust's income tax return.[188]

If the trust is a grantor trust, page 6 of the instructions to Form 1041 (2005) provides that the trust can use the grantor's Social Security number as the trust's taxpayer identification number ("TIN"). The grantor reports the trust's income directly on the grantor's Form 1040 individual tax return. An added benefit of using the grantor's Social Security number is that if the trust does not generate taxable income, the proper taxpaying entity (the grantor) will still file a tax return to report other income. On the other hand, if the trust has a separate TIN, has no taxable income and does not file a return; the IRS often will send several notices requesting a tax return. While this is not a legal problem, it can be a large administrative inconvenience that can be easily avoided by using the grantor's Social Security number.

IV. GENERATION SKIPPING TRANSFER TAX

A. Background

Most irrevocable trusts are designed for the primary benefit of the grantor's spouse and children. The trust, if funded with life insurance, provides the trustee with cash to buy assets from the grantor's (or spouse's) estate. Those trust assets are distributed to the grantor's children, either immediately or when the children reach a certain age.

Sometimes, however, the grantor designs the trust to benefit not only the children but future generations as well. The focus may be on just the grandchildren (a typical generation skipping trust); or the focus may be on several future generations (the "dynasty" trust). When the trust is designed to benefit these lower generations, the grantor must be concerned with the generation skipping tax (GST).

The purpose of the GST is to collect a transfer tax at every generation. Take estate planning 101: Dad leaves everything to Daughter, with a potential estate tax imposed on Dad. Daughter then leaves everything to Grandson, again with potential estate tax consequences to Daughter.

But what if Dad leaves everything directly to Grandson. Congressional wisdom is that the bypassed estate tax at Daughter's level is "lost revenue." The GST imposed on the transfer to Grandson treats the transfer as though it went through Daughter first. In other words, the transfer is, effectively, taxed twice.

B. What Transfers Are Subject to the GST?

Three types of transfers are subject to the GST: "direct skips," "taxable terminations," and "taxable distributions."

1. Direct Skips

A direct skip is a transfer to a skip person.[189] A skip person is someone two or more generations below that of the transferor.[190] A trust benefiting only skip persons is also a skip person.[191] A direct skip takes place when a grandparent makes a gift to a grandchild. The amount subject to the GST is the value of the

[188] If the trust is not a grantor trust, the trust must report its taxable income but also gets a tax deduction for any income distributed to the beneficiaries. I.R.C. §661. The beneficiary then reports the distributed income on his tax return. I.R.C. §662.
[189] I.R.C. §2612(c).
[190] I.R.C. §2613(a)(1).
[191] I.R.C. §2613(a)(7)(A). A trust also qualifies as a skip person if no person holds an interest in the trust and no distributions can be made to non-skip persons. I.R.C. §2613(a)(2)(B).

property received by the grandchild, and the grandparent is liable for any GST.[192] The grandparent's payment of the GST is itself a gift, causing an additional tax.[193]

A transfer from a grandparent to a grandchild will not be a direct skip, if at the time of the transfer the grandchild's parent (who of course is also the grandparent's child) is dead.[194] This "predeceased ancestor exception" causes the grandchild to "move up" to the parent's generation.

2. Taxable Terminations

A taxable termination occurs when a trust beneficiary's interest terminates, and after the termination non-skip persons have no interest in the trust.[196] This somewhat convoluted definition can be illustrated by a simple example. Grandma creates a trust that gives her child all of the income for life. At the child's death the property remains in trust to be administered for the sole benefit of the grandchild. A taxable termination occurs at the child's death because (1) the child's interest in the trust terminates and (2) only a skip person (grandchild) has an interest in the trust. The amount subject to GST is the value of the property at the time of termination (the child's death), and the liability for any GST falls on the trustee.[197]

3. Taxable Distributions

A taxable distribution is any trust distribution to a skip person other than a taxable termination or direct skip.[198] A common example is where Grandpa sets up a trust that allows the trustee to make distributions to a variety of family members, including children and grandchildren. If the trustee does distribute property to a grandchild, the distribution is a taxable distribution. The taxable amount is the value of the property received, and the tax liability falls on the transferee.[199] If the trustee pays the transferee's tax liability, that payment is also treated as a taxable distribution.[200]

C. Calculating the Tax

The GST is equal to the taxable amount (discussed above) multiplied by the "applicable rate."[201] The applicable rate is equal to the maximum federal estate tax rate multiplied by the "inclusion ratio."[202] The ideal inclusion ratio is zero, because that "zero," when multiplied by the transfer tax rate, makes the applicable rate zero. In other words, no GST.

The inclusion ratio is zero if the gift is outright (i.e., a direct skip) and is a non-taxable gift under either §2503(b) (an annual exclusion gift) or §2503(e) (transfers for medical and educational expenses).[203] If the transfer is a direct skip to a trust, it will have a zero inclusion ratio if (1) the trust is designed solely for the benefit of one person (the skip person), (2) during the skip person's life, income and corpus can only be distributed to the skip person, and (3) if the skip person dies before the trust terminates, the trust assets will be included in the skip person's gross estate.[204]

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192 I.R.C. §§2603(a)(3); 2623.
193 I.R.C. §2515.
194 I.R.C. §2651(e).
196 I.R.C. §2612(a)(1). A taxable termination is avoided if, after the termination, no distribution can be made to a skip person. I.R.C. §2612(a)(1)(B).
197 I.R.C. §§2603(a)(2); 2622.
198 I.R.C. §2612(b).
199 I.R.C. §§2603(a)(1); 2621(a).
200 I.R.C. §2621(b).
201 I.R.C. §2602.
202 I.R.C. §2641.
203 I.R.C. §2642(c).
204 I.R.C. §2642(c)(2).

If the transfer does not result in a zero inclusion ratio under §2642, the transferor can still achieve a zero inclusion ratio by allocating GST exemption to the transfer.[205] This GST exemption is equal to the estate tax exemption.[206] The allocation is irrevocable, and is made for lifetime transfers on Form 709 and for testamentary transfers on Form 706 (Schedule R-1).

The game plan for GST planning is straightforward: if the trust is designed to make GST transfers, the inclusion ratio for the trust should be zero. If the trust is not designed to make GST transfers, the inclusion ratio should be one (i.e., the transferor should not "waste" any GST exemption on this trust).

What if the trust is not designed to result in GST transfers, but there is that risk? Should the practitioner advise the transferor to do a protective allocation? A classic example is Grandpa creates a trust that is to terminate when Son reaches 35 years of age. When the trust terminates, Son will receive all of the trust assets. Son is sole beneficiary until that time. No GST transfers were contemplated or intended by Grandpa. But what if Son dies before reaching 35? The trust provides that the property will be held in trust for Grandchild; in other words a GST transfer (a taxable termination) takes place if Son dies before age 35.

Under the Code prior to 2001, there was limited relief under these circumstances. Grandpa could allocate his GST exemption at Son's death, but would have to use the trust's value at Son's death.[207] The transferor had a choice: either (1) allocate GST exemption to the trust, most likely wasting the exemption because actuarially the Son will live to 35 or (2) not allocate, but if Son does die and trust property has appreciated between the date of gift and the date of Son's death, use more GST exemption that would have been required at the time of the transfer. The 2001 Tax Act[208] provides Grandpa relief in this situation. If Son dies prematurely, Grandpa can retroactively allocate his GST exemption based on date of gift (not date of son's death) values.[209]

Another option is to give Son a general power of appointment over the trust property. The property will be included in Son's gross estate but (1) that will happen anyway if Son dies after the trust terminated but before he exhausts the distributed assets and (2) it avoids the GST problem altogether because even if Son does not exercise his power, the fact that the property is included in his gross estate prevents Son's death from resulting in a taxable termination.[210]

D. Planning Opportunities

Life insurance is a good fit for GST planning. As long as all gifts to the trust are sheltered by an allocation of the GST exemption, the trust will be GST exempt. So gifts to pay life insurance premiums up to the full amount of the GST exemption can go into the trust, and the trust assets (including the death benefit) will always be GST exempt.

But while Grandma may like the idea of leveraging this wealth transfer to her grandchildren, she may not like the idea of shutting her children out of this trust. The key to designing the GST trust is to make sure that none of the trust property is included in the children's gross estates (otherwise, there is no reason to

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[205] Under EGTRRA, this allocation is now not only automatically done (if the transferor does not affirmatively elect out of the transfer) for direct skip transfers, but for transfers to certain trusts as well. I.R.C. §2632(c). The practitioners should examine every transfer to a trust to determine (1) does the transferor want to allocate GST exemption and then (2) affirmatively either allocate or elect out of an automatic allocation (if necessary) in accordance with the transferor's plan.

[206] I.R.C. §2631(c). This section was added to the Tax Code by EGTRRA, therefore, it is subject to sunset on December 31, 2010. Thereafter, the GST exemption will again be $1,000,000 indexed from 1997. EGTRRA Act Sec. 901; I.R.C. §2631(c)

[207] I.R.C. §2642(b)(3).

[208] EGTRRA.

[209] I.R.C. §2632(d)(1).

[210] Treas. Reg. §26.2612-1(b)(1)(i).

allocate GST exemption to keep the trust GST free). This can be accomplished while still giving the children a meaningful trust interest.

First, the child can be trustee. The child can also be beneficiary, but the child's ability to make distributions to herself must be limited by an ascertainable standard relating to the child's health, education, maintenance and support.[211] Second, the ability to make distributions to the grandchildren should not include the child's support obligations.[212] Instead, a co-trustee should be appointed, and be given sole authority to make these distributions.[213] Third, the child can be given the right to all trust income. Finally, the child can have the right to transfer the trust property to anyone except herself, her creditors, her estate or the creditors of her estate.[214] Consequently, Grandpa can give the child access to the trust property yet, at the same time, avoid estate tax at the child's generation. But note that to the extent trust property is used to benefit the child, we have "wasted" some of Grandpa's GST exemption. A better option may be to benefit child from a trust that is not GST exempt.

A planning concern with a GST trust is giving Crummey powers to the children. The whole game with a GST trust is avoiding estate inclusion for the children. If the child receives a Crummey withdrawal right that exceeds the 5 x 5 amount, the child is going to have to allocate his own gift tax exemption upon lapse of that power, because the grantor will not want to give the children hanging powers or testamentary powers of appointment for fear of inclusion in the childrens' gross estates.[215]

A solution? Limit the children's withdrawal rights to the 5 x 5 amount. When that power lapses, there is no gift from the child to the trust.[216] Presuming the trust is not designed to avoid inclusion in the grandchildren's estates (in other words, the trust is designed to eventually terminate and pay out to the grandchildren rather than to operate as a "dynasty trust"), the grandchildren can be given withdrawal rights up to the entire annual exclusion amount. If the cumulative Crummey rights given are not enough to offset the premium, the grantor can use his gift tax exemption or finance the purchase of the insurance to avoid current gift tax.

V. TRUST ISSUES FOR THE MARRIED COUPLE: COMMUNITY PROPERTY CONCERNS, SECOND-TO-DIE LIFE INSURANCE AND THE RECIPROCAL TRUST DOCTRINE

Married couples face certain unique issues when designing their irrevocable trusts. First, if they live in a community property state, how do we avoid making the non-insured spouse a grantor? Second, how does second-to-die life insurance change trust design, and does it reduce flexible design opportunities? Finally, if the couple does not want second-to-die life insurance so their plan can be more flexible, how do they avoid the reciprocal trust doctrine?

A. Community Property Considerations

As stated earlier, if someone makes transfers to a trust and retains possession or enjoyment of trust property, the trust property is included in that person's estate.[217] If both Dad and Mom make gifts to the trust, and Mom has a beneficial interest in the trust that allows her to possess and/or enjoy the trust property, the property will be in Mom's estate, proportionate to her share of trust contributions. The

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211 See section III.B.3.c. *supra*.
212 See section III.B.3.d. *supra*.
213 *Id*.
214 *Id*.
215 See section II.A.3.d.v. *supra*.
216 I.R.C. §2514(e).
217 I.R.C. §2036(a)(1).

irrevocable trust is generally designed so that one spouse (the insured) is the grantor, the other is the beneficiary.

In community property states, the grantor spouse should transfer separate property, rather than community property, to the trust. If an insurance policy is being transferred to the trust, the policy should be the grantor's separate property under state law. If not, the spouses can recharacterize the policy as separate property prior to the transfer by methods recognized in their state (e.g., partitioning, marital property agreement, and the like).

Gifts of cash to the trust should be from the grantor's separate property. Again, the spouses can classify property as separate property. This issue is also present in non-community property states if the cash comes out of a joint bank account. To avoid this issue, the grantor should set up a separate bank account, and make gifts to the trust out of that account.

While this seems straightforward, beware of imputed gifts in arrangements such as a split-dollar plan. If the one-year term cost is imputed income to the insured, and consequently an imputed gift to the trust, the gift will be community property. This result can be avoided with a contributory plan funded with the insured spouse's separate property.

B. Second-To-Die Life Insurance

1. Why Is It Used?

Under both the estate tax and gift tax laws, one spouse can give an unlimited amount of property to the other spouse without the imposition of transfer tax.[218] "Estate Planning 101" dictates that the first spouse to die transfers an amount equal to the estate tax exemption into a trust that does not qualify for the unlimited martial deduction (for example, into a credit shelter trust) and transfers the rest of the estate to the surviving spouse. No matter how large the estate is, this plan defers estate tax liability until the death of the surviving spouse.

This typical estate plan was the impetus for second-to-die life insurance. This policy pays a death benefit only at the death of the surviving spouse--the exact event that will trigger the couple's estate tax liability and the need for cash to help pay that liability.

2. Planning With Second-To-Die Insurance

To insure that the whole death benefit is available to provide estate tax liquidity at the survivor's death, the plan should be designed to avoid inclusion in either spouse's gross estate. An irrevocable trust is commonly used to achieve this goal.

The practitioner will face more restrictions in trust design because both spouses will be insureds. First, it is advisable that neither spouse act as trustee.[219] Second, while one of the spouses can be a trust beneficiary, there are risks to that trust design.[220] If one of the spouses is going to be a beneficiary, the couple should use the other spouse's money to make gifts to the trust.[221]

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[218] I.R.C. §§2056; 2523.

[219] See section III.B.3.a.iv. *supra*. However, in Priv. Ltr. Rul. 2004-04-013 (January 23, 2004) the Service ruled no estate inclusion for an insured trustee who was neither a grantor nor beneficiary.

[220] See Priv. Ltr. Rul. 2005-18-005 (May 6, 2005).

[221] I.R.C. §2036. It is possible to avoid inclusion in the beneficiary spouse's estate, even if that spouse is a grantor, if the interest is completely discretionary. Even if the interest is completely discretionary, however, the IRS may be able to include the trust

Using the non-beneficiary spouse's money for gifts should not create concerns while both spouses are alive, but when the grantor-spouse dies how are the premiums going to be paid? This problem is a potential roadblock to either spouse having a beneficial interest in the trust. There are two possible solutions: (1) the trust can own a single life policy insuring the non-beneficiary spouse so that the trust should have enough death benefit to fund the premiums on the second-to-die policy; (2) the non-beneficiary spouse's estate plan can provide for a distribution to the trust in an amount equal to the future premiums, perhaps using a formula.

With a second-to-die policy, neither spouse can be both a trustee and trust beneficiary. Therefore an estate plan using second-to-die insurance cannot be as flexible as a plan that separately insures both spouses. With single life policies, Dad can create a trust to own an insurance policy on his life and he can make gifts to the trust to pay premiums. He can design the trust to make Mom the trustee and the beneficiary.[222] He can give Mom the right to make distributions to herself during his life (and of course after his death), and can give Mom a limited power to appoint trust property (i.e., the policy or its death proceeds).[223] If estate liquidity needs change or if Mom's needs change, she can use the policy's cash value to meet her lifetime needs or she can use her power of appointment to transfer the policy out of the trust. Dad is a permissible appointee. Mom can then design her trust similarly.

C. Reciprocal Trust Doctrine

Notice that Mom is designing her trust similarly rather than identically to Dad's trust. That is because if the two trusts are identical, there is a risk of the trust property being included in the spouses' gross estates under the reciprocal trust doctrine.

The seminal case dealing with the reciprocal trust doctrine is *U.S. v. Estate of Grace*.[224] A married couple created identical trusts. Each named the other as a co-trustee and trust beneficiary. The Supreme Court "uncrossed" the trusts, and held that the trust created by Mom was in Dad's. The theory was that Mom, for example, really did not create the trust that gave Dad the interest. The true creator was Dad; Mom just stood in the role of creator for tax avoidance. Likewise, Mom was deemed the grantor of the trust nominally created by Dad.

The Supreme Court held that for the reciprocal trust doctrine to apply the trusts need to: (1) be interrelated and (2) leave both parties in the same objective economic position as if they had created the trust that names them as beneficiary.[225]

The Tax Court expanded this standard when it held that "same economic position" is not limited to situations where Dad is a beneficiary of the trust created by Mom, but also includes situations where Dad has powers over Mom's trust that would have caused the trust property to be included in Dad's gross estate if he were the grantor.[226] Under *Bischoff*, if Dad creates a trust that gives Mom the right to control who gets trust property and/or the timing of the enjoyment (both powers that cause inclusion in the gross estate under §§2036(a)(2) and 2038(a)(1)), and Mom creates an identical trust; Dad will be treated as the grantor of the trust created by Mom. The value of that trust's property will be included in Dad's gross

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property in the beneficiary spouse's estate by showing pre-arrangement (or stated more accurately, if the decedent's estate cannot disprove pre-arrangement). See section III.B.3.b. *supra*.

[222] See section III.B.3.c. *supra*. for how to design Mom's powers to avoid estate inclusion for Mom under I.R.C. §2041.

[223] *Id*.

[224] 395 U.S. 316 (1969).

[225] *Grace*, 395 U.S. at 338.

[226] *Estate of Bischoff v. Comm'r*, 69 T.C. 32 (1977).

estate, even though Dad was not a beneficiary of the trust and could not make distributions of trust property to himself.

The Supreme Court in *Grace* announced three criteria that determine whether the reciprocal trust doctrine applies:

1. Do the trusts have identical terms?
2. Are the trusts created at approximately the same time?
3. Do the trusts have the same economic value?

If the practitioner, for the sake of flexible plan design, creates two separate trusts, it is crucial to keep these criteria in mind. The practitioner may want to have different death benefits, policies designed with different "mixes" to result in different cash values, and policies with different premium responsibilities. The practitioner may also want to avoid the creation of the trusts that look like part of a pre-arranged, interrelated plan. If feasible, the trusts should be created at different times, and should not be communicated to anyone as part of the same plan.

Finally, if possible, the trusts should have different terms.[227] Different dispositive standards, different beneficiaries, and maybe even different fiduciary powers each may work. The Tax Court has said one difference that *will* work is to give one spouse a power of appointment and not give a power of appointment to other spouse.[228] In *Levy*, Herbert Levy and his wife Ilse each set up a trust for the benefit of their only child, Lawrence. Herbert transferred 12.5 shares of Wel-Fit Shoes stock to the trust, named Ilse as trustee, and named Lawrence as the trust beneficiary. Herbert's trust also gave Ilse the power to transfer the trust income or corpus at any time during her life and prior to Herbert's death to anyone except herself, her creditors, her estate, or the creditors of her estate (in other words, a limited power of appointment).

Ilse's trust was created on the same day, by the same attorney, was funded with 12.5 shares of Wel-Fit Shoes stock, and named Lawrence as beneficiary. In fact, the terms of Ilse's trust were identical to Herbert's trust except that Ilse's trust did not give Herbert a limited power of appointment.
The Tax Court held that because Ilse had a limited power of appointment and Herbert did not, the reciprocal trust doctrine did not apply. The Tax Court stated that Herbert and Ilse had markedly different interests in, and control over, the trusts created by the other. The Court reasoned that the reciprocal trust doctrine does not reach transfers in trust which create different interests and which change the effective position of each party with respect to the transferred property. In other words, Ilse's rights over the 12.5 shares of stock in Herbert's trust (the right to transfer those shares to any number of people) were clearly different from Herbert's rights over the 12.5 shares in Ilse's trust (to manage the property as trustee and perhaps determine when distributions are made--but not to control or alter who actually gets the property).

VI. TRANSFERRING AN EXISTING POLICY TO ANOTHER TRUST

Some irrevocable trusts are not drafted with enough flexibility to handle changing circumstances. Then, when circumstances change, these trusts no longer meet their intended purpose. At that time, the trustee may decide that the property should be held by a more flexible trust. Unfortunately, the trust is irrevocable, and may not have a procedure to allow someone to amend its terms. The trustee will need to move the trust assets out of the current trust to a more suitable trust.

[227] See for example Priv. Ltr. Rul. 2004-26-008 (June 25, 2004) in which the Service ruled that Husband's trust and Wife's trust differed and were not interrelated and therefore were not subject to the reciprocal trust doctrine.
[228] *Estate of Levy v. Comm'r*, 46 T.C.M. 910 (1983).

A. Distribution Directly to a New Trust

The best option is for the trustee to make a distribution of the policy directly to the new trust. If the trustee is authorized to make this distribution, the assets will end up in the new trust without income, gift or estate tax consequences.[229]

The key is whether the trustee is authorized to make a distribution directly to the new trust. The trustee and practitioner should examine the trust for authorizing language. An example of language the practitioner can use to add this flexibility is:

> The trustee may transfer all or part of the trust property to one or more of the trust beneficiaries, or to a trust for the benefit of one or more of the trust beneficiaries. The trust receiving the distribution does not need to have the same terms as the distributing trust.

B. Distribution to Beneficiary

If the current trust does not authorize the trustee to make transfers to the new trust, but does authorize distributions to the beneficiaries during the grantor's life, the trustee can distribute the policy directly to the beneficiaries. This distribution again has no income, gift or estate tax consequences. Of course, after the distribution, the beneficiaries own the policy. At their discretion, they can own it individually, they can sell it, or they can even surrender it. From the grantor's and trustee's perspective, the beneficiaries can hopefully be persuaded to transfer the policy to the new trust.

If the beneficiaries transfer the policy to the new trust, the beneficiaries will be making a gift equal to the policy's value (generally the policy's interpolated terminal reserve, plus unused premiums minus loans).[230] If that value exceeds the potential annual gift tax exclusion, the transfer could have gift tax consequences to the transferring beneficiary. Further, and possibly more problematic, are the potential estate tax concerns for those beneficiaries. The beneficiaries are contributing property to the new trust; therefore, if the trust gives them trust income or other rights described in §2036 or §2038, the trust property may be included in the beneficiary's gross estate.[231]

C. Sale to Grantor/Gift to the New Trust

Another way to transfer the policy to the new trust is first to get the policy in the grantor's hands, and then have the grantor transfer the policy to the new trust. Generally, the grantor will not be a trust beneficiary so the trustee may not be able to distribute the policy directly to the grantor. The trustee can, however, sell the policy to the grantor.

The grantor will have to pay the trustee the policy's fair market value, generally its interpolated terminal reserve plus unused premiums minus loans. This will result in some cash being in the old trust.

Further, if the policy's gross cash value is greater than its basis, the trust has a gain equal to that difference. Whether the trust will have to recognize that gain depends on whether the trust is a grantor trust. If the trust is a grantor trust, for income tax purposes the trust is the grantor. In other words, for income tax purposes, no sale takes place and the trust does not recognize the gain.[232]

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[229] I.R.C. §643; Treas. Reg. §25.2511-1(g)(1).
[230] Treas. Reg. §25.2512-6(a), Example 4.
[231] I.R.C. §2036(a)(1).
[232] Rev. Rul. 85-13, 1985-1 C.B. 184.

Once the grantor has the policy, the grantor can make a gift of the policy to the new trust. The policy's fair market value will constitute a gift from the grantor to the trust. The grantor may use Crummey powers to qualify the entire gift for the annual exclusion. The value of this gift will also be more "manageable" if the policy's fair market value is reduced through policy loans by the trustee prior to the sale of the policy to the grantor or by the grantor prior to giving the policy to the trust.[233] Of course, if the trustee takes out the policy loan, the loan proceeds will still be in the old trust.

An issue that may cause concern is that a new three-year inclusion period commences under §2035. If the grantor dies in the three years following the gift, the policy's death benefit is in the grantor's gross estate.

D. Sale to a New Trust

To avoid a new three-year rule, the old trust can sell the policy directly to the new trust. The grantor makes a cash gift or a loan to the new trust equal to the policy's value. Again, the amount of this gift can be reduced if the old trustee executes policy loans.

A sale of an insurance policy with a gross cash value in excess of basis generally triggers taxable income to the seller. But if both trusts are grantor trusts, the grantor should be treated as the "owner" of both for income tax purposes. The sale should not trigger any taxable income to the old trust because the sale is "disregarded" for income tax purposes.[234] In addition, because the sale is ignored, there is no transfer for value. [235] In addition, the new trust will take an income tax basis in the policy equal to the old trust's basis. Given that the basis of the policy in the hands of the transferee (the new trust) is equal to the policy in the hands of the transferor (the old trust), the transfer for value rules do not apply.[236] A boot-strap solution is to make the trust the insured's partner in a valid partnership to procure yet another exception to the transfer for value rule.[237]

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[233] One issue that can arise in certain situations is if, at the time of the gift, the loan on the policy exceeds the policy's basis, that excess is taxable income to the party making the gift. *Estate of Levine v. Comm'r.*, 72 T.C. 780 (1979). But this does not trigger taxable income when the transfer is between a grantor and a grantor trust.
[234] Rev. Rul. 85-13, 185-1 C.B. 184.
[235] Priv. Ltr. Ruls. 2006-36-086 (September 8, 2006); 2006-06-027 (February 10, 2006); 2005-18-061 (May 6, 2005); 2005-14-001 and 002 (April 8, 2005); 2002-47-006 (November 22, 2002), and 2002-28-019 (April 10, 2002).
[236] *Id*. I.R.C. §101(a)(1)(A). See Section II.B.4.e. *supra* for a more in-depth discussion of the transfer-for-value rule.
[237] I.R.C. §101(a)(1)(B).

APPENDIX

IRREVOCABLE TRUST AGREEMENTS WITH COMMENTS

The following agreements and comments were prepared for the use of legal counsel by Michael R. Doucette, J.D., CLU of Atlanta, Georgia. The content of the trust, will vary depending on the client's particular facts and circumstances. There is no categorical treatment of clients in preparing estate planning documents. The form is provided for guidance only and is only to be used by legal counsel well versed in the legal concepts covered by the documents and this study.

Appendix I is designed to own a policy on the life of the grantor (a single life policy). Appendix II is a trust designed to own a second-to-die policy.

APPENDIX I

IRREVOCABLE TRUST AGREEMENT

(to hold a single life policy insuring the life of the Donor)

This is an agreement between [Name of Donor], of [Name of County] County, [Name of State] (the "Donor") and [Name of Trustee] (the "Trustee"), of [Name of Trustee's County] County, [Name of Trustee's State]. Today's date is _______________, 20__.

RECITALS

1. The Donor wants to establish a Trust for the benefit of Donor's spouse, [Name of Spouse], and Donor's lineal descendants from time to time living, all of whom are referred to as the "beneficiaries".

2. The Donor wants to set aside property to provide for the beneficiaries.

3. The Trustee is willing to accept the trusteeship.

4. The name of this Trust is the [Name of Donor] Irrevocable Trust.

Donor assigns to the Trustee the property described in Schedule "A". Such property, along with such other property as may be assigned or made payable to the Trustee by the Donor or by any other person shall be known as the Trust Estate.

ITEM I

A. This Trust is irrevocable. After this Trust is executed, Donor shall have no right, title, or interest in this Trust or in any Trust Property. Donor shall have no right to alter, amend, revoke, or terminate this Trust or any of its provisions.

B. Donor declares that this Trust is not established to discharge any of the legal obligations of the Donor. Any payment of income or principal to or for the benefit of any beneficiary is not intended to be made, and shall not in fact be made, in lieu of or in discharge of any of Donor's legal obligations.

COMMENT 1 – *The withdrawal rights created in ITEM II qualify gifts to the trust for the annual gift tax exclusion. Several things are noteworthy about ITEM II. First, all of Donor's lineal descendants have withdrawal rights. Note that all of the lineal descendants are currently discretionary trust beneficiaries. They are not remote, contingent takers of trust property. Second, each beneficiary has an annual withdrawal right up to the maximum allowable annual exclusion. Note that withdrawal rights expire thirty days after the gift is made to the trust. After the thirty day period, amounts previously subject to withdrawal are now subject to a limited testamentary power of appointment. The purpose of this power of appointment is to prevent the beneficiaries from making completed gifts to the trust. See pages 26 and 27 for a discussion of this technique. Third, the trust does not require the Trustee to give notice of withdrawal rights to beneficiaries. This is because the IRS argues that beneficiaries must be given actual notice of withdrawal rights. It doesn't argue that the trust must require notice to be given. Whether notice is or is not required, it is usually prudent to notify beneficiaries of withdrawal rights as soon as a gift is made to the trust. A sample notice on behalf of a minor beneficiary would read as follows:*

"Re: The [Name of Trust]

Dear [Name of Guardian]:

As guardian of <u>[Name of Beneficiary]</u>, a beneficiary under the above referenced trust, you are notified that on <u>[Date of Gift]</u> a gift was made to the trust. This gift created in <u>[Name of Beneficiary]</u> a withdrawal right in the amount of $________, which you can exercise on behalf of <u>[Name of Beneficiary]</u>. This withdrawal right can be exercised by your delivery to me on or before the expiration date set forth below, a letter stating your intention to make such withdrawal on behalf of <u>[Name of Beneficiary]</u>. If you do not want to make a withdrawal, this right will expire on [Date of Expiration].

Sincerely,
[Name of Trustee]"

For an adult beneficiary, the notice could read:

"Re: The [Name of Trust]

Dear [Name of Beneficiary]:

As a beneficiary under the above referenced trust, you are notified that on <u>[Date of Gift]</u> a gift was made to the trust. This gift created in you a withdrawal right in the amount of $__________. This withdrawal right can be exercised by your delivery to me on or before the expiration date set forth below, a letter stating your intention to make such withdrawal. If you do not want to make a withdrawal, this right will expire on [Date of Expiration].

Sincerely,
[Name of Trustee]"

See pages 18-21 of the text for a discussion of the possible drawbacks associated with requiring notice of withdrawal rights to be given to beneficiaries. Fourth, no person is designated to exercise withdrawal rights on behalf of minor trust beneficiaries. See page 21 for a discussion.

ITEM II

Notwithstanding any other provision of this Trust, whenever a contribution is made to the Trust by Donor or by any other person, each beneficiary (other than Donor's spouse) shall have the absolute, unrestricted, and immediate right and power to withdraw from this Trust, by giving written notice to the Trustee, an amount equal to: (i) the value of the contribution giving rise to such withdrawal right, divided by (ii) the number of beneficiaries then living (but not including Donor's spouse). However, no such beneficiary shall have the right to withdraw more in any calendar year than the maximum amount which can qualify for the annual gift tax exclusion allowed under Section 2503(b) of the Internal Revenue Code, as in effect at the time the gift is made which gives rise to the withdrawal right. In determining the maximum amount that qualifies for such withdrawal, it shall be conclusively presumed that the contributor and the contributor’s spouse, if any, will elect to treat such contributions as if made 1/2 by each under Section 2513 of the Internal Revenue Code, regardless of whether such election is, in fact, made. The aforesaid rights to immediately withdraw trust contributions shall be exercisable for a period of thirty (30) days after the date on which the contribution is made to the Trust that gives rise to the withdrawal right in question. To this end, the Trustee shall, at all times while any such withdrawal right is outstanding, retain sufficient transferable assets to satisfy all such withdrawal rights which are then outstanding. After the expiration of such thirty (30) day period, each beneficiary who theretofore had a withdrawal right shall have the ongoing right and power to appoint the value of any property which was theretofore subject to a power of withdrawal by such beneficiary, and any income attributable thereto, to any then living lineal descendants of Donor, or to a trust or trusts for their benefit. Such power of appointment shall be exercised only by a provision in the last will of the person expressly exercising such power. Unless within ninety (90) days following such person's death the Trustee has actual notice of the existence of a will exercising such power, the Trustee shall, without incurring any liability to any appointee, proceed as if such power had not been exercised; provided, however, that this sentence shall not bar any right which an appointee may have to enforce this appointment.

COMMENT 2 – *ITEM III contains the dispositive provisions of the Trust. Note that distributions under Sub-paragraphs A1 and A2 are permissible even while the Donor is alive. See page 48 for discussion.*

ITEM III

A. The trust property shall be held in trust by the Trustee upon the following terms and conditions:

1. The Trustee shall hold and administer the trust property, collect the income, and shall accumulate or pay the net income in such amounts or proportions and at such times as it may deem appropriate in its sole and absolute discretion to or for the benefit of Donor's spouse, [Name of Spouse] and Donor's lineal descendants from time to time living, for their health, maintenance, support, and education, taking into consideration the needs of each beneficiary and any other known means of support which may be available or, in the opinion of the Trustee, ought to be available, to any such beneficiary. Such distributions of income may be made without equalization from year to year or between beneficiaries or classes of beneficiaries. Donor's primary concerns are that Donor's said spouse be supported and maintained and that Donor's children be supported and educated. Donor requests the Trustee to be guided by those concerns when deciding on distributions of income from this Trust.

2. The Trustee shall have the power in its sole and absolute discretion to distribute the principal of this trust in such amounts and at such times as it may deem necessary to provide for the health, maintenance, support, and education of Donor's said spouse and Donor's lineal descendants from time to time living taking into account any other sources of support that may be available or, in the opinion of the Trustee, ought to be available, to any beneficiary. Such distributions of principal may be made without equalization from year to year or between beneficiaries or classes of beneficiaries. Donor's primary concerns are that Donor's spouse be supported and maintained as well as possible and that Donor's children be supported and educated rather than the preservation of the principal, and Donor asks the Trustee to be guided by these concerns when deciding on distributions of principal from this Trust.

3. Donor's said spouse shall have the right by such spouse’s Will, by making express reference to this power, to appoint any part or all of the property of this Trust to Donor's lineal descendants or spouses of Donor's lineal descendants, in trust or otherwise, provided that Donor's said spouse shall have no power to appoint such property in favor of [himself or herself], [his or her] estate, [his or her] creditors, or the creditors of [his or her] estate.

COMMENT 3 – *Sub-Paragraph 4 contemplates minor beneficiaries. If the Donor has adult children, the language below should be modified. First, the trust should be divided as soon as the Donor and the Donor’s spouse die. Second, sub-paragraph A4b should state that the share of any living child of Donor should be distributed to such child in fee simple. Sub-paragraphs A4c and d cold be deleted.*

4. After the deaths of Donor and Donor's said spouse, and upon Donor's youngest living child attaining age ***, or after the deaths of Donor and Donor's said spouse and the deaths of all of Donor's children before the youngest such child attains age ***, the Trustee shall divide the then remaining Trust property into as many equal shares as Donor has then living children and deceased children with lineal descendants then living. Each such equal share shall be held and distributed as follows:

(a) The share of any deceased child of Donor shall be distributed to his or her then living lineal descendants, per stirpes, subject to the provisions of Paragraph B of this Item.

(b) The share of any living child of Donor shall be held in a separate trust for such child. The Trustee shall pay to each child of Donor for whom a trust is held all the net income from his or her trust, in quarterly or more frequent installments. The trustee shall also be authorized, in the Trustee's sole and absolute discretion, to distribute the principal of a child's trust for the benefit of such child as provided above in this Paragraph A.

(c) When each child of Donor for whom a trust is held hereunder reaches the age of ***, the Trustee shall distribute outright to such child ____% of the then remaining property in his or her trust. When each such child reaches the age of ***, the Trustee shall distribute outright to such child in fee simple ___% of the remaining property in his or her trust. When each such child reaches the age of ***, the Trustee shall distribute outright to such child in fee simple all the remaining property in his or her trust.

(d) If any child of Donor for whom a trust is held hereunder dies before receiving all the property in his or her trust, any remaining property in such child's trust shall be distributed to his or her then living lineal descendants per stirpes, if any, and, if none, to the shares and trusts created for Donor's other children and lineal descendants of deceased children, subject to the provisions of Paragraph B. below.

5. If, at any time before the termination of this trust, Donor is not living and Donor's wife is no longer a beneficiary, and all of Donor's children have died without surviving lineal descendants, the remaining trust property shall be distributed as follows:

One-half (1/2) of the remaining trust property shall be distributed to Donor's heirs at law and one-half (1/2) shall be distributed to Donor's spouse's heirs at law, determined according to applicable [Name of State] law, as if they had died intestate at that time, neither of them surviving the other.

6. The term "education" as used in this Trust Agreement shall include private elementary and secondary education, public or private college, postgraduate and professional education, and technical and vocational training.

7. The Trustee may (keeping in mind Donor's primary concerns for this Trust) at any time distribute to any child of Donor a portion of the principal of the Trust to enable such child to marry, to purchase a home, or to enter into a trade or business. Any money or property distributed to such child under this paragraph shall be deducted without interest from the share of such child or his or her lineal descendants, as the case may be, at the time of division into shares. The Trustee shall not be liable if the share of such child or his or her lineal descendants at the time of distribution is insufficient to cover any such advance.

B. Whenever the Trustee is directed to distribute any property outright to a person other than a child of Donor who has not attained age 21, the Trustee shall continue to hold the share of such person in trust for such person until he or she attains age 21, at which time the remaining trust share shall be distributed outright to such person. Meanwhile, the Trustee may distribute the income or principal of the share of such person to provide for the health, maintenance, support, and education of such person. If such person dies before attaining age 21, the property remaining in the share shall be distributed to the personal representative of such person's estate. Whenever the Trustee is directed to pay or use Trust property to or for the benefit of any minor or any person suffering under any legal disability, the Trustee shall not required to seek the appointment of a guardian. Rather, the Trustee shall be authorized in its best judgment to pay or deliver such property to the person having custody of such beneficiary, or to such beneficiary without the intervention of a guardian, or to a legal guardian of the beneficiary if one has been appointed, or to apply such property for the benefit of such beneficiary.

COMMENT 4 – *The purpose of Paragraphs C and D is to make sure that if any property is included in the insured's gross estate under Section 2035, the property so included can qualify for the marital deduction. Note that this marital deduction savings clause, unlike many others, qualifies the property for the marital deduction pursuant to the terms of the trust (instead of directing the property included in the insured' gross estate to be distributed to the insured's probate estate or revocable trust. See footnote 8 on page 5. The first option for Paragraph D qualifies the property for the marital deduction by giving the property outright to the surviving spouse. The second option for Paragraph D qualifies the property for the marital deduction by creating "qualified terminable interest property. (QTIP)".*

C. Notwithstanding the foregoing, if Donor dies and is survived by Donor's spouse, [Name of Spouse], and if any or all of the property in this Trust is includible in Donor's Gross Estate for Federal Estate Tax purposes, then such property as is so includible shall be distributed as provided in Paragraph D. below.

D. The property distributable under this Paragraph shall be distributed outright, in fee simple, to Donor's spouse, [Name of Spouse].

OR

D. The property distributable under this Paragraph shall be held in Trust under the following terms and conditions.

1. The Trustee shall pay to Donor's said spouse all the net income of the Trust, in annual or more frequent installments, as may be agreed upon, from the time of Donor's death until Donor's said spouse dies.

2. If, in the sole judgment of the Trustee, the income being paid to Donor's said spouse, together with any other income or periodic payments known to the Trustee that is being paid to Donor's said spouse are insufficient for such spouse's health, maintenance, and support, then the Trustee may distribute trust principal to such spouse to make up any such shortfall.

3. When Donor's said spouse dies, any undistributed income shall be paid to the personal representative of such spouse's estate. Any remaining principal shall continue to be held, administered and distributed by the Trustee according to the terms provided in Paragraph A. of this ITEM I.

4. When Donor's said spouse dies, the Trustee may withhold distribution of any property which might then might be needed, in the judgment of the Trustee, to satisfy any liability that might be imposed on the Trustee for Estate or other taxes.

5. Donor's Executor shall be authorized to either exercise or fail to exercise any election to qualify all or any portion of the property distributable under this Paragraph for the marital

deduction in determining the federal estate tax liability of Donor's estate. The decision of Donor's Executor to make or not to make such election, in whole or in part, shall be final and conclusive on the Trustee and all other parties.

COMMENT 5 – *Paragraph A of ITEM IV has a fairly straight-forward trustee designation. A sole trustee, with one successor, is named. Another possibility is to name a sole Trustee while the insured is alive (when the trust will presumably own only a policy), and to nominate Co-Trustees after the insured dies (when the trust will presumably own the life insurance proceeds). Note that Paragraph B creates a mechanism whereby successor trustees can be named.*

ITEM IV

A. ________________ shall serve as the sole Trustee of this Trust. If ________________ fails to serve or ceases to serve, then Donor nominates ____________________ to serve as successor Trustee.

B. If there is a vacancy in the office of Trustee, and a successor is not appointed or designated pursuant to Paragraph A., then Donor, if living, or if not, Donor's spouse, shall within thirty (30) days after such office becomes vacant, by instrument in writing delivered to the retiring Trustee, appoint a successor Trustee. If Donor or Donor's said spouse fails or refuses within thirty (30) days to so appoint such successor, then such successor may be appointed by the Senior Judge of [Name of County and Name of Court of competent jurisdiction] upon application of any person interested in such Trust or upon application of the retiring Trustee. Any successor Corporate Trustee shall, regardless of the method of appointment, be a bank or trust company authorized to perform trust functions having a capital and surplus of not less than $100,000,000.00. Such retiring Trustee shall, at the cost and expense to the Trust, execute and deliver to such Successor Trustee all conveyances and things as may be necessary to vest Trustee in the Trust Estate. When the retiring Trustee properly accounts to the Successor Trustee for all money and property received and disbursed by it, it shall be discharged from any and all further liability.

C. The Trustee accepts the Trust and agrees with the Donor that it will execute the its duties with due fidelity and will account for all money and property received and disbursed by it to the beneficiaries. The Trustee or its successor or successors may resign its trusteeship. Upon properly accounting for all money and property received and disbursed by it, the Trustee shall be discharged from any and all further liability.

COMMENT 6 – *Paragraph D gives the trust beneficiaries the right to remove a corporate Trustee. As written below, it is contemplated that there won't be a corporate Trustee until Donor and Donor's spouse are both dead.*

D. After the deaths of Donor and his spouse, [Name of Spouse], those persons comprising more than 50% of the current income beneficiaries of the subject trust or their guardians acting for them, upon written notice delivered to any corporate Trustee, may remove such Trustee from office. This right of removal may be exercised at such times and from time to time as may be desired.

E. After the death of Donor and Donor's wife, the power to appoint successor Trustees, as provided in Paragraph B. above, may be exercised by those persons comprising more than 50% of the current income beneficiaries of the subject trust or subtrust or by their guardians acting for them,

F. If any Trustee or Successor Trustee appointed under this Trust Agreement is domiciled outside the State of [Name of State], such Trustee shall be authorized to remove the Trust assets to the domicile of such Trustee. Thereafter the administration of such Trust shall be governed by the laws of the State in which such Trustee is domiciled, but the construction of such Trust and the right of the beneficiaries thereof shall continue to be governed by the laws of the State of [Name of State].

G. The Trustee and any successor Trustee shall not be required to inquire into or audit the acts or doings of any Executor or any predecessor Trustee or to make any claim against any such Executor or predecessor.

H. Any Successor Trustee shall have and may exercise any or all of the privileges and immunities granted herein conferred on the Trustee as fully and to the same extent as if such successor had originally been named as the Trustee herein.

I. As used in this Trust Agreement, the term "Trustee" refers individually or collectively to all Trustees acting at any time as the context may require, and the term "Corporate Trustee" shall refer to any Trustee which is a state of national banking association or trust company with trust powers.

J. Notwithstanding anything to the contrary, any person serving as a Trustee or Co-Trustee hereunder shall not participate in any discretionary decision of the Trustee to:

1. Allocate income or corpus to himself or herself as a beneficiary except as such power of the Trustee is limited by an ascertainable standard relating to the health, education, support or maintenance of himself or herself; or

2. Allocate income or corpus to other beneficiaries for whom such Trustee has a legal obligation of support.

3. In addition, if this trust at any time owns a policy of insurance insuring the life of any Trustee, the Trustee who is the insured shall have no authority, notwithstanding any other provision of this Trust, to exercise or participate in the exercise of any incident of ownership respecting such policy.

K. Notwithstanding any other provision of this Trust, Donor shall never be permitted to serve as Trustee or Co-Trustee hereunder, and shall not, either alone or in conjunction with any person, have the right to designate the persons who shall possess or enjoy the trust property or the income therefrom.

L. Any Corporate Trustee shall receive such compensation for its services as is normally charged to similar trusts under its regularly published fee schedule as the same may from time to time be amended, or as may be otherwise agreed with Donor's spouse or a majority of the current beneficiaries of this Trust.

M. The designation of any Corporate Trustee shall include any bank or trust company with which it may be merged or consolidated.

N. Whenever a Successor Trustee is to be appointed by anyone other than Donor to replace a retiring corporate Trustee, such successor shall be a corporate Trustee meeting the requirements set forth in Paragraph B. above.

[OR]

N. Whenever a Successor Trustee is to be appointed by anyone other than Donor or Donor's spouse, [Name of Spouse], to replace a retiring Corporate Trustee, such successor shall be a Corporate Trustee meeting the requirements set forth in Paragraph B. above.

ITEM V

Notwithstanding any other provisions contained in this Trust, the Trustees shall not:

A. Permit Donor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or income therefrom for less than an adequate consideration in money or money's worth;

B. Permit the Donor to borrow the corpus or income directly or indirectly without adequate interest or security.

COMMENT 7 = *If Donor and Donor's spouse are divorced, Donor's spouse is treated as having died for all purpose of the Trust. This provision not only removes the divorced spouse as a Trustee and a beneficiary; it also eliminates the need for the Donor's children to wait until the spouse dies before receiving their shares of trust property. In spite of its seemingly harsh language, the purpose of this provision is to benefit the Donor's children rather than to punish the divorced spouse. In the absence of this provision, if the Donor and the Donor's spouse are divorced, there is a good chance that the insurance will be cancelled. If this provision is included, there's a good chance that the insurance will be maintained for the Donor's children.*

ITEM VI

Notwithstanding any other provision of this Trust, if Donor and Donor's spouse [Name of Spouse] are ever divorced, then Donor's said spouse shall be treated, and this Trust shall be interpreted, for all purposes, as if such spouse had died as of the date of such divorce.

ITEM VII

A. The income and support provided in this Trust Agreement for the beneficiaries shall not be transferred, assigned or conveyed and shall not be subject to the claims of any creditors of any beneficiary, and the Trustee shall continue to pay such income and support directly to or for the support of such beneficiary notwithstanding any purported transfer, assignment or conveyance, and notwithstanding any action by creditors.

B. If, however, the Trustee is prevented by any transfer, assignment or conveyance or by any proceeding brought by any creditor or by any bankruptcy, receivership or other proceeding, from paying such income or support directly to or for the support of such beneficiary, then the Trustee shall hold and accumulate the income and corpus which would have been paid to or for the support of such beneficiary until the Trustee is able to pay the same directly to or for the support of such beneficiary or until the death of such beneficiary, whichever occurs first. On the death of such beneficiary, any income or support so accumulated shall become a part of the principal of the trust and be disposed of as such.

C. The provisions of this Item shall not apply to any property for which a marital deduction is allowable from Donor's estate.

ITEM VIII

A. If life insurance policies ("Policies") become a part of the Trust Estate, the Trustee shall be vested with all right, title, and interest in and to the Policies. The Trustee is authorized to exercise all the options, benefits, rights, and privileges under the Policies, including the right to borrow upon any policy or to pledge it for a loan. The insurance companies which have issued the Policies are authorized to recognize the Trustee as such absolute owner, and any receipts, releases, and other instruments executed by the Trustee in connection with the Policies shall be binding and conclusive upon such insurance companies. The Donor relinquishes all rights and powers which are not assignable. The Trustee shall be under no obligation to pay premiums on the Policies and it shall have no liability if such premiums are not paid, but it shall apply any dividends received by it from the Policies to the payment of premiums.

B. Upon the death of the Donor, the Trustee shall make reasonable effort to collect the proceeds of the Policies. However, it shall be under no duty to engage in litigation unless its expenses, including counsel fees and costs, have been advanced or guaranteed in an amount and in a manner which is reasonably satisfactory to it. The Trustee shall have full authority to make any compromise or settlement with respect to any such Policies. No issuer of any Policies shall be required to inquire into any of the provisions of this Trust or to see to the application or disposition of the proceeds of such Policies. The receipt of the Trustee to any such insurance company shall release and discharge said insurance company for any payments it makes and shall be binding upon every beneficiary of the Trust.

ITEM IX

The Trustee shall have, the following rights, powers, authorities, exemptions and immunities, all of which may be fairly and equitably exercised without any order of, or report to, any Court.

A. (1) To hold, manage, protect and improve the Trust property and to pay all taxes, fees, costs, charges and expenses which may be necessary or incident to the management and administration of the Trust.

(2) To use the whole or any part of the Trust property to form, become interested in, carry on, operate, participate in, or manage any corporation, general or limited partnership, association, joint venture, limited liability company, or any other form of business organization under the laws of any state or territory, that it in its discretion shall deem advisable and proper and to the best interests of the Trust, and to perform such acts, execute writings, and incur and pay such expenses and obligations as may be necessary or desirable in the formation or continuance thereof.

(3) To hire agents, attorneys, appraisers, accountants, managers, foremen, workmen and others to act under them in the administration of the Trust, and to fix the fees, compensation, salaries or wages of such persons.

(4) To buy, exchange, sell, pledge, alienate, or deal in any property, at public or private sale, upon such terms as they deem proper; to lease any property of the Trust upon such terms as it deems best and for any duration of time regardless of the duration of the administration of the Trust, all with or without any advertisement.

(5) To lend and borrow money, to give credit, and to extend or renew loans.

(6) To secure any loan or debt by mortgaging, encumbering, conveying or subjecting to a lien any part or all of the Trust property.

(7) To select depositories for the funds, securities and properties administered by it and to designate the manner and method and the persons authorized to deposit and withdraw funds and securities and other properties from such depositories.

(8) To retain, invest and reinvest in any property of any nature whatsoever (including common trust funds of any corporate Trustee, stock of any corporate Trustee, and mutual fund shares), whether or not authorized by law as a permitted investment for Trustees, and any investment made or retained by it in good faith shall be proper, although of a kind or in an amount or proportion not authorized by law as suitable for Trustees. To register any stock, bond or other property or security in the name of a nominee with or without disclosure of any fiduciary relationship, but accurate records shall be maintained showing such is an asset of the Trust.

(9) To vote directly or by proxy on any matter or question, any stock or security held by it, and to make such exchanges, pay such expenses and otherwise act as it deems proper in any merger, reorganization or consolidation affecting the property of the Trust.

(10) To rescind, release, discharge, vary, compromise, settle and adjust any contract, claim, debt, account, action or suit of or against the Trust, and to ask, demand, sue for, recover and receive all property and all sums of money, debts, and dues owing or due the Trust; and to pay any claim or debt upon such evidence as the Trustee deems sufficient.

(11) To execute, acknowledge and deliver all the necessary and proper contracts, deeds, receipts, releases, notes, mortgages, deeds to secure debt, deeds of trust, or similar evidence of indebtedness and other instruments, whether or not under seal, incident to any of its powers or rights.

(12) In purchasing securities or other assets or property at a premium or discount, to charge or credit such premium or discount to the principal of the Trust, and, subject to standard and sound accounting practice, to allocate expenses or receipts between principal and income.

(13) In distributing the income or corpus of the Trust under the provisions of this Trust Agreement, the Trustee may, unless specifically otherwise provided in this Trust Agreement, make such distributions in such amounts and proportions or installments or at such time as it in its sole discretion deems proper.

(14) Except as state otherwise to the contrary, any distribution by the Trustee may be made wholly or partially in kind, or it may sell any part or all of the Trust property and distribute the proceeds of such sale, or it may make such distribution partially in kind and without allocating the same property to different distributees and partially in cash, all as may be deemed best and most advisable in the sole discretion of the Trustee. In determining the value of any property distributed in kind, the judgment or valuation of the Trustee shall be final and binding.

(15) Whenever a distribution of principal or income is to be made to a beneficiary, the Trustee may in its discretion, make such distribution directly to such beneficiary, whether or not such beneficiary has a guardian, or it make such distribution to the beneficiary's parent or guardian, or it may make distribution to the spouse of such person in any manner which in its discretion it may deem proper, or it may make such distribution to a custodian for such beneficiary or to another trust or trusts for such beneficiary's benefit (even if such trust has other beneficiary's) and in the case of any distribution made

for the benefit of such person in any of the manners just authorized, the receipt of the person to whom payment is made shall be a full discharge to the Trustee.

(16) To acquire by purchase or otherwise, life insurance contracts of any kind or nature on the life of the Donor or anyone in whom the Trust, or any of the beneficiaries, have an insurable interest, and may pay all premiums or charges incurred in connection therewith.

(17) The Trustee shall have the right and power to exercise all of the rights, powers, and exemptions set forth in this ITEM even if the Trustee, the Donor, any beneficiary, or any relative of any of said persons has any interest in its individual capacity or as a fiduciary in any property in which the Trust invests. However, in the case of any transaction with any of said persons, all sales to or purchases from them shall be at the fair market value of the property sold or purchased, and all loans or advances shall be upon an adequate and fair rate of interest.

(18) To generally do, perform and execute any other act, deed, matter, or thing whatsoever, which ought to be done, executed or performed, or which in the discretion of the Trustee ought to be done, executed or performed, in and about the premises, as fully and effectually as the Donor could do himself.

(19) The Trustee may do anything which it is empowered to do under this Trust without any order of any Court, or any notice to anyone, or any advertisement of any kind, at private or public transaction.

(20) All of the powers and privileges enumerated in this ITEM shall be exercised for the sole benefit of the Trust.

(21) No power, option, benefit, right or authority of the Trustee shall be exhausted by the use thereof, but each such power, benefit, option, right or authority may be continuously exercised during the term of this Trust.

(22) All of the powers and privileges enumerated in this ITEM shall be cumulative and in addition to the powers and privileges granted to Trustees by the laws of the State of [Name of State].

B. The Trustee, regardless of whether or not it is a resident of the State of [Name of State], shall not be required to give any bond, surety or security, or to make or file any returns or inventories or appraisals of the Trust property to any Court.

C. The Trustee shall have the right from time to time to change the name of this Trust.

D. The Trustee shall keep or cause to be kept under its supervision and control, a complete and permanent record of all transactions, receipts and disbursements made for or on account of the Trust. The Trustee shall prepare an account and report annually, and shall, upon request in writing, deliver or send by registered mail, a copy such to the beneficiaries of legal age and/or the natural or legal guardian of the property or person of any beneficiary who is a minor at such time.

E. Whenever any matter, valuation, act, deed or decision is left to the judgment or discretion of the Trustee, its reasonable discretion, judgment, opinion, act, deed, decision or valuation under the circumstances shall be final and binding.

F. Any Trustee may give to his or her Co-Trustee(s) power of attorney to act for or to sign the name of such Trustee to any paper and any action taken pursuant to such power of attorney shall be valid for all purposes as if done or signed in person by the Trustee giving such power. Any such power of attorney may be general or may be limited to certain acts or instruments or contain conditions or restrictions and may be changed or revoked at any time by the Trustee who gave such power, giving notice of its change or revocation to his or her Co-Trustee. Furthermore, the Trustee may agree in writing, from time to time, with any financial institution, transfer agent, etc., as to the manner in which deposits or withdrawals from any account may be carried on, including, if the Trustee sees fit, the doing of all or any of said acts on behalf of the Trustee by any one or more of said Trustees, either acting alone or in such manner as the Trustees may specify.

G. Upon the death of Donor or Donor's wife, the Trustee may, at its discretion, purchase assets from either of their estates at a fair value or lend money to either of their estates at an adequate rate of interest and with adequate security. The propriety of the purchase and/or loan, the value of such assets purchased, and the determination of fair value shall be solely within the discretion of the Trustee. The Trustee shall not be liable as a result of any such purchase or loan, whether or not such assets constitute investments which may be legally made by Trustees and whether or not the Trustee and the personal representative of such estates are the same person.

H. Donor specifically authorizes the Trustee to retain in the same form as received any property deposited hereunder. Such property need not be sold merely for purposes of diversification or because the Trustee may deem such property somewhat speculative. This paragraph shall not prevent the Trustee from selling any such property if, in the opinion of the Trustee, such property should be sold.

I. The Trust shall indemnify and hold harmless each Trustee who is a party, plaintiff or defendant, or who is threatened to be made a party by anyone in connection with any action taken by the Trustee in its capacity as Trustee. Such indemnification shall extend to expenses (including attorney's fees), judgments, fines, and amounts paid in any settlement actually and reasonably incurred by the Trustee so long as the Trustee acted in a manner it believed to be in or not opposed to the best interest of the Trust or any beneficiary and, with respect to any criminal action or proceeding had no reasonable cause to believe his conduct was unlawful. Nevertheless, no indemnification shall be made in connection with any claim as to which the Trustee is adjudged liable for gross negligence or misconduct in the performance of its duty unless and only to the extent that the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability, the Trustee is fairly and reasonably entitled to indemnity for such expenses.

COMMENT 8 – *Paragraph J should be included if the parties want the trust to be a grantor trust under Sections 671-678 of the Internal Revenue Code. The person named in the blank must be neither a fiduciary nor the Donor.*

J. ________________ shall have the power to acquire and reacquire the trust principal without the consent of the Trustee, by substituting other property of an equivalent value.

ITEM X

A. The term "Trust Fund", "Trust Property", "Trust Estate" or "Trust" means, unless otherwise provided, all property and assets of whatever kind or character held by the Trustee.

B. The term "lineal descendant" shall include an unborn but conceived child who is born within the period of gestation from the date of the death of the deceased parent, and shall include any adopted child or children.

C. The term "Donor" or "Donors" shall include the present as well as any future Donor to this Trust for the purpose of determining those persons who may make gifts to this Trust; however, in all respects, reference to "Donor" in this Trust shall mean only the original Donor.

D. The term "income" shall mean all proceeds, profits, revenues and receipts which the Trustee receives from any investment of the principal and/or any business or enterprise which may be operated by the Trustee except: (1) Liquidating and stock dividends, (but including all other dividends, ordinary as well as extraordinary); and (2) Subscription rights issued in connection with any securities forming part of the Trust principal and any securities purchased upon the exercise thereof. The Trustees may determine whether capital gains or losses (determined as provided for by the Internal Revenue Code), shall constitute and be added to principal (or in case of capital losses, deducted from principal) or whether such capital gains or losses shall be added to or deducted from income, all as may be fair and equitable under the circumstances and consistent with sound accounting practice.

The term "net income" shall mean the income of the Trust after deducting: (1) all reasonable and proper reserves, deductions, expenses and charges necessary or incidental to the administration of the Trust or any property or interest in any property of the Trust, or to the operation of any business or enterprise which may be operated by the Trustees, and (2) all taxes assessed against any part of the Trust property of the Trustees.

Except as otherwise provided, or except as required by law, the determination of income and net income shall be in accordance with standard and sound accounting practice.

E. The terms "corpus" and "principal" shall mean the property conveyed by the Donor as a gift upon the creation of this Trust, any addition thereto, and any accumulated net income not distributed during any taxable year of the Trust.

F. The term "Trustee," "Trustee(s)" or "Trustees" wherever used in this instrument shall be deemed to mean the Trustee or Trustees then holding office.

G. The term "heirs at law" shall mean the heirs as determined by the laws of descent and distribution of the State of [Name of State].

H. The singular shall include the plural and the plural shall include the singular; the male shall include the female gender and the female gender shall include the male gender, all as the context and meaning of this Trust may require.

I. Unless clearly indicated to the contrary, the term “spouse”, when used with reference to Donor’s spouse shall refer solely to [Name of Spouse].

ITEM XI

Anything in this Trust Agreement to the contrary notwithstanding, all property of every Trust created by this Trust Agreement shall vest in and be distributed to the persons then entitled to the income from such property at the expiration of 21 years after the death of the last surviving beneficiary under this Trust Agreement who was in life at the time of the creation of this Trust, unless sooner vested as herein provided. The purpose of this provision is to prevent any possible violation of the rule against perpetuities and this provision should be so construed. If the persons to receive the income from any property, or the amount of such income to be received by each person are to be determined in the discretion of the Trustee, then the Trustee shall distribute such property among each of the persons to whom the Trustee is authorized to distribute income and in such portions as the Trustee, in its discretion, shall determine.

IN WITNESS WHEREOF, the parties hereto have hereunto set their hands and seals, the day and year first above written.

Signed, sealed and delivered
in the presence of:

______________________________ ______________________________

(SEAL)
Witness [Name of Donor], Donor

____

Notary Public

Signed, sealed and delivered
in the presence of:

______________________________ ______________________________

(SEAL)
Witness [Name of Trustee], Trustee

____

Notary Public

SCHEDULE A

Ten dollars ($10.00) delivered herewith by Donor to Trustee, receipt of which is hereby acknowledged by Trustee.

APPENDIX II

IRREVOCABLE TRUST AGREEMENT

(to hold a last-to-die policy insuring the lives of both Donors)

This is an agreement between [Names of Donors], of [Name of County] County, [Name of State] (the "Donors") and [Name of Trustee] (the "Trustee"), of [Name of Trustee's County] County, [Name of Trustee's State]. Today's date is _______________, 20__.

RECITALS

1. The Donors want to establish a Trust for the benefit of their lineal descendants from time to time living, all of whom are referred to as the "beneficiaries".

2. The Donors want to set aside property to provide for the beneficiaries.

3. The Trustee is willing to accept the trusteeship.

4. The name of this Trust is the [Donors' Surname] Irrevocable Family Trust.

Donors assign to the Trustee the property described in Schedule "A". Such property, along with such other property as may be assigned or made payable to the Trustee by the Donors or by any other person shall be known as the Trust Estate.

ITEM I

A. This Trust is irrevocable. After this Trust is executed, neither Donor shall have any right, title, or interest in this Trust or in any Trust Property. Neither Donor shall have any right to alter, amend, revoke, or terminate this Trust or any of its provisions.

B. Donors declare that this Trust is not established to discharge any of their legal obligations. Any payment of income or principal to or for the benefit of any beneficiary is not intended to be made, and shall not in fact be made, in lieu of or in discharge of any of Donors' legal obligations.

COMMENT 1 – *The withdrawal rights created in ITEM II qualify gifts to the trust for the annual gift tax exclusion. Several things are noteworthy about ITEM II. First, all of Donors' lineal descendants have withdrawal rights. Note that all of the lineal descendants are currently discretionary trust beneficiaries. They are not remote, contingent takers of trust property. Second, each beneficiary has an annual withdrawal right up to the maximum allowable annual exclusion. Note that withdrawal rights expire thirty days after the gift is made to the trust. After the thirty day period, amounts previously subject to withdrawal are now subject to a limited testamentary power of appointment. The purpose of this power of appointment is to prevent the beneficiaries from making completed gifts to the trust. See pages 26 and 27 for a discussion of this technique. Third, the trust does not require the Trustee to give notice of withdrawal rights to beneficiaries. This is because the IRS argues that beneficiaries must be given actual notice of withdrawal rights. It doesn't argue that the trust must require notice to be given. Whether notice is or is not required, it is usually prudent to notify beneficiaries of withdrawal rights as soon as a gift is made to the trust. A sample notice on behalf of a minor beneficiary would read as follows:*

"Re: The [Name of Trust]

Dear [Name of Guardian]:

As guardian of [Name of Beneficiary], a beneficiary under the above referenced trust, you are notified that on [Date of Gift] a gift was made to the trust. This gift created in [Name of Beneficiary] a withdrawal right in the amount of $_______, which you can exercise on behalf of [Name of Beneficiary]. This withdrawal right can be exercised by your delivery to me on or before the expiration date set forth below, a letter stating your intention to make such withdrawal on behalf of [Name of Beneficiary]. If you do not want to make a withdrawal, this right will expire on [Date of Expiration].

Sincerely,
[Name of Trustee]"

For an adult beneficiary, the notice could read:

"Re: The [Name of Trust]

Dear [Name of Beneficiary]:

As a beneficiary under the above referenced trust, you are notified that on [Date of Gift] a gift was made to the trust. This gift created in you a withdrawal right in the amount of $_________. This withdrawal right can be exercised by your delivery to me on or before the expiration date set forth below, a letter stating your intention to make such withdrawal. If you do not want to make a withdrawal, this right will expire on [Date of Expiration].

Sincerely,
[Name of Trustee]"

See pages 18-21 of the text for a discussion of the possible drawbacks associated with requiring notice of withdrawal rights to be given to beneficiaries. Fourth, no person is designated to exercise withdrawal rights on behalf of minor trust beneficiaries. See page 21 for a discussion.

ITEM II

Notwithstanding any other provision of this Trust, whenever a contribution is made to the Trust by either Donor or by any other person, each beneficiary shall have the absolute, unrestricted, and immediate right and power to withdraw from this Trust, by giving written notice to the Trustee, an amount equal to: (i) the value of the contribution giving rise to such withdrawal right, divided by (ii) the number of beneficiaries then living. However, no such beneficiary shall have the right to withdraw more in any calendar year than the maximum amount which can qualify for the annual gift tax exclusion allowed under Section 2503(b) of the Internal Revenue Code, as in effect at the time the gift is made which gives rise to the withdrawal right. In determining the maximum amount that qualifies for such withdrawal, it shall be conclusively presumed that the contributor and the contributor's spouse, if any, will elect to treat such contributions as if made 1/2 by each under Section 2513 of the Internal Revenue Code, regardless of whether such election is, in fact, made. The aforesaid rights to immediately withdraw trust contributions shall be exercisable for a period of thirty (30) days after the date on which the contribution is made to the Trust that gives rise to the withdrawal right in question. To this end, the Trustee shall, at all times while any such withdrawal right is outstanding, retain sufficient transferable assets to satisfy all such withdrawal rights which are then outstanding. After the expiration of such thirty (30) day period, each beneficiary who theretofore had a withdrawal right shall have the ongoing right and power to appoint the value of any property which was theretofore subject to a power of withdrawal by such beneficiary, and any income attributable thereto, to any living lineal descendants of Donor, or to a trust or trusts for their benefit. Such power of appointment shall be exercised only by a provision in the last will of the person expressly exercising such power. Unless within ninety (90) days following such person's death the Trustee has actual notice of the existence of a will exercising such power, the Trustee shall, without incurring any liability to any appointee, proceed as if such power had not been exercised; provided, however, that this sentence shall not bar any right which an appointee may have to enforce this appointment.

COMMENT 2 – *ITEM III contains the dispositive provisions of the Trust. Note that distributions under Sub-paragraphs A1 and A2 are permissible even while the Donors are alive. See page 48 for discussion.*

<u>ITEM III</u>

A. The trust property shall be held in trust by the Trustee upon the following terms and conditions:

1. The Trustee shall hold and administer the trust property, collect the income, and shall accumulate or pay the net income in such amounts or proportions and at such times as it may deem appropriate in its sole and absolute discretion to or for the benefit of Donors' lineal descendants from time to time living, for their health, maintenance, support, and education, taking into consideration the needs of each beneficiary and any other known means of support which may be available or, in the opinion of the Trustee, ought to be available, to any such beneficiary. Such distributions of income may be made without equalization from year to year or between beneficiaries or classes of beneficiaries. Donors' primary concerns are that Donors' children be supported and educated. Donors request the Trustee to be guided by those concerns when deciding on distributions of income from this Trust.

2. The Trustee shall have the power in its sole and absolute discretion to distribute the principal of this trust in such amounts and at such times as it may deem necessary to provide for the health, maintenance, support, and education of Donors' lineal descendants from time to time living taking into account any other sources of support that may be available or, in the opinion of the Trustee, ought to be available, to any beneficiary. Such distributions of principal may be made without equalization from year to year or between beneficiaries or classes of beneficiaries. Donors' primary concerns are that their children be supported and educated rather than the preservation of the principal, and Donors ask the Trustee to be guided by these concerns when deciding on distributions of principal from this Trust.

COMMENT 3 – *Sub-Paragraph 4 contemplates minor beneficiaries. If the Donors have adult children, the language below should be modified. First, the trust should be divided as soon as the Donors die. Second, sub-paragraph A4b should state that the share of any living child of Donors should be distributed to such child in fee simple. Sub-paragraphs A4c and d cold be deleted.*

3. After the deaths of both Donors, and upon Donors' youngest living child attaining age ***, or after the deaths of both Donors and the deaths of all of Donors' children before the youngest such child attains age ***, the Trustee shall divide the then remaining Trust property into as many equal shares as Donors have then living children and deceased children with lineal descendants then living. Each such equal share shall be held and distributed as follows:

(a) The share of any deceased child of the Donors shall be distributed to his or her then living lineal descendants, per stirpes, subject to the provisions of Paragraph B of this Item.

(b) The share of any living child of the Donors shall be held in a separate trust for such child. The Trustee shall pay to each child of Donor for whom a trust is held all the net income from his or her trust, in quarterly or more frequent installments. The trustee shall also be authorized, in the Trustee's sole and absolute discretion, to distribute the principal of a child's trust for the benefit of such child as provided above in this Paragraph A.

(c) When each child of the Donors for whom a trust is held hereunder reaches the age of ***, the Trustee shall distribute outright to such child ____% of the then remaining property in his or her trust. When each such child reaches the age of ***, the Trustee shall distribute outright to such child in fee simple ___% of the remaining property in his or her trust. When each such child reaches the age of ***, the Trustee shall distribute outright to such child in fee simple all the remaining property in his or her trust.

(d) If any child of the Donors for whom a trust is held hereunder dies before receiving all the property in his or her trust, any remaining property in such child's trust shall be distributed to his or her then living lineal descendants per stirpes, if any, and, if none, to the shares and trusts created for Donors' other children and lineal descendants of deceased children, subject to the provisions of Paragraph B. below.

4. If, at any time before the termination of this trust, neither Donor is living and all of Donors' children have died without surviving lineal descendants, the remaining trust property shall be distributed as follows:

One-half (1/2) of the remaining trust property shall be distributed to [Husband's Name]'s heirs at law and one-half (1/2) shall be distributed to [Wife's Name]'s heirs at law, determined according to applicable [Name of State] law, as if they had died intestate at that time, neither of them surviving the other.

5. The term "education" as used in this Trust Agreement shall include private elementary and secondary education, public or private college, postgraduate and professional education, and technical and vocational training.

6. The Trustee may (keeping in mind Donor's primary concerns for this Trust) at any time distribute to any child of Donors a portion of the principal of the Trust to enable such child to marry, to purchase a home, or to enter into a trade or business. Any money or property distributed to such child under this paragraph shall be deducted without interest from the share of such child or his or her lineal descendants, as the case may be, at the time of division into shares. The Trustee shall not be liable if the share of such child or his or her lineal descendants at the time of distribution is insufficient to cover any such advance.

B. Whenever the Trustee is directed to distribute any property outright to a person other than a child of Donors who has not attained age 21, the Trustee shall continue to hold the share of such person in trust for such person until he or she attains age 21, at which time the remaining trust share shall be distributed outright to such person. Meanwhile, the Trustee may distribute the income or principal of the share of such person to provide for the health, maintenance, support, and education of such person. If such person dies before attaining age 21, the property remaining in the share shall be distributed to the personal representative of such person’s estate. Whenever the Trustee is directed to pay or use Trust property to or for the benefit of any minor or any person suffering under any legal disability, the Trustee shall not required to seek the appointment of a guardian. Rather, the Trustee shall be authorized in its best judgment to pay or deliver such property to the person having custody of such beneficiary, or to such beneficiary without the intervention of a guardian, or to a legal guardian of the beneficiary if one has been appointed, or to apply such property for the benefit of such beneficiary.

ITEM IV

A. _________________ shall serve as the sole Trustee of this Trust. If ________________ fails to serve or ceases to serve, then Donor nominates ____________________ to serve as successor Trustee.

B. If there is a vacancy in the office of Trustee, and a successor is not appointed or designated pursuant to Paragraph A., then [Name of Either Husband or Wife], if living, or if not, [Name of Other Spouse], shall within thirty (30) days after such office becomes vacant, by instrument in writing delivered to the retiring Trustee, appoint a successor Trustee. If neither Donor appoints such successor within 30 days, then such successor may be appointed by the Senior Judge of [Name of County and Name of Court of competent jurisdiction] upon application of any person interested in such Trust or upon application of the retiring Trustee. Any successor Corporate Trustee shall, regardless of the method of appointment, be a bank or trust company authorized to perform trust functions having a capital and surplus of not less than $100,000,000.00. Such retiring Trustee shall, at the cost and expense to the Trust, execute and deliver to such Successor Trustee all conveyances and things as may be necessary to vest Trustee in the Trust Estate. When the retiring Trustee properly accounts to the Successor Trustee for all money and property received and disbursed by it, it shall be discharged from any and all further liability.

C. The Trustee accepts the Trust and agrees with the Donors that it will execute its duties with due fidelity and will account for all money and property received and disbursed by it to the beneficiaries. The Trustee or its successor or successors may resign its trusteeship. Upon properly accounting for all money and property received and disbursed by it, the Trustee shall be discharged from any and all further liability.

COMMENT 4 – *Paragraph D gives the trust beneficiaries the right to remove a corporate Trustee.*

D. After the deaths of both Donors, those persons comprising more than 50% of the current income beneficiaries of the subject trust or their guardians acting for them, upon written notice delivered to any corporate Trustee, may remove such Trustee from office. This right of removal may be exercised at such times and from time to time as may be desired.

E. After the deaths of both Donors, the power to appoint successor Trustees, as provided in Paragraph B. above, may be exercised by those persons comprising more than 50% of the current income beneficiaries of the subject trust or subtrust or by their guardians acting for them,

F. If any Trustee or Successor Trustee appointed under this Trust Agreement is domiciled outside the State of [Name of State], such Trustee shall be authorized to remove the Trust assets to the domicile of such Trustee. Thereafter the administration of such Trust shall be governed by the laws of the State in which such Trustee is domiciled, but the construction of such Trust and the right of the beneficiaries thereof shall continue to be governed by the laws of the State of [Name of State].

G. The Trustee and any successor Trustee shall not be required to inquire into or audit the acts or doings of any Executor or any predecessor Trustee or to make any claim against any such Executor or predecessor.

H. Any Successor Trustee shall have and may exercise any or all of the privileges and immunities granted herein conferred on the Trustee as fully and to the same extent as if such successor had originally been named as the Trustee herein.

I. As used in this Trust Agreement, the term "Trustee" refers individually or collectively to all Trustees acting at any time as the context may require, and the term "Corporate Trustee" shall refer to any Trustee which is a state of national banking association or trust company with trust powers.

J. Notwithstanding anything to the contrary, any person serving as a Trustee or Co-Trustee hereunder shall not participate in any discretionary decision of the Trustee to:

1. Allocate income or corpus to himself or herself as a beneficiary except as such power of the Trustee is limited by an ascertainable standard relating to the health, education, support or maintenance of himself or herself; or

2. Allocate income or corpus to other beneficiaries for whom such Trustee has a legal obligation of support.

3. In addition, if this trust at any time owns a policy of insurance insuring the life of any Trustee, the Trustee who is the insured shall have no authority, notwithstanding any other provision of this Trust, to exercise or participate in the exercise of any incident of ownership respecting such policy.

K. Notwithstanding any other provision of this Trust, neither Donor shall ever be permitted to serve as Trustee or Co-Trustee hereunder, and neither shall, either alone or in conjunction with any person, have the right to designate the persons who shall possess or enjoy the trust property or the income therefrom.

L. Any Corporate Trustee shall receive such compensation for its services as is normally charged to similar trusts under its regularly published fee schedule as the same may from time to time be amended, or as may be otherwise agreed with Donor's spouse or a majority of the current beneficiaries of this Trust.

M. The designation of any Corporate Trustee shall include any bank or trust company with which it may be merged or consolidated.

N. Whenever a Successor Trustee is to be appointed by anyone other than either Donor to replace a retiring corporate Trustee, such successor shall be a corporate Trustee meeting the requirements set forth in Paragraph B. above.

ITEM V

Notwithstanding any other provisions contained in this Trust, the Trustees shall not:

A. Permit either Donor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or income therefrom for less than an adequate consideration in money or money's worth;

B. Permit either Donor to borrow the corpus or income directly or indirectly without adequate interest or security.

ITEM VI

A. The income and support provided in this Trust Agreement for the beneficiaries shall not be transferred, assigned or conveyed and shall not be subject to the claims of any creditors of any beneficiary, and the Trustee shall continue to pay such income and support directly to or for the support of such beneficiary notwithstanding any purported transfer, assignment or conveyance, and notwithstanding any action by creditors.

B. If, however, the Trustee is prevented by any transfer, assignment or conveyance or by any proceeding brought by any creditor or by any bankruptcy, receivership or other proceeding, from paying such income or support directly to or for the support of such beneficiary, then the Trustee shall hold and accumulate the income and corpus which would have been paid to or for the support of such beneficiary until the Trustee is able to pay the same directly to or for the support of such beneficiary or until the death of such beneficiary, whichever occurs first. On the death of such beneficiary, any income or support so accumulated shall become a part of the principal of the trust and be disposed of as such.

ITEM VII

A. If life insurance policies ("Policies") become a part of the Trust Estate, the Trustee shall be vested with all right, title, and interest in and to the Policies. The Trustee is authorized to exercise all the options, benefits, rights, and privileges under the Policies, including the right to borrow upon any policy or to pledge it for a loan. The insurance companies which have issued the Policies are authorized to recognize the Trustee as such absolute owner, and any receipts, releases, and other instruments executed by the Trustee in connection with the Policies shall be binding and conclusive upon such insurance companies. The Donors relinquish all rights and powers which are not assignable. The Trustee shall be under no obligation to pay premiums on the Policies and it shall have no liability if such premiums are not paid, but it shall apply any dividends received by it from the Policies to the payment of premiums.

B. Upon the deaths of the Donors, the Trustee shall make reasonable effort to collect the proceeds of the Policies. However, it shall be under no duty to engage in litigation unless its expenses, including counsel fees and costs, have been advanced or guaranteed in an amount and in a manner which is reasonably satisfactory to it. The Trustee shall have full authority to make any compromise or settlement with respect to any such Policies. No issuer of any Policies shall be required to inquire into any of the provisions of this Trust or to see to the application or disposition of the proceeds of such Policies. The receipt of the Trustee to any such insurance company shall release and discharge said insurance company for any payments it makes and shall be binding upon every beneficiary of the Trust.

ITEM VIII

The Trustee shall have, the following rights, powers, authorities, exemptions and immunities, all of which may be fairly and equitably exercised without any order of, or report to, any Court.

A. (1) To hold, manage, protect and improve the Trust property and to pay all taxes, fees, costs, charges and expenses which may be necessary or incident to the management and administration of the Trust.

(2) To use the whole or any part of the Trust property to form, become interested in, carry on, operate, participate in, or manage any corporation, general or limited partnership, association, joint venture, limited liability company, or any other form of business organization under the laws of any state or territory, that it in its discretion shall deem advisable and proper and to the best interests of the Trust, and to perform such acts, execute writings, and incur and pay such expenses and obligations as may be necessary or desirable in the formation or continuance thereof.

(3) To hire agents, attorneys, appraisers, accountants, managers, foremen, workmen and others to act under them in the administration of the Trust, and to fix the fees, compensation, salaries or wages of such persons.

(4) To buy, exchange, sell, pledge, alienate, or deal in any property, at public or private sale, upon such terms as they deem proper; to lease any property of the Trust upon such terms as it deems best and for any duration of time regardless of the duration of the administration of the Trust, all with or without any advertisement.

(5) To lend and borrow money, to give credit, and to extend or renew loans.

(6) To secure any loan or debt by mortgaging, encumbering, conveying or subjecting to a lien any part or all of the Trust property.

(7) To select depositories for the funds, securities and properties administered by it and to designate the manner and method and the persons authorized to deposit and withdraw funds and securities and other properties from such depositories.

(8) To retain, invest and reinvest in any property of any nature whatsoever (including common trust funds of any corporate Trustee, stock of any corporate Trustee, and mutual fund shares), whether or not authorized by law as a permitted investment for Trustees, and any investment made or retained by it in good faith shall be proper, although of a kind or in an amount or proportion not authorized by law as suitable for Trustees. To register any stock, bond or other property or security in the name of a nominee with or without disclosure of any fiduciary relationship, but accurate records shall be maintained showing such is an asset of the Trust.

(9) To vote directly or by proxy on any matter or question, any stock or security held by it, and to make such exchanges, pay such expenses and otherwise act as it deems proper in any merger, reorganization or consolidation affecting the property of the Trust.

(10) To rescind, release, discharge, vary, compromise, settle and adjust any contract, claim, debt, account, action or suit of or against the Trust, and to ask, demand, sue for, recover and receive all property and all sums of money, debts, and dues owing or due the Trust; and to pay any claim or debt upon such evidence as the Trustee deems sufficient.

(11) To execute, acknowledge and deliver all the necessary and proper contracts, deeds, receipts, releases, notes, mortgages, deeds to secure debt, deeds of trust, or similar evidence of indebtedness and other instruments, whether or not under seal, incident to any of its powers or rights.

(12) In purchasing securities or other assets or property at a premium or discount, to charge or credit such premium or discount to the principal of the Trust, and, subject to standard and sound accounting practice, to allocate expenses or receipts between principal and income.

(13) In distributing the income or corpus of the Trust under the provisions of this Trust Agreement, the Trustee may, unless specifically otherwise provided in this Trust Agreement, make such

distributions in such amounts and proportions or installments or at such time as it in its sole discretion deems proper.

(14) Except as state otherwise to the contrary, any distribution by the Trustee may be made wholly or partially in kind, or it may sell any part or all of the Trust property and distribute the proceeds of such sale, or it may make such distribution partially in kind and without allocating the same property to different distributees and partially in cash, all as may be deemed best and most advisable in the sole discretion of the Trustee. In determining the value of any property distributed in kind, the judgment or valuation of the Trustee shall be final and binding.

(15) Whenever a distribution of principal or income is to be made to a beneficiary, the Trustee may in its discretion, make such distribution directly to such beneficiary, whether or not such beneficiary has a guardian, or it make such distribution to the beneficiary's parent or guardian, or it may make distribution to the spouse of such person in any manner which in its discretion it may deem proper, or it may make such distribution to a custodian for such beneficiary or to another trust or trusts for such beneficiary's benefit (even if such trust has other beneficiary's) and in the case of any distribution made for the benefit of such person in any of the manners just authorized, the receipt of the person to whom payment is made shall be a full discharge to the Trustee.

(16) To acquire by purchase or otherwise, life insurance contracts of any kind or nature on the lives of the Donors or on anyone in whom the Trust, or any of the beneficiaries, have an insurable interest, and may pay all premiums or charges incurred in connection therewith.

(17) The Trustee shall have the right and power to exercise all of the rights, powers, and exemptions set forth in this ITEM even if the Trustee, the Donor, any beneficiary, or any relative of any of said persons has any interest in its individual capacity or as a fiduciary in any property in which the Trust invests. However, in the case of any transaction with any of said persons, all sales to or purchases from them shall be at the fair market value of the property sold or purchased, and all loans or advances shall be upon an adequate and fair rate of interest.

(18) To generally do, perform and execute any other act, deed, matter, or thing whatsoever, which ought to be done, executed or performed, or which in the discretion of the Trustee ought to be done, executed or performed, in and about the premises, as fully and effectually as the Donor could do himself.

(19) The Trustee may do anything which it is empowered to do under this Trust without any order of any Court, or any notice to anyone, or any advertisement of any kind, at private or public transaction.

(20) All of the powers and privileges enumerated in this ITEM shall be exercised for the sole benefit of the Trust.

(21) No power, option, benefit, right or authority of the Trustee shall be exhausted by the use thereof, but each such power, benefit, option, right or authority may be continuously exercised during the term of this Trust.

(22) All of the powers and privileges enumerated in this ITEM shall be cumulative and in addition to the powers and privileges granted to Trustees by the laws of the State of [Name of State].

B. The Trustee, regardless of whether or not it is a resident of the State of [Name of State], shall not be required to give any bond, surety or security, or to make or file any returns or inventories or appraisals of the Trust property to any Court.

C. The Trustee shall have the right from time to time to change the name of this Trust.

D. The Trustee shall keep or cause to be kept under its supervision and control, a complete and permanent record of all transactions, receipts and disbursements made for or on account of the Trust. The Trustee shall prepare an account and report annually, and shall, upon request in writing, deliver or send by registered mail, a copy such to the beneficiaries of legal age and/or the natural or legal guardian of the property or person of any beneficiary who is a minor at such time.

E. Whenever any matter, valuation, act, deed or decision is left to the judgment or discretion of the Trustee, its reasonable discretion, judgment, opinion, act, deed, decision or valuation under the circumstances shall be final and binding.

F. Any Trustee may give to his or her Co-Trustee(s) power of attorney to act for or to sign the name of such Trustee to any paper and any action taken pursuant to such power of attorney shall be valid for all purposes as if done or signed in person by the Trustee giving such power. Any such power of attorney may be general or may be limited to certain acts or instruments or contain conditions or restrictions and may be changed or revoked at any time by the Trustee who gave such power, giving notice of its change or revocation to his or her Co-Trustee. Furthermore, the Trustee may agree in writing, from time to time, with any financial institution, transfer agent, etc., as to the manner in which deposits or withdrawals from any account may be carried on, including, if the Trustee sees fit, the doing of all or any of said acts on behalf of the Trustee by any one or more of said Trustees, either acting alone or in such manner as the Trustees may specify.

G. Upon the death of either Donor, the Trustee may, at its discretion, purchase assets from either of their estates at a fair value or lend money to either of their estates at an adequate rate of interest and with adequate security. The propriety of the purchase and/or loan, the value of such assets purchased, and the determination of fair value shall be solely within the discretion of the Trustee. The Trustee shall not be liable as a result of any such purchase or loan, whether or not such assets constitute investments which may be legally made by Trustees and whether or not the Trustee and the personal representative of such estates are the same person.

H. Donors specifically authorize the Trustee to retain in the same form as received any property deposited hereunder. Such property need not be sold merely for purposes of diversification or because the Trustee may deem such property somewhat speculative. This paragraph shall not prevent the Trustee from selling any such property if, in the opinion of the Trustee, such property should be sold.

I. The Trust shall indemnify and hold harmless each Trustee who is a party, plaintiff or defendant, or who is threatened to be made a party by anyone in connection with any action taken by the Trustee in its capacity as Trustee. Such indemnification shall extend to expenses (including attorney's fees), judgments, fines, and amounts paid in any settlement actually and reasonably incurred by the Trustee so long as the Trustee acted in a manner it believed to be in or not opposed to the best interest of the Trust or any beneficiary and, with respect to any criminal action or proceeding had no reasonable cause to believe his conduct was unlawful. Nevertheless, no indemnification shall be made in connection with any claim as to which the Trustee is adjudged liable for gross negligence or misconduct in the performance of its duty unless and only to the extent that the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability, the Trustee is fairly and reasonably entitled to indemnity for such expenses.

COMMENT 5 – *Paragraph J should be included if the parties want the trust to be a grantor trust under Sections 671-678 of the Internal Revenue Code. The person named in the blank must be neither a fiduciary nor either of the Donors.*

J. ________________ shall have the power to acquire and reacquire the trust principal without the consent of the Trustee, by substituting other property of an equivalent value.

ITEM X

A. The term "Trust Fund", "Trust Property", "Trust Estate" or "Trust" means, unless otherwise provided, all property and assets of whatever kind or character held by the Trustee.

B. The term "lineal descendant" shall include an unborn but conceived child who is born within the period of gestation from the date of the death of the deceased parent, and shall include any adopted child or children.

C. The term "Donor" or "Donors" shall include the present as well as any future Donor to this Trust for the purpose of determining those persons who may make gifts to this Trust; however, in all respects, reference to "Donors" in this Trust shall mean only the original Donors.

D. The term "income" shall mean all proceeds, profits, revenues and receipts which the Trustee receives from any investment of the principal and/or any business or enterprise which may be operated by the Trustee except: (1) Liquidating and stock dividends, (but including all other dividends, ordinary as well as extraordinary); and (2) Subscription rights issued in connection with any securities forming part of the Trust principal and any securities purchased upon the exercise thereof. The Trustees may determine whether capital gains or losses (determined as provided for by the Internal Revenue Code), shall constitute and be added to principal (or in case of capital losses, deducted from principal) or whether such capital gains or losses shall be added to or deducted from income, all as may be fair and equitable under the circumstances and consistent with sound accounting practice.

The term "net income" shall mean the income of the Trust after deducting: (1) all reasonable and proper reserves, deductions, expenses and charges necessary or incidental to the administration of the Trust or any property or interest in any property of the Trust, or to the operation of any business or enterprise which may be operated by the Trustees, and (2) all taxes assessed against any part of the Trust property of the Trustees.

Except as otherwise provided, or except as required by law, the determination of income and net income shall be in accordance with standard and sound accounting practice.

E. The terms "corpus" and "principal" shall mean the property conveyed by the Donors as a gift upon the creation of this Trust, any addition thereto, and any accumulated net income not distributed during any taxable year of the Trust.

F. The term "Trustee," "Trustee(s)" or "Trustees" wherever used in this instrument shall be deemed to mean the Trustee or Trustees then holding office.

G. The term "heirs at law" shall mean the heirs as determined by the laws of descent and distribution of the State of [Name of State].

H. The singular shall include the plural and the plural shall include the singular; the male shall include the female gender and the female gender shall include the male gender, all as the context and meaning of this Trust may require.

ITEM XI

Anything in this Trust Agreement to the contrary notwithstanding, all property of every Trust created by this Trust Agreement shall vest in and be distributed to the persons then entitled to the income from such property at the expiration of 21 years after the death of the last surviving beneficiary under this Trust Agreement who was in life at the time of the creation of this Trust, unless sooner vested as herein provided. The purpose of this provision is to prevent any possible violation of the rule against perpetuities and this provision should be so construed. If the persons to receive the income from any property, or the amount of such income to be received by each person are to be determined in the discretion of the Trustee, then the Trustee shall distribute such property among each of the persons to whom the Trustee is authorized to distribute income and in such portions as the Trustee, in its discretion, shall determine.

IN WITNESS WHEREOF, the parties hereto have hereunto set their hands and seals, the day and year first above written.

Signed, sealed and delivered
in the presence of:

______________________________ ______________________________

(SEAL)
Witness [Name of Donor], Donor

____

Notary Public

Signed, sealed and delivered
in the presence of:

______________________________ ______________________________

(SEAL)
Witness [Name of Donor], Donor

____

Notary Public

Signed, sealed and delivered
in the presence of:

______________________________ ______________________________

(SEAL)
Witness [Name of Trustee], Trustee

____

Notary Public

<u>SCHEDULE A</u>

Ten dollars ($10.00) delivered herewith by Donor to Trustee, receipt of which is hereby acknowledged by Trustee.

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