# QPRTS FOR DUMMIES (AND OTHER IDITS?)

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## I. IRREVOCABLE TRUSTS[1]

A. Functions. An irrevocable trust can shift property value and income to:

1. Build an educational fund for a child;
2. Provide current income for an adult child;
3. Provide current income for an aged parent; or
4. Provide asset protection for others.

a. If the beneficiaries do not have immediate access to trust funds, those funds are unavailable to their creditors (until an actual distribution).

> ***Example:*** Parent, in a 45% tax bracket must earn approximately $1,900 (before tax) to transfer approximately $1,000 by gift. By deflecting income into trust, the income tax liability could be considerably less than the $900 otherwise payable by Parent. The donee could use his or her personal exemption and a lower tax bracket to enable substantial tax savings to accrue within the family unit, assuming the "kiddie tax" is not applicable.[2]

B. Income Taxation to Grantor.

1. Basic Structure of Grantor Trust Rules. To shift the income from the assets placed into the trust to the trust or the beneficiaries, the grantor must not retain any of the following "grantor trust" powers (Sections 671-679):

a. The power to control the beneficial enjoyment of the trust corpus or income;
b. Certain administrative powers; or
c. A power to revoke the transfer.

Moreover, the income must not be (i) able to be held or accumulated for future distribution to the grantor or the grantor's spouse; or (ii) actually applied in payment of the grantor's legal support obligations.

2. Reversionary Interest. The grantor is treated as the owner of any portion of a trust in which he or she has a reversionary interest in either corpus or the income if the value of such reversionary interest exceeds five percent of the value of that portion of the trust subject to the reversionary interest.

a. The grantor is not treated as the owner of such portion solely by reason of a reversionary interest which would take effect upon the death of a beneficiary before that beneficiary attains age 21 when the beneficiary:

i. is a lineal descendant of the grantor; and
ii. holds all of the present interests in any portion of a trust.

b. The measurement of the value of the reversionary interest will be from the time funding has been accomplished (at the inception of the interest subject to the reversion).

3. Power to Control Beneficial Enjoyment.

a. The grantor will be treated as "owner" of the trust assets if he or she retains the power to “sprinkle” corpus, unless that power is limited by an ascertainable standard.

i. An independent trustee may exercise the right to sprinkle income or corpus (not limited by a standard) without the trust grantor being treated as the owner of the trust corpus and income.

b. The grantor (as trustee or otherwise) may enjoy the power to distribute or accumulate income only if the income is ultimately payable to a designated beneficiary.

4. Administrative Powers. The grantor is treated as the owner of a trust if he or she possesses, or exercises, certain specified administrative powers, including:

a. the power to deal with the trust for less than adequate and full consideration;
b. the power to borrow without adequate interest or security;
c. the actual borrowing of trust funds; and/or
d. certain general powers of administration exercisable in a nonfiduciary capacity.

5. Assignment of Income Principles. "Assignment of income" principles may apply to grantor trusts. Therefore, even though the grantor is not required to include the trust's gross income under the statutory rules, inclusion cannot be avoided where the income has previously been economically earned by or otherwise accrued to the trust grantor.

C. Trust Income Taxation. Assuming the grantor trust rules do not apply, a trust will be subject to the income tax rules applicable to nongrantor trusts, which categorize such trusts as "simple" or "complex."

1. Classification of Trust as Simple or Complex. Each year, a determination needs to be made as to whether a trust is simple or complex.

a. A simple trust is one which satisfies the following three statutory requirements:

i. The trust must require that all of the trust's (fiduciary accounting) income must be distributed currently;

ii. The trust must not allow any amounts to be paid, permanently set aside, or used for the charitable purposes outlined in § 642(c); and

iii. The trust must not distribute any amount during the year other than the income required to be distributed currently.

b. A complex trust is a trust which is not a simple trust.

2. General Rules.

a. A trust must use a calendar year as its taxable year.

b. Taxable income for a nongrantor trust consists of gross income minus deductions computed in the same manner as for an individual with exceptions, many of which are found in § 642.

c. Trusts are also subject to the alternative minimum tax, with an exemption amount of $22,500 that is phased out at the rate of 25 percent starting at $75,000 of alternative minimum taxable income.

d. The trust is subject to a two percent floor for miscellaneous itemized deductions.

e. § 469(a)(2)(A) provides that trusts are subject to the passive loss rules. To the extent that the losses are not passive in light of material participation by the trustees, they may be deducted currently. Losses of the decedent that were disallowed previously as passive losses are taken on the decedent's final return. Losses of the trust which are passive cannot be deducted until the year of termination of the trust.

f. If the trust has unused loss carryovers and excess deductions, they are subject to § 642(h).

i. In the year of termination, the trust may pass through to the beneficiaries certain carryovers and excess deductions:

(a) The trust's NOL can be carried out to the beneficiaries (who can take the NOL as an above-the-line deduction); and

(b) Excess deductions may be carried out to the beneficiaries as a below-the-line deduction.

g. The distributable net income ("DNI") of the nongrantor trust will be taxed either:

i. to the beneficiaries to whom the income is distributed (or is required to be distributed); or

ii. to the trust (treated as a separate taxpayer).

This income tax liability of the trust is based on the amount held by the trust after payments of income made to the beneficiaries (or required to be made to them) have been taken as deductions.

D. Gift Tax Consequences. A transfer of property into an irrevocable trust constitutes delivery for gift tax purposes. When no reversionary interest is retained by the grantor, the value of the transfer is the fair market value of the property transferred. The gift tax will apply even if the transfer is ineffective under the grantor trust rules to shift the income from the grantor.

1. Annual Exclusion. To qualify for the annual exclusion under § 2503, a gift must be a present interest.

a. When a minor is the beneficiary, the trust could be structured to fit within § 2503(c), which requires trust income to be paid currently, and termination/distribution at age 21.

b. Alternatively, (e.g., where a discretionary income distribution structure is desired), a "demand" or "Crummey" right might be used.

i. Demand or "Crummey" Powers. Under Crummey, the annual exclusion is available where a donee has an unrestricted right to the immediate use, possession or enjoyment of property. The actual use or possession of such property is not required. Thus, the key element is the right to demand property gifted into trust.

(a) Background. The Service's original concession to the Crummey case structure came in Rev. Rul. 73-405. That ruling approved the annual exclusion for a demand power extending to the entire trust property. The Service concluded that the demand power in a minor beneficiary would create a present interest so long as no impediment existed to the appointment of a guardian of the minor.

(b) Crummey. The Crummey decision extended the demand principle and allowed the annual exclusion even though: (i) the demand power extended only to annual contributions to the trust; (ii) the demand right expired at the end of the calendar year during which the transfer into trust was made; (iii) the beneficiary-power holder was a minor for whom no guardian had been appointed; and (iv) no procedure existed to notify the donee that a transfer had been made to the trust.

(1) Even if the demand period extends into a calendar year different from the one in which the transfer was made, the transferor will be entitled to the annual exclusion in the year of the transfer, provided the beneficiaries are given notice of their demand rights and no impediment exists to the appointment of guardians under local law.

(c) Subsequent Developments. The IRS has elaborated on its position regarding the availability of the annual exclusion for trust property subject to the power of withdrawal, stating that the power holder must be given:

(1) Notice of the existence of the withdrawal power; and

(2) A reasonable time within which to exercise the power.

(d) "Hanging Powers." Because of the possible difference between (i) the $12,000 annual donee exclusion Crummey withdrawal power and (ii) a lesser amount subject to the "5 or 5" power, planners have attempted to use a "hanging power" to avoid lapses occurring in excess of that power (which would be transfers for estate tax purposes, i.e., a gift from the donee-powerholder to the trust beneficiaries). In this context, the powerholder could be given (i) the right to withdraw an amount equal to the annual donee exclusion but (ii) the amount which would lapse each year (for gift and estate tax purposes) would be equal to the "5 or 5" limitation. The remaining portion would carryover to the following years until fitting within the "5 or 5" exception. If the corpus is appreciating, the five percent amount would also be expending, thereby increasing the lapsing portion. The IRS has refused to recognize the validity of a hanging power.

(e) Multiple Annual Exclusions.

(1) In *Cristofani Est. v. Comr.* (1991) 97 T.C. 74, the Tax Court allowed gifts to be made under the annual exclusion to grandchildren, even though the grandchildren's interest reverted back to the child if the exercise of a withdrawal rights was not exercised.

(2) Donors often attempt to include multiple beneficiaries eligible for the withdrawal power, so as to increase the number of available annual donee exclusions. However, the IRS has regularly challenged such multiple withdrawal powers. For planning purposes, beneficiaries for whom an annual exclusion is claimed must have real, substantive property interests under the gift transfer.

(f) Multiple Trusts. A donor may attempt to create several trusts each having withdrawal powers with the objective of enabling multiple annual donee exclusions through multiple withdrawal rights. The IRS has ruled, however, that Crummey powers must be aggregated.

(g) Donee's Income Tax Consequences. The use of Crummey powers can generate income tax exposure for the donee. To the extent that the donee possesses a power to demand property from the trust, the donee is deemed (under the grantor trust rules) to be the owner of that property, taxable on its income.

(h) Donee's Gift Tax Consequences. Because a Crummey withdrawal power allows the donee to appoint the property to himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate, the Crummey power is a general power of appointment. § 2514 provides that the exercise or release of a general power is deemed a transfer of property by the power holder. Thus, the lapse of a Crummey power may cause a taxable gift under § 2514.

(i) Donee's Estate Tax Exposure.

(1) If a taxable lapse occurs, a proportionate amount of the value of the trust property at the date of death is included in the gross estate of the power-holder.

(2) Inclusion as to the amount of property subject to the annual demand right existing at death is mandated (even if the donee is a minor not capable of exercising the withdrawal power).

E. Estate Tax Consequences.

1. Unified Tax Computation. The value of the property shifted to the irrevocable trust and treated as a completed gift will be included in the grantor's unified transfer tax base (to the extent in excess of the annual donee exclusion, assuming a present interest transfer). This will affect the rate of the transfer tax applicable to testamentary transfers.

2. Estate Tax Transfer Provisions. To ensure the assets transferred to the irrevocable trust are removed from the gross estate, the grantor must avoid problems created by Sections 2036, 2037 and 2038.

a. § 2036 -- Retained Life Estate. Under § 2036, unless the transfer was for full and adequate consideration, a decedent's gross estate includes the value of all property transferred by the decedent with respect to which he or she has retained for his or her life:

i. The possession or enjoyment of, or the right to the income from, the property; or

ii. The right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

b. § 2037 -- Transfers Taking Effect at Death. Under § 2037, the grantor's gross estate includes the value of all property to the extent of any interest therein of which the decedent has made a transfer (except for an adequate and full consideration) if:

i. Possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent; and

ii. The decedent has retained a reversionary interest in the property the value of which, immediately before his or her death, exceeds five percent of the value of the property.

c. § 2038 -- Revocable Transfers. Under § 2038, the grantor's gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except for an adequate and full consideration) where the enjoyment thereof was subject at the date of the grantor's death to any change through the exercise of a power by the decedent to alter, amend, revoke, or terminate the transfer.

F. Generation Skipping Transfer Taxes. An irrevocable trust might also be a "generation-skipping" trust if the transfers are for the benefit of grandchildren. The generation-skipping transfer ("GST") tax may be applicable, unless protected through the $1 million exemption for the grantor and, possibly, an additional $1 million exemption for a consenting spouse.

## II. GRANTOR-RETAINED INCOME TRUSTS ("GRITS")

Grantor-retained income trusts typically involve the creation of an inter vivos irrevocable trust in which the grantor retains an interest in the income produced by the trust assets. The basic structure consists of:

- A Transfer. The transfer of an income producing asset, such as an apartment building, by the grantor to an independent trustee of an irrevocable trust.
- Right to Payments Retained by Grantor. For a specified term (e.g., 10 or 15 years) or for the life of the grantor, the grantor receives a periodic payment from the trust equal to the income from the trust, a qualified annuity or a unitrust payment.
- The Remainder. Upon expiration of the trust term, the remainder passes to one or more beneficiaries identified by the grantor.

A. § 2702: The "Zero-Value" Rule. § 2702 of the Code limits future interest gifting programs by providing that, when transfers of future interests in property are made by gift to family members, the present value of the income interest is to be valued at zero. Consequently, the remainder is valued at 100 percent of the property's value.

***Example:*** Assume that parents of Son and Daughter own certain assets having a value of $1,000,000. Parents form a trust with those assets, retaining an income interest for ten years. Assuming that the interest retained by the parents was actuarially valued at $650,000, the remainder interest gifted to the children would have an actuarial value of $350,000. However, because the income interest retained by the parents is valued by § 2702 at zero, the amount of the "gift" for tax purposes is increased to $1,000,000.

1. Exceptions to the Zero-Value Rule. § 2702 contains several exceptions to the "zero-value" rule. Two of the significant exceptions are "qualified interests" that consist of the right to receive not less frequently than annually (i) fixed amounts (Grantor Retained Annuity Trusts -- "GRATS"); or (ii) a fixed percentage of the fair market value of the property in the trust as determined annually (Grantor Retained Unitrusts -- "GRUTS"). Other exceptions cover certain qualified personal residence trusts ("QPRTs") and trusts for non-family members.

## III. GRATS

A. Basic GRAT Requirements. A GRAT is an irrevocable trust in which the grantor retains the right to an annuity for a specified term.

In order to qualify as a GRAT, a trust must satisfy the following requirements (Reg. § 25.2702-3(b)):

1. Irrevocable Right to Payment for a Fixed Term. There must be an irrevocable right for the annuity holder, i.e., the grantor, to receive a "fixed amount" for each taxable year for a specified term, which may be measured by the life of the grantor. The annuity payment may be made after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the trust's federal income tax return (without regard to extensions). At the end of the term, the trust terminates and the corpus is distributed to the remainder beneficiaries.

a. A fixed amount means:

(A) A stated dollar amount payable periodically, but not less frequently than annually, but only to the extent the amount does not exceed 120% of the stated dollar amount payable in the preceding year; or

(B) A fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120% of the fixed fraction or percentage payable in the preceding year.

2. Payment Not By Withdrawal or Prepayment (Commutation) Right. Payment must be mandatory and fixed. A grantor's right to withdraw or right to be prepaid his or her interest is not permitted. An annuity interest does not fail to be a qualified annuity interest merely because the trust permits income in excess of the amount required to pay the annuity amount to be paid to or for the benefit of the holder of the qualified annuity interest. Nevertheless, the right to receive the excess income is not a qualified interest and is not taken into account in valuing the qualified annuity interest.

3. Adjustments for Incorrect Valuations. If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust assets, the governing instrument or trust agreement must provide a mechanism to adjust an incorrect determination. (Regs. §§ 25.2702-3(b)(2) and 1.664-2(a)(1)(iii).) This provision is necessary should the IRS successfully challenge the value of the assets transferred.

4. Short and Last Taxable Years. The trust agreement must require that a prorated annuity amount be paid to the grantor in the case of short taxable years.

5. No Additional Contributions. The trust agreement must prohibit any additional contributions to the trust beyond the initial contribution.

6. Prohibited Distributions. The trust agreement must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity interest during the term of that interest. (Regs. § 25.2702-3(d)(2).)

B. GRAT Term. A GRAT may be established for any term of years desired. In choosing a term, factors to consider include:

1. Gift Tax Cost. The grantor is often motivated to reduce the tax cost of the transfer by providing for a long trust term. The longer the period that an annuity interest in the GRAT is retained by the grantor, the smaller the value of the transferred remainder interest that is subject to gift tax.

2. Survivorship. If the grantor fails to survive the term of the GRAT, all or most of the corpus of the GRAT will be included in the grantor's estate under § 2036 because of the retained annuity interest.

Therefore, selection of the GRAT's term is something of a gamble. The grantor must select a term that is long enough to provide a favorable reduced transfer tax cost, but short enough that the grantor is likely to survive.

If a long term is selected, and the grantor does not survive, the inclusion of all or a substantial portion of the GRAT corpus in the grantor's gross estate may be more heavily taxed than if the grantor had merely made outright gifts of the assets.[3]

## IV. GRUTS

A. Basic GRUT Requirements. A GRUT is an irrevocable trust in which the grantor retains the right to a "unitrust amount" for a specified term, where such amount is a qualified unitrust amount. The "unitrust amount" is defined as a fixed percentage of the fair market value of the trust assets, determined annually.

In order to qualify as a GRUT, a trust must satisfy the following requirements (Reg. § 25.2702-3(c)):

1. Irrevocable Right to Payment of Unitrust Amount. There must be an irrevocable right to receive payment periodically (not less frequently than annually), of a fixed percentage of the net fair market value of the trust assets, determined annually. The unitrust payment may be made after the close of the taxable year, provided that the payment is made no later than the date by which the trustee is required to file the trust's federal income tax return for the year (without regard to extensions). At the end of the trust term, the trust terminates and the corpus is distributed to the remainder beneficiaries.

2. Payment Not by Withdrawal or Prepayment (Computation) Right. Payment must be mandatory for each taxable year of the term. A grantor's right to withdraw or to be prepaid his or her interest is not permitted.

3. Adjustments for Incorrect Valuations. The governing instrument or trust agreement must provide a mechanism to adjust an incorrect determination of the value of trust assets. This mechanism must require that the trust pay to the recipient (in the case of an undervaluation) and that the recipient repay (in the case of an overvaluation) an amount equal to the difference between the amount that should have been paid and the amount actually paid. (See Reg. § 1.664-3(a)(1)(iii).)

4. Short and Last Taxable Years. The trust agreement must require that a prorated unitrust amount be paid to the grantor in the case of short taxable years.

5. Prohibited Distributions. The trust agreement must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified unitrust interest during the term of that interest.

B. Term of a GRUT. A GRUT may be established for any term of years desired. However, in choosing a term, the factors generally parallel those described for a GRAT in § IV.B., above.

C. GRUT: Valuation. The value of the gift that is made when a GRUT is created may be calculated by using tables established by the IRS.[4]

## V. QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRTS)

A. In General. A third important exception to the zero-value rule of § 2702(a) is found in § 2702(a)(3)(A)(ii), for any transfer which

> . . . involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust.

Such interests have become known as Qualified Personal Residence Trusts or "QPRTS," a specialized form of a grantor-retained income trust. If a personal residence trust satisfies the requirements for a QPRT, most of which are contained in Regulations § 25.2702-5, and the grantor survives the term of the QPRT, a significant transfer of wealth can be achieved at a relatively lesser tax cost than had an equivalent amount of property been sold by the grantor or his beneficiaries.

> ***Example:*** In January 1997, a 64-year old widow transferred a house valued at $1,000,000 to a Grantor Retained Trust with a seven-year term that is not subject to the special valuation rules of § 2702 because the trust satisfies the requirements of a QPRT. The value of the gift, using the § 7520 interest rate for that month of 7.4% is 50.4562% of $1,000,000 or $504,562. The value of the retained interest is 49.5438% of $1,000,000 or $495,438. If the residence appreciates at 6% each year, the remainder beneficiaries will receive a house worth approximately $1,500,000 at the end of the seven-year term. If the beneficiaries sell the house and capital gains tax is paid on the appreciation, they will have an after-tax fund of approximately $1,200,000 ($1,500,000 less $100,000 in capital gains tax and $200,000 in gift tax). The result is less dramatic if the grantor has a low basis in the house at the date of transfer.\

> NOTE: Transfers to QPRTs are gifts of future interests that do not qualify for the § 2503(b) annual exclusion. This result cannot be avoided by providing the beneficiaries Crummey withdrawal powers.

B. Requirements for a QPRT. A personal residence trust is a trust which cannot hold any asset other than one residence to be used or held for use as a personal residence of the term holder and certain "qualified proceeds." (Reg. §25.2702-5(b)(1).)

In order for a personal residence trust to be a QPRT, all of the following requirements must be met:

1. Personal Residence. For purposes of the requirements of a QPRT, a personal residence is either:

   a. The principal residence of the term holder (within the meaning of § 1034);

b. One other residence of the term holder (within the meaning of § 280A(d)(1), but without regard to § 280A(d)(2)); or

c. An undivided fractional interest in either.

A personal residence may include appurtenant structures used for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). The fact that a residence is subject to a mortgage does not affect its status as a personal residence. The term personal residence does not include any personal property (e.g., household furnishings). A residence is a personal residence only if its primary use is as a residence of the term holder when occupied by the term holder. The principal residence of the term holder will not fail to meet the requirements of the preceding sentence merely because a portion of the residence is used in an activity meeting the requirements of § 280A(c)(1) or (4) (relating to deductibility of expenses related to certain uses), provided that such use is secondary to use of the residence as a residence.

If spouses hold interests in the same residence (including community property interests), the spouses may transfer their interests in the residence (or a fractional portion of their interests in the residence) to the same QPRT, provided that the governing instrument prohibits any person other than one of the spouses for holding a term interest in the trust concurrently with the other spouse.

2. Income. Any income of the trust must be distributed to the term holder not less frequently than annually.

3. Distributions to Other Persons. The governing instrument must prohibit distributions of corpus to any beneficiary other than the transferor prior to the expiration of the retained term interest.

4. Assets. In general, the governing instrument must prohibit the trust from holding any asset other than one residence to be used or held for use as a personal residence of the term holder. However, the governing instrument may permit a QPRT to hold the following assets (in addition to the residence) in the amounts and in the manner described.

a. Additions of Cash for Payment of Expenses, Etc.

i. Additions. The governing instrument may permit additions of cash to the trust, and may permit the trust to hold additions of cash in a separate account, in an amount which, when added to the cash already held in the account for such purposes, does not exceed the amount required:

(a) For payment of trust expenses (including mortgage payments) already incurred or reasonably expected to be paid by the trust within 6 months from the ate the addition is made;

(b) For improvements to the residence to be paid by the trust within 6 months from the date the addition is made;

(c) For purchase by the trust of the initial residence, within three months of the date the trust is created, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence; and

(d) For purchase by the trust of a residence to replace another residence, within three months of the date the addition is made, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence.

ii. Distributions of Excess Cash. If the governing instrument permits additions of cash to the trust, the governing instrument must require that the trustee determine, not less frequently than quarterly, the amounts held by the trust for payment of expenses in excess of the amounts permitted and described above, and must require that those amounts be distributed immediately thereafter to the term holder. In addition, the governing instrument must require, upon termination of the term holder's interest in the trust, any amounts held by the trust for the permitted purposes that are not used to pay trust expenses due and payable on the date of termination be distributed outright to the term holder within 30 days of termination.

b. Improvements. The governing instrument may permit improvements to the residence to be added to the trust and may permit the trust to hold such improvements, provided that the residence, as improved, meets the requirements of a personal residence.

c. Sale Proceeds. The governing instrument may permit the sale of the residence and may permit the trust to hold proceeds form the sale of the residence, in a separate account.

d. Insurance and Insurance Proceeds. The governing instrument may permit the trust to hold one or more policies of insurance on the residence. In addition, the governing instrument may permit the trust to hold, in a separate account, proceeds of insurance payable to the trust as a result of damage to or destruction of the residence. Amounts (other than insurance proceeds payable to the trust as a result of damage to or destruction of the residence) received as a result of the involuntary conversion (within the meaning of § 1033) of the residence are treated as proceeds of insurance.

5. Commutation. The governing instrument must prohibit commutation (prepayment) of the term holder's interest.

6. Termination of Use as a Personal Residence. The governing instrument must provide that a trust ceases to be a QPRT if the residence ceases to be used or held for use as a personal residence of the term holder. The governing instrument must also provide that the trust ceases to be a qualified personal residence trust with respect to all proceeds of sale held by the trust not later than the earlier of:

a. The date that is 2 years after the date of sale;
b. The termination of the term holder's interest in the trust; or
c. The date on which a new residence is acquired by the trust.

7. Disposition of Trust Assets on Termination as QPRT. The governing instrument must provide that, within 30 days after the date on which the trust has ceased to be a QPRT with respect to certain assets, either:

a. The assets be distributed outright to the term holder;

b. The assets be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a qualified annuity interest; or

c. In the trustee's sole discretion, the trustee may elect to comply with either of the above-stated alternatives.

Where the estate planning objective is to remove the residence from the grantor's estate, the return of the sales proceeds to the grantor is not an option. Therefore, the QPRT should require conversion into a GRAT upon termination.

8. Required Conversion to GRAT. For assets that are to be converted to and held as a qualified annuity interest the governing instrument must contain all provisions required by § 25.2702-3 of the Regulations with respect to a qualified annuity interest. If, on the conversion date, the assets of the trust do not include a residence used or held for use as a personal residence, the annuity may not be less than an amount determined by dividing the lesser of the value of all interests retained by the term holder (as of the date of the original transfer or transfers) or the value of all the trust assets (as of the conversion date) by an annuity factor determined:

a. For the original term of the term holder's interest; and

b. At the rate used in valuing the retained interest at the time of the original transfer.

## VI. GIFT TAX CONSEQUENCES

A. Annual Exclusion Unavailable. § 2503(b) allows an annual exclusion of up to $12,000 per donee for gifts of present interests. Because a gift by way of a GRAT or GRUT will not be presently enjoyed by the remainder beneficiaries, it is a future gift, and no exclusion is allowed.

1. An interesting and unusual question is whether a GRAT could provide a Crummey power which would somehow cure the future gift problem for annual exclusions wherein a remainderman has a limited right to demand receipt of the present value of his or her future gift.

2. One consequence of the absence of the annual exclusion is that a gift tax return will be required in all instances. Further, if the grantor has fully used his or her unified credit amount as the result of prior gifts, there will be gift taxes due upon the funding to the extent that the value of the future interest transferred by gifts.

B. Valuation. The benefit of a GRAT or GRUT arrangement results from the computation of the value of the gift that is made on transfer to the trust. The value of the gift is the value of the property transferred to the trust less the present actuarial value of that annuity or unitrust interest the grantor retains for the shorter of the trust term or the grantor's lifetime.

For purposes of this calculation, the retained interest is valued under § 7520, using the IRS's actuarial tables and an assumed interest rate (rounded to the nearest 0.2%) equal to 120% of the midterm applicable federal rate (compounded annually), under § 1274(d)(1) for the month in which the gift is made.

a. GRAT Valuation Example.

FACTORS INVOLVING ONE LIFE AND A TERM OF YEARS

Based on an interest rate of 8.0%, the present worth of a temporary annuity of $1.00 per annum payable annually for 10 years or until the prior death of a person aged 60 is $6.22690405, determined as follows:

Initial age = 60
Term of years = 10
Terminal age = 70

| | | |
|---|---|---|
| N-factor, TABLE H(8.0), age 60 | = | 7402.570 |
| minus N-factor, TABLE H(8.0), age 70= | | <2253.756> |
| Difference | = | 5148.814 |
| D-factor, TABLE H(8.0), age 60 | = | 826.8658 |
| Required Annuity Factor = 5148.814 ÷ 826.8658 | = | 6.2269 |

The value of an annual annuity of $10,000 payable for a term of 10 years or life, if shorter, is $62,269, and the present value of the remainder is $37,731 ($100,000 - $62,269 = $37,731).

C. Limits on "Zeroed-Out" Gift. Minimization or elimination of the gift element of a GRAT (but not of a GRUT) is limited in the following respects:

1. The retained interest is valued as an annuity, an amount less than the value of all of the annuity interest may be deducted by the trust if income exceeds the annuity.

2. If there is a possibility that the trust fund will be exhausted, a separate computation will be required to take the exhaustion of the fund into account.

3. The value of the future gift is not reduced for a grantor's contingent reversion provision, i.e., if the GRAT's agreement states that the trust assets revert to the grantor where the grantor fails to survive the trust term. Because the grantor's reversionary interest is not a qualified interest, as a result, it is valued at zero under § 2702.

D. "Zeroed-Out" GRAT. Before the end of 1995, it was theoretically possible to set annuity payments at a sufficiently high level to thereby create a "zeroed-out" GRAT in which the value of the retained annuity interest equaled (or minimally exceeded) the value of the property transferred to the GRAT. In December 1995, the IRS promulgated Regulations dealing with valuations of interests under § 7520 that effectively preclude creation of a zeroed-out GRAT. Under those Regulations, if the trust fund is expected to be exhausted before all annuity payments have been made (using the assumed interest rate in effect under IRC § 7520), a special valuation computation must be made to take into account the possible exhaustion of the trust fund, and for this purpose, it will be assumed that it is possible for each measuring life to survive to age 110. (Reg. § 25.7520-3(b)(2)(i).)

E. Mortgage Payments. Where property transferred into a trust is subject to a mortgage, there is a risk that the IRS might argue that any principal repayments made on the mortgage should be treated as the making of an additional gift due to the fact that principal reduction payments will benefit the remaindermen receiving the property upon the termination of a GRAT or a GRUT.

On the other hand, where the mortgage payment made is in connection with a business that is held by an entity, a position should exist that the principal reduction created no benefit to the remaindermen. Because the payment was made out of cash funds that would have otherwise been retained by the business, there is no benefit to the trust holding an interest in the entity. This position should be available so long as mortgage payments are made out of the funds of the entity.

## VII. ESTATE TAX CONSEQUENCES

A. Reversionary Interest. § 2036 provides that the gross estate includes the value of property to the extent that the retained interest "does not in fact end before his death." § 2036(a) requires the grantor to include part or all of the value of his or her GRAT or GRUT should he or she predecease the term of his or her trust where the GRAT does not end by reason of the grantor's death.

Because this rule creates a problem wherein trust assets are unavailable to pay estate taxes, GRATs and GRUTs typically provide that, upon the death of the grantor before its term-end, the trust assets revert to the grantor and are available to be included in the grantor's estate. This feature recognizes that a GRAT/GRUT gifting plan will fail where the Grantor does not survive the term of the trust. Therefore, as the failure has already occurred, it makes no sense to continue the term of the GRAT or GRUT.

Under § 2037, the gross estate of a decedent includes the value of all property to the extent the decedent has made a transfer by trust if either (i) possession or enjoyment can be obtained only by surviving the decedent, and (ii) decedent's reversionary interest immediately before death exceeds five percent of the value of such property.

The effect of this is that the reversion feature itself usually causes the inclusion of the assets of the GRAT/GRUT in the decedent's estate. The consequence of this is that the grantor of a GRAT "bets" that he or she can survive the term of the trust. If he or she survives the term of the trust, then certain estate tax benefits will be received. Should he or she not survive the term, maintaining the GRAT/GRUT will not provide any estate tax benefits.

## VIII. GENERATION-SKIPPING TRANSFER TAX

A GRAT or GRUT creates a risk of generation-skipping transfer tax ("GST tax") under § 2601.[5]

The initial formation and funding of a GRAT or GRUT does not result in GST tax. However, the Regulations do take a "wait and see" approach, and GST tax may apply upon termination of the GRAT. For example, the GST tax may apply if the trust ultimately transfers transfer property to the grantor's grandchildren.

While one option to deal with the GST tax would be to have property pass only to the grantor's children, i.e., surviving child takes all, this may not be an acceptable option where there is a predeceased parent. The other option is to allocate the $1 million GST exemption to the GRAT/GRUT under Sections 2631 and 2632. An allocation must be made on the grantor's gift tax return, filed before Grantor's death for the year of the gift. Because the allocation applies to all trust assets, there is no leveraging of the allocation to account for the future gift interest. For example, if the property transferred to the GRAT is valued at $1 million and the future gift to the remainder is $350,000, the GST exemption allocation used to protect the trust would be $1 million.

The conclusion with respect to GST tax is that, if no GST exemption allocation is made, the person forming a GRAT must assume the risk that GST tax might apply. As a result, the "bet" is that all of the grantor's children will survive the term of the GRAT/GRUT. The grantor has the option to allocate or not allocate the GST exemption on his or her gift tax return.

## IX. INCOME TAX

A GRAT is usually regarded as a grantor trust, and income from the GRAT is taxed to the grantor. As a result, the distributions to the grantor do not necessarily coincide with the income allocations reported by the trust to the grantor.

A. Grantor Trust. The grantor of a GRAT is entitled to receive an annuity payment from the trust during its term. When the term expires, the trust corpus will pass to remainder beneficiaries irrevocably specified in the GRAT instrument.

For income tax purposes, the GRAT will be considered a grantor trust as to ordinary income under § 677(a) if the amount of ordinary income is less than the gross value of future annuity payments (and not the present value of the future annuity payments). If the GRAT generates no income in a future year, the entire annuity payment in that year may be satisfied from income accumulated in the current year, thus triggering application of § 677(a)(2).

Furthermore, if the GRAT provides for a reversionary interest if the grantor dies during the trust term, and the reversionary interest exceeds five percent, the GRAT will also be a grantor trust as to "principal income" or capital gains (IRC § 673(a)). Therefore, capital gains will also be taxed to the grantor.

1. The exception in § 674(b)(3) (power exercisable only by will as exception to rule that grantor is treated as owner of trust subject to grantor's power of disposition) will not apply because the GRAT's principal income is accumulated for disposition by the grantor on his or her death before the trust term expires.

B. Additional Distribution/Reimbursement Clause. Although the grantor can use the income received from the GRAT to pay the income taxes attributable to the trust's ordinary income, if the GRAT's income exceeds the annuity payment, the grantor may lack funds to pay the taxes attributable to the undistributed income or to pay the income taxes attributable to the trust's capital gains. While from an overall tax perspective, this produces a positive economic result because the grantor's estate is reduced by, in effect, paying the remainder beneficiaries' taxes, for a particular grantor, this result may cause difficulties associated with paying taxes, such as capital gains taxes, without a source of funds to make the payments.

To alleviate the foregoing problem, the GRAT can provide for additional distributions of trust income to the grantor, either all income or sufficient income to reimburse the grantor for any taxes paid on income not received by the grantor. The Regulations authorize distributions to the grantor of GRAT income that accrues in addition to the amount necessary to satisfy the annuity payment, although the right to receive excess income is not a qualified interest and therefore has no value under § 2702. (Reg. § 25.2702-3(b)(1)(iii).) Income is not defined in either § 2702 or the Regulations under that section. Presumably, income includes both ordinary and capital gains income. (See IRC § 643(b) (income refers to income of all types except for certain purposes under subparts B, C, and D of subchapter J of Chapter 1A of the IRC).) Thus, a grantor concerned about a tax liability in excess of income may include a reimbursement clause without adversely affecting the trust's status as a GRAT. In fact, at one point the IRS sought to require grantors to include reimbursement clauses in their GRATs. (See Letter Ruling 9444033 (includes paragraph, subsequently deleted in IRS Letter Ruling 9543049, that a reimbursement clause was required or the donor would be treated as making an additional gift to the trust).)

A reimbursement clause or any other provision authorizing additional distributions from the GRAT to the grantor should not provide a grantor-trustee with discretion in making the distribution. That discretion may cause the gift to be incomplete for gift tax purposes. Instead, either the additional distribution should be mandatory or the discretion to make the distribution should be vested in an independent person. The grantor must realize, however, that retaining the right to receive additional distributions, even if required, will not reduce the GRAT remainder value for gift tax purposes.

C. S Corporation. It may be advisable to have the GRAT considered a grantor trust so that it is an eligible shareholder of an S corporation. Permissible shareholders of S corporation stock include qualified subchapter S trusts ("QSSTs"). (IRC § 1361(b).) A QSST is a non-grantor trust that has a single individual as its current beneficiary during the beneficiary's lifetime and that either (i) requires all its income to be distributed to that individual or (ii) actually distributes all its income to that individual. (IRC § 1361(d)(3).) Trusts that are wholly grantor trusts continue to be eligible shareholders of S corporation stock. If it is not a grantor trust, the GRAT cannot satisfy the requirements of a QSST, because the grantor's interest may terminate during the grantor's lifetime.

If the grantor's reversionary interest in the GRAT does not exceed five percent, the GRAT may not be a grantor trust as to all "principal income." Because capital gains income in a given year may be distributed to the grantor or accumulated for distribution to the grantor to satisfy the annuity amount in a future year, principal income may still be taxed to the grantor under § 677(a). To the extent the trust is not considered a grantor trust, however, the trust's capital gains will be taxed to the trust. (IRC §§ 673(a), 671.)

D. Grantor Trust Opportunity. Besides ensuring qualification of a GRAT to hold S corporation stock and allowing the grantor to pay the taxes on any capital gains generated by the trust, additional benefits to having the principal portion of the trust considered a grantor trust result from the IRS's position in Rev. Rul. 85-13, that the grantor and his or her grantor trust are a single entity for income tax purposes and there cannot be tax transactions between the two. For example:

1. Appreciated assets can be distributed to the grantor from the GRAT to satisfy the annuity amount without recognition of *Kenan* gain. If not considered a grantor trust, the distribution of appreciated property from a trust in satisfaction of a pecuniary annuity amount will give rise to gain. (*Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940).)

2. The grantor can sell property to or purchase property from the trust without income tax consequences.

3. The grantor can lend money to the GRAT without generating additional income from interest on the loan. For gift tax purposes, the loans must still provide for the payment of interest under the rationale of *Dickman v. Commissioner*, 465 U.S. 330 (1984), and it may not be possible to use these loans to pay the grantor the required annuity.

If the grantor wants to have the GRAT treated as a grantor trust and its terms would not otherwise cause it to be so treated, it is probably best to allow the grantor to reacquire GRAT assets by exchanging other assets of equivalent value. (IRC § 675(4)(C).)

> ***Example:*** If the trust has $700,000 of income, but the distribution is only $500,000, then the grantor will be taxed on the $700,000 trust income before distribution. Accordingly, it is important to review this phantom income problem to determine whether or not it is a problem.

E. Tax Basis. The interests placed into trust will have a carryover basis for income tax purposes. Should the grantor of a GRAT survive the term, then the successors will receive the grantor's tax basis for income tax purposes increased gift taxes paid. (IRC § 1014.) By contrast, property not placed in a GRAT which is received at a decedent's death generally receives a tax basis "step up" wherein the survivor's tax basis equals the fair market value of the property at the decedent's death.

## X. CALIFORNIA PROPERTY TAX

The proposed transfer of property to a GRAT or a GRUT, particularly where there is a transfer of an interest in a legal entity, may cause a property tax reassessment where California real property is involved. While the immediate transfer into the GRAT/GRUT is not usually a problem since the grantor is considered to continue to be the owner, the termination of the trust may create a problem.

A. Parent Child Transfer Exemption. Where a transfer to a GRAT/GRUT is of a direct interest in real property, the parent-child transfer exemption is available to exclude up to $1 million of assessed value real property transfers from a parent (excluding exempt transfers of personal residences).

## XI. INTENTIONALLY DEFECTIVE INCOME TRUSTS ("IDITS")

A. Fundamental Concept. If the grantor trust rules are not applicable, a grantor is not treated as the "owner" of a trust's income. Rather, the trust's income is either taxed to the trust or, if distributed (or required to be distributed), to the beneficiaries. Conversely, if the trust is "defective" (for income tax purposes), the income (or loss) will be taxed to the grantor.

B. Potential Income Tax Planning Benefits. A variety of income tax planning reasons exist for making a trust a "defective grantor trust" for income tax purposes, even though the trust is not defective for estate tax purposes:

1. Interest expense might be paid on a borrowing by the trust and that interest expense might be beneficial as an income tax deduction to the grantor;

2. The grantor might obtain tax benefits by matching of income and deductions, such as offsetting capital gains by capital losses or offsetting passive activity income by passive activity losses;

3. A grantor may have a net operating loss which can be applied against income being received by the trust;

4. The tax rate structure applicable to trusts will not be applicable if the income belongs to the trust grantor;

5. A personal residence trust defective as to corpus could, if the property is sold at a gain, enable the availability of the § 121 exclusion;

6. The transfer of an installment note will not constitute a disposition accelerating gain recognition;

7. Stock acquired under an incentive stock option (ISO) plan can be transferred into the trust within 2 years of the grant of the option or within 1 year of the exercise of the option without the transfer being treated as a disqualifying disposition; and

8. Tax-free gifts can be achieved if income taxes that would have been paid by the trust (indirectly for the account of the beneficiary-donee) are paid by the grantor.[6]

C. Choices for Structuring the Income Tax Defective Trust. For income tax purposes, a trust will be "defective" as to the grantor if one of the grantor trust provisions is violated.[7] However, caution should be exercised to ensure that the trust is not also made estate tax defective.

## XII. ESTATE TAX DEFECTIVE TRUST

In limited situations a trust which is defective for estate tax purposes, but not for income tax purposes may be useful. In this situation, the trust income would be taxed to the actual recipient (trust or beneficiary), but the assets would be included in the estate of the grantor for estate tax purposes. This would, for example, allow an income tax basis step-up at the time of death for the assets held in the trust.

Status as estate tax defective can be achieved through a violation of one of the estate tax transfer provisions (e.g., IRC Sections 2036 or 2038), without triggering the applicability of any of the grantor trust provisions. This can be accomplished by having the grantor retain a power, in conjunction with an adverse party, to designate the persons who shall possess or enjoy the property or the income from the trust.[8] Since the existence of a requirement of the approval or consent of an adverse party makes the income tax grantor trust rules inapplicable,[9] this desired tax status could be achieved. This tax status could also be accomplished through retention by the grantor of a power to accelerate a beneficiary's interest.

## XIII. IRREVOCABLE LIFE INSURANCE TRUSTS ("ILITS")

A. Overview/Problem. When a client owns life insurance, the value of the policy as of the date of death is included in the client's estate. If the client is also the insured, the death benefit is included in the estate, too. While the client could make an annual exclusion gift to a child and have the child buy the insurance, the child may prefer to simply spend the money, or the child's creditors could have access to the policy/proceeds. How then can policy proceeds, free of transfer tax, be made available to provide funds for payment of estate taxes?

1. Solution. An ILIT which tracks the estate plan, which can buy assets from or loan money to the grantor's/insured's estate or trust.

B. Insurance Products Used. While term, whole life or universal was most commonly used in the past, new insurance products (variable life and second to die policies) have come on the market.

1. Second to Die Policies. The benefit of a second to die policy is that the cost is less than the cost of a policy on any one life alone. Moreover, the timing of payment of the death benefit is set for the time when the estate tax hit is the hardest -- on the second death, when no marital deduction is available.

2. Variable Life. The variable life policy is attractive to those who wish a higher rate of return than the six to eight percent common in most whole life policies. The variable life allows the owner to direct where the funds are invested (typically, in a form of mutual fund). This may well be more attractive to the younger client used to constant double digit market returns, but the prudence of selecting such a policy for an ILIT should be weighed carefully as the certainty of death benefit is most important.

C. Gift Tax Consequences.

1. When the grantor transfers a life insurance policy into an ILIT, the grantor has made a gift subject to gift taxation. Moreover, if the grantor dies within three years of the transfer, the death benefit is brought back into the grantor's estate under Sections 2035 and 2042.

2. Likewise, when the grantor transfers cash into an ILIT which the trustee uses to pay premium, the grantor has made a taxable gift unless the gift is excluded under the annual exclusion.

a. Crummey Withdrawal Rights. The ILIT should always have sufficient liquid assets to satisfy any exercise of any Crummey withdrawal powers. This can be accomplished by making gifts to the Trust long enough before the premium due date that the withdrawal powers will expire before the premium must be paid. Crummey withdrawal rights should probably last for a minimum of 30 days. Thus, you should finalize and fund the ILIT early enough to allow the Trustee to defer making payment until 30 days after he or she has given the beneficiaries notice of their withdrawal rights.

b. 2503(c)?

D. Estate Tax Consequences.

1. To avoid having the policy proceeds from being included in the insured's gross estate, the insured must avoid retaining any incidents of ownership under Section 2042. Moreover, the transfer of any such incidents of ownership within three years of the insured's death results in inclusion under Section 2035.

a. Incidents of Ownership. Incidents of ownership arise when the insured or his or her estate receive an economic benefit.

i. Regulation Section 20.2042-1(c)(2) indicates that these benefits include powers to:

(a) Change beneficiaries;
(b) Surrender or cancel policy;
(c) Assign the policy;
(d) Revoke an assignment;
(e) Pledge the policy for a loan;
(f) Obtain a loan against the cash value of the policy;
(g) Change the time or manner in which proceeds are received;
(h) Exercise an option to repurchase the policy from an assignee; and
(i) Veto any change in beneficiary designations on assignment or cancellation of the policy or any incident of ownership.

ii. If an insurance trust requires a trustee to use the proceeds to pay an insured's estate taxes, the insurance will be deemed to be payable to the insured's estate and includable in the insured's gross estate. Accordingly, the Trust should provide the necessary liquidity indirectly (by allowing the Trustee to purchase assets from your revocable trust and/or to loan funds to that trust).

iii. It is not advisable for an insured to act as trustee.

(a) The insured should not retain the power to remove and replace the trustee.

(1) Based on *Wall Est. v. Comr*. (1993) 101 T.C. 300, and Revenue Ruling 95-58, it would appear that a power to remove and replace the trustee will not be considered an incident of ownership as long as the permissible successor trustees are not related or subordinate to the insured within the meaning of Section 672(c).

(2) Consideration should be given to the use of a trust protector. A trust protector is a person who has the absolute power to remove any trustee and designate

another. The trust protector provides another layer of checks and balances to monitor the activities of the trustees to make sure they accord with the grantor's objective in setting up the trust. To ensure that the trust protector is not influenced by conflicts of interest, the trust protector should be prohibited from appointing as trustee him or herself, his or her spouse, his or her relatives, or individuals in business with him or her. Similarly, the grantor, the grantor's spouse, and beneficiaries of the trust should be prohibited from acting as trust protectors.

iv. The right to convert a group term life policy to an individual policy should the insured cease to be employed is not considered an incident of ownership.

2. To minimize the risk that the Trust will be included in the Grantor's taxable estate under Internal Revenue Code § 2035, the Trustee should apply for any life insurance to be acquired. Further, the premium on any such policy should be paid out of the Trust (after expiration of the Crummey withdrawal rights discussed, above).

3. While Section 2035 acts to bring the transfer of insurance within three years of death back into the estate, in *Silverman Est. v. Comr.* (1973) 61 T.C. 338, it was held that when an insured assigned a policy of life insurance to an assignee and the assignee thereafter pays the premium, the portion of the policy that relates to such premiums paid by the assignee are not included in the gross estate.

E. Generation Skipping Tax Consequences. An outright transfer to a grandchild in the amount of an annual exclusion gift should not be subjected to GST tax under Sections 2503(b) and 2642(c)(1). However, a transfer of an annual exclusion amount into an ILIT that does not allow distribution to other than the skip person or his estate can qualify as a nontaxable gift and not cause use of the donor's $1 million GST exemption.

F. Income Taxation of ILIT.

1. As the typical life insurance trust has no income until the date of death, income is usually a moot issue until the insured's death. Nonetheless, Section 677(a)(3) treats the grantor as an owner where income, without the consent or approval of an adverse party or in the discretion of the grantor or a nonadverse party, or both, is applied to the payment of life insurance on the grantor's life or his or her spouse's life.

2. Likewise, when the policy produces no income during the insured's lifetime, income taxation is a moot issue. However, if there is income, the beneficiary can be deemed an owner under the grantor trust rules. For example, a Crummey clause which provides the donee-powerholder the right to withdraw is subject to reporting the income produced on the portion of trust subject to the withdrawal right.

## XIV. CHARITABLE REMAINDER INCOME TRUSTS ("CRITS")

A. Basic Structure. The basic structure and formation of the typical charitable remainder trust is the transfer of property into trust with the grantor retaining an interest approximating an income interest for life, while making a gift of the remainder to a charitable beneficiary. The trustee then pays the life beneficiary an annual amount calculated according to the terms of the trust. The grantor receives a charitable contribution deduction for the value of the remainder. On death of the grantor/life beneficiary, the trust corpus will be included in his or her estate. However, as the corpus vests in the charity at that point, the decedent's estate receives a deduction equal to the amount included. Unfortunately, a decedent dying prior to the expiration of the term of years will have such value included in his or her estate with no corresponding charitable contribution.

In the case of a grantor who is only interested in investing the proceeds from the sale of appreciated assets before tax, the annuity rate may be set so that there is a small remainder to charity which does not result in a significant economic loss to the grantor or his heirs.

As heirs are effectively disinherited of the remainder interest to the charity, grantors frequently purchase ("wealth replacement") life insurance with some of the increased income so as to provide for their heirs.

1. Trust. A CRIT is an irrevocable trust:

a. From which a sum certain is payable no less often than annually;

b. The sum certain (not less than five percent nor more than 50 percent of the value of the initial trust corpus in the case of an annuity trust, and not less than five percent nor more than 50 percent) of the fair market value of the trust corpus valued annually in the case of a unitrust) is payable to at least one person who is not a charitable organization.

i. In the case of an individual, the sum certain must be payable over the life of such individual or a term of not more than twenty (20) years; and

ii. In the case of life beneficiaries who are not individuals, the sum certain must be payable over a period of not more than twenty (20) years.

c. On termination of the annuity payments, the remaining corpus must go to a charitable beneficiary.

d. a trust is not a Charitable Remainder Annuity Trust ("CRAT") unless its governing instrument provides that no additional contributions may be made to the CRAT after the initial contribution. For purposes of this rule, all property passing to a CRAT by reason of death of the grantor shall be considered one contribution. (Regs. § 1.664-2(b).)

i. A trust is not a qualified Charitable Remainder Unitrust ("CRUT") unless its governing instrument either prohibits additional contributions to the trust after the initial contribution or provides that for the taxable year of the trust in which the additional contribution is made:

(a) Where no valuation date occurs after the time of the contribution and during the taxable year in which the contribution is made, the additional property shall be valued as of the time of contribution; and

(b) The amount payable shall be computed as in the following examples:

> ***Example (1):*** On March 2, 2001, X makes an additional contribution of property to a CRUT. The taxable year of the trust is the calendar year and the regular valuation date is January 1 of each year. For purposes of computing the required payout with respect to the additional contribution for the year of contribution, the additional contribution is valued on March 2, 2001, the time of contribution. The property had a value on that date of $5,000. Income from such property in the amount of $250 was received on December 31, 2001. The required payout with respect to the additional contribution for the year of contribution is $208 (5 percent x $5,000 x 305/365). The income earned after the date of the contribution and after the regular valuation date does not enter into the computation.
>
> ***Example (2):*** On July 1, 2001, X makes an additional contribution of $10,000 to a CRUT. The taxable year of the trust is the calendar year and the regular valuation date is December 31 of each year. The fixed percentage is 5 percent. Between July 1, 2001, and December 31, 2001, the additional property appreciates in value to $12,500 and earns $500 of income. Because the regular valuation date for the year of contribution occurs after the date of the additional contribution, the additional contribution including income earned by it is valued on the regular valuation date. Thus, the required payout with respect to the additional contribution is $325.87 (5 percent x [$12,500 + $500] x 183/365). (Regs. § 1.664-3(b).)

e. A fully funded trust, annuity or unitrust, may not provide for the return of contributed assets if the Service disallows a tax deduction. (Rev. Rul. 76-309, 1976-2 C.B. 196.)

2. <u>Trustee</u>. Subject to state law considerations, the grantor may be the trustee. However, the grantor must not have any powers that would cause him or her to be deemed the owner of the trust under the grantor trust rules. Further, if the corpus consists of property over which the grantor can affect the value, the charitable deduction will be subject to close scrutiny.

3. Life Beneficiary. There appear to be no restrictions on who may be a life beneficiary, other than that there be at least one that is not a charitable organization. However, as annuities must be paid either for a term of years not greater than twenty (20) or the life of a person, if an entity is chosen the annuity must be for a term of years.

4. Charitable Remainder Beneficiary. The remainder beneficiary must be a charitable organization described in IRC section 170(c). To qualify under Section 664, the value of the remainder interest must be at least ten percent of the initial fair market value of all property placed in trust.

B. Income Tax Consequences on Formation. There is no recognized gain on the contribution of appreciated property to a qualified charitable organization. However, if the property is subject to debt, the amount of debt is treated as a partial sale of the property to the charity and a partial contribution.

1. Sales of Appreciated Property. A properly prepared CRIT is not subject to income taxes. This allows the owner of significantly appreciated property to contribute property to a CRIT and then have it sold. As no tax is paid on the sale, the grantor, who is usually the life beneficiary, receives a larger stream of income than would otherwise be the case. While a sale may be imminent, it is imperative that the trustee be under no compulsion to sell the property at the time of the transfer into trust.

2. Charitable Contribution Deduction. A taxpayer is allowed a charitable contribution of the remainder value of a CRIT only if it qualifies under Section 664. However, if the circumstances of the trust and life beneficiary arrangement are such that the probability that the charitable beneficiary will receive a bequest is negligible, the deduction is disallowed. The contribution is determined by the present value of the remainder interest which is calculated according to IRS tables, and that value must be at least ten percent of the value of the assets placed in trust.

> ***Example:*** In the case where a $400,000 annuity trust was to pay an annuity of $40,000 to a 61-year-old woman for life, the IRS disallowed a deduction to the estate because, according to its calculations, the probability that the charitable remainder beneficiary would actually receive a gift was not in excess of 5%, which the Service treated as negligible.

C. Life Beneficiary Payment Considerations.

1. Annuity Trusts v. Unitrusts.

a. Annuity Trusts. A CRAT is a CRIT in which the annual payment ("Annuity Amount") is calculated as a percent of the fair market value of the property originally contributed to the trust.

> ***Example:*** If the grantor contributes $3,000,000 in property to a CRIT for a 10% annuity, the grantor will receive an annual payment of $300,000, even if such amount exceeds the income of the trust.

CRATS are more conservative than CRUTS in that they ensure the grantor of a level payment. However, if the trust earns significantly more income than the annuity amount, the grantor may not retrieve it.

b. Unitrusts. A CRUT is a CRIT in which the annuity ("Unitrust Amount") is calculated as a fixed percent of the annual fair market value of the trust assets. While such an arrangement allows the grantor to receive the benefits of superior investment performance, it also exposes the grantor to investment losses. While a CRAT will also expose the grantor to investment losses, it is less immediate.

> ***Example:*** (CRAT v. CRUT): Property worth $3,000,000 at date of transfer is contributed to a CRIT for an 10% annuity. Property increases to $4,000,000 in year two and decreases to $2,000,000 in year three.
>
> **CRAT** (annual payment is fixed at date of contribution):
>
> Year 1 payment $300,000
> Year 2 payment $300,000
> Year 3 payment $300,000
>
> **Unitrust** (annual payment fluctuates with asset value):
>
> Year 1 payment $300,000
> Year 2 payment $400,000
> Year 3 payment $200,000

While the total amount received under both scenarios in this example is equal, the annual fluctuations are significant. Thus, it is frequently wise to divide the assets into an annuity trust and a unitrust to provide the client with diversified protection from fluctuations in asset value.

i. CRUT Income exception. Instead of paying the stated percentage amount described above, the governing instrument may provide that the CRUT shall pay for any year either such amount or amounts based on income described as follows:

(a) The amount of trust income (as defined in section 643(b)) for a taxable year to the extent that such amount is not more than the fixed percentage required to be distributed (the "income only," but not in excess of the fixed percentage method).

(b) An amount of trust income for a taxable year which is in excess of the fixed percentage for such year, to the extent that the aggregate of the amounts paid in prior years was less than the aggregate of required amounts payable under the fixed percentage (a "make-up" amount).

> ***Example:*** A unitrust is on a calendar year. The governing instrument provides that the recipient receives the lesser of trust income or 5% of the net fair market value of the trust assets, valued on the first day of the taxable year. On January 1, 2000, and January 1, 2001, the net fair market value of the trust assets is $100,000. In 2000 and 2001 the trust has net income (within the meaning of Section 643(b)) of $4,000 and $6,500 respectively. Accordingly, the beneficiary would receive $4,000 (the net income) in 2000 and $5,000 (the fixed percentage amount) in 2001. If the governing instrument includes a make-up provision, the beneficiary would, instead, received $6,000 in 2001, $1,000 of which would represent the shortfall for 2000.

D. Taxation of Nonexempt Charitable Remainder Trusts. If the charitable remainder trust has any unrelated business taxable income (see Section 512, determined as if such rules applied to such trust) for any taxable year, the trust is subject to all of the taxes imposed by subtitle A for such taxable year.

> ***Example:*** In 2005, a charitable remainder trust which has a calendar year as its taxable year has $1,000 of ordinary income, including $100 of unrelated business taxable income, and no deductions other than charitable deductions and distributions to beneficiaries. The trust is required to pay out $700 for 2005, to a noncharitable recipient. Because the trust has some unrelated business taxable income in 2005, it is not exempt for such year. Consequently, the trust is taxable on all of its income as a complex trust. Under Section 661(a) (income distributions) the trust is allowed a deduction of $700. Under Section 642(b) (personal exemptions) the trust is allowed a deduction of $100. Consequently, the taxable income of the trust for 1995, is $200 ($1,000 – ($700 + $100)). (Reg. § 1.664-1(c).)

E. Treatment of Annual Distributions to Recipients.

1. Character of Distributions. The character of distributions received by the annuitant, either unitrust or annuity trust, are determined under the following four tier analysis:

a. Order of Distributions. Annuity and unitrust amounts shall be treated as having the following characteristics in the hands of the recipients (whether or not the trust is exempt) without credit for any taxes which are imposed by subtitle A on the trust. (Regs. § 1.664-1(d)(1)(i).)

i. Ordinary income. First, as ordinary income to the extent of the sum of the trust's ordinary income for the taxable year of the trust and its undistributed ordinary income for prior years. An ordinary loss for the current year shall be used to reduce undistributed ordinary income for prior years and any excess shall be carried forward indefinitely to reduce ordinary income for future years. The amount of current and prior years' income shall be computed without regard to the deduction for net operating losses provided by sections 172 or 642(d). (Reg. § 1.664-1(d)(1)(i)(a).)

ii. Capital gain. Second, as capital gain to the extent of the trust's undistributed capital gains. Undistributed capital gains of the trust are determined on a cumulative net basis, without regard to the provisions of Section 1212. (Regs. § 1.664-4(d)(1)(i)(b).)

(a) Long and short-term capital gains. If, in any taxable year of the trust, the trust has both undistributed short-term capital gain and undistributed long-term capital gain, then the short-term capital gain shall be deemed distributed prior to any long-term capital gain.

(b) Capital losses in excess of capital gains. If the trust has for any taxable year capital losses in excess of capital gains, any excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year and any excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

(c) Capital gains in excess of capital losses. If the trust has for any taxable year capital gains in excess of capital losses, any excess of the net short-term capital gain over the net long-term capital loss for such year shall be, to the extent not deemed distributed, a short-term capital gain in the succeeding taxable year and any excess of the net long-term capital gain over the net short-term capital loss for such year shall be, to the extent not deemed distributed, a long-term capital gain in the succeeding taxable year.

iii. Other income. Third, as other income, including exempt income, to the extent of the sum of the trust's other income for the taxable year and its undistributed other income for prior years. A loss in this category for the current year shall be used to reduce undistributed income in such category for prior years and any excess shall be carried forward indefinitely to reduce such income for future years. (Reg. § 1.664-1(d)(1)(c).)

iv. Corpus. Finally, as a distribution of trust corpus. "Corpus" means the net fair market value of the trust assets less the total undistributed income (but not loss) in each of the above categories. (Reg. § 1.664-1(d)(1)(d).)

b. Rules relating to character of distributions. The determination of the character of amounts distributed shall be made as of the end of the taxable year of the trust. Amounts treated as paid from one of the categories of income described in Section XIV.E.1.a., b., or c., above, shall be treated as consisting of the same proportion of each class of items included in such category as the total of the current

and accumulated income of each class of items bears to the total of the current and accumulated income for that category. A loss in one of such categories may not be used to reduce a gain in any other category. (Regs. § 1.664-1(d)(ii).)

2. Allocation of deductions. Items of deduction which are directly attributable to one or more classes of items within a category of income or to corpus (determined under Section XIV.E.1.a., above) shall be allocated to such classes of items or to corpus. All other allowable deductions for such taxable year (which are not directly attributable to one or more classes of items within a category of income or to corpus) shall be allocated among the classes of items within the category on the basis of the gross income of such classes for such taxable year reduced by the deductions allocated thereto, but in no event shall the amount of expenses allocated to any class of items exceed such income of such class for the taxable year. Items of deduction which are not allocable under the above two rules may be allocated in any manner. All taxes imposed by subtitle A for which the trust is liable because it has unrelated business taxable income and all taxes imposed by chapter 42 of the Code shall be allocated to corpus. Any expense which is not deductible in determining taxable income and which is not allocable to any class of income items described shall be allocated to corpus. The deductions allowable to a trust for personal exemptions, charitable contributions and distributions of income are not allowed in determining the amount or character of any class of items within a category of income or to corpus. (Regs. § 1.664-1(d)(1)(ii)(2).)

3. Allocation of income among recipients. If there are two or more recipients, each will be treated as receiving his or her pro rata portion of the categories of income and corpus. The application of this rule may be illustrated by the following example:

> ***Example:*** X transfers $40,000 to a charitable remainder annuity trust which is to pay $3,000 per year to X and $2,000 per year to Y for a term of 5 years. During the first taxable year the trust has $3,000 of ordinary income, $500 of capital gain, and $500 of tax exempt income after allocation of all expenses. X is treated as receiving ordinary income of $1,800 ($3,000/ $5,000 x $3,000), capital gain of $300 ($3,000/$5,000 x $500), tax exempt income of $300 ($3,000/$5,000 x $500), and corpus of $600 ($3,000/$5,000 x [$5,000 - $4,000]). Y is treated as receiving ordinary income of $1,200 ($2,000/$5,000 x $3,000), capital gain of $200 ($2,000/ $5,000 x $500), tax exempt income of $200 ($2,000/$5,000 x $500), and corpus of $400 ($2,000/$5,000 x [$5,000 - $4,000]). (Regs. § 1.664-1(d)(ii)(3).)

4. Year of Inclusion--General Rule. The annuity or unitrust amount is includable in the recipient's gross income for the taxable year in which the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the taxable year of the trust. If a recipient has a different taxable year from the taxable year of the trust, the amount he or she is required to include in gross income shall be included in his or her taxable year in which or with which ends the taxable year of the trust in which such amount is required to be distributed. (Regs. § 1.664-1(d)(ii)(4).)

5. Distributions in kind. The annuity or unitrust amount may be paid in cash or in other property. In the case of a distribution made in other property, the amount paid, credited, or required to be distributed shall be considered as an amount realized by the trust from the sale or other disposition of the property. The basis of the property in the hands of the recipient is its fair market value at the time it was paid, credited, or required to be distributed.

> ***Example:*** On January 1, 2001, X creates a charitable remainder annuity trust, whose taxable year is the calendar year, under which X is to receive $5,000 per year. During 2001, the trust receives $500 ordinary income. On December 31, 2001, the trust distributed cash of $500 and a capital asset of the trust having a fair market value of $4,500 and a basis of $2,200. The trust is deemed to have realized a capital gain of $2,300. X treats the distribution of $5,000 as being ordinary income of $500, capital gain of $2,300 and trust corpus of $2,200. The basis of the distributed property is $4,500 in the hands of X. (Regs. § 1.664-1(d)(ii)(5).)

6. Character of distributions to exempt organizations. An amount distributed by the trust to an exempt organization other than the annuity or unitrust amount shall be considered as a distribution of corpus and of those categories of income specified above in an order inverse to that prescribed. The character of such amounts shall be determined as of the end of the taxable year of the trust in which the distribution is made after the character of the annuity or unitrust amount has been determined. (Regs. § 1.664-1(e)(1).)

a. Distributions in kind to exempt organizations. In the case of a distribution of an amount to an exempt organization no gain or loss is realized by the trust by reason of a distribution in kind unless such distribution is in satisfaction of a right to receive a distribution of a specific dollar amount or in specific property other than that distributed. (Reg. § 1.664-1(e)(2).)

F. ("Wealth Replacement") Life Insurance to Compensate the Grantor's Heirs. If the grantor wishes to protect his heirs from a loss due to the CRIT requirement that the remainder go to charity, the grantor may purchase life insurance, generally held in an irrevocable life insurance trust ("ILIT"), which offsets the CRIT bequest to a charity. However, grantors should exercise care in determining the amount of wealth replacement insurance they buy.

> ***Example:*** A grantor transferring $3,000,000 need not purchase $3,000,000 to provide his or her heirs with what they would have otherwise received. Assuming a 45% marginal estate tax rate, such amount would be $1,530,000, not $3,000,000 (because $1,470,000 would be paid in estate taxes, anyway).

G. Estate Tax Consequences. An estate tax deduction is allowed for the bequest of a remainder interest to a charitable organization. Therefore, while a decedent who was the grantor/ life beneficiary of a CRIT will have the property in the trust included in his or her estate, the estate will be allowed a deduction for a like amount because it immediately vests in the charity. However, if the annuity is for a term of years and the decedent dies prematurely, the deduction will only be for the present value of the charitable bequest.

## XV. CRIT INCOME TAX REPORTING REQUIREMENTS

The tax return requirements for charitable remainder trusts are referenced in the Section 664 Regulations. All returns must be filed annually on or before the 15th day of the fourth month following the close of the trust's taxable year. In light of the requirement that all charitable remainder trusts adopt a calendar year, this means that all returns must be filed on or before April 15 of the following year.

A charitable remainder trust must file Form 5227 annually. For the trust's first taxable year a copy of the governing instrument, certified by the fiduciary under penalties of perjury to be true and correct, must be attached to Form 5227. In addition, a charitable remainder trust must file Form 1041-A on an annual basis, with the exception of any year in which all of the net income for the year is required to be distributed currently to the beneficiary. This exception should only apply in the case of a "net income only" unitrust where the trust is required to distribute the lesser of a specified percentage of the trust income and the trust income is less than the specified percentage.

The instructions to Form 5227 require charitable remainder trusts to distribute a Form 1041, Schedule K-1 to the recipient of the Unitrust or Annuity Amount, reporting the income and deductions reflected on the Form 5227. A charitable remainder trust is not required to file a Form 1041, unless the trust has unrelated business taxable income. In such case, the trust must file a Form 1041 in addition to a Form 1041-A and a Form 5227, and the trust may be required to make estimated payments with Form 1041-ES.

## XVI. EDUCATION

A. Education IRAs. Education IRAs were expanded under the 2001 Tax Act. Because of the broad scope of these revisions, the changes are best explained by reexamining Education IRAs (now called Education Savings Plans) in their entirety.

1. In General. Since 1998, Congress allowed a meager $500 maximum per child to annually be deposited into a self-directed tax-deferred savings account called an education individual retirement account ("Education IRA").

Education IRAs are not retirement vehicles. Rather, earnings on deposits are allowed to (i) accumulate tax free and (ii) be distributed tax free provided distributions are used to pay qualified education expenses.

2. Setting Up an Education IRA. Opening an Education IRA is generally as simple as would be the opening of a CUTMA account at a bank or securities firm. An adult opens up an account for a child age

17 or younger and matters contributions to the account. All contributions must be in cash. No portion may be invested in a life insurance contract.

3. Exempt Distributions. Distributions used for qualified higher deduction expenses of the designated beneficiary are excluded from tax.

4. Distributions Not Used for Education. Distributions not used for education received by a beneficiary are taxable to the beneficiary at the beneficiary's tax rate. Non tax-free distributions are deemed paid pro rata from both contributions (which are always tax-free) and earnings (which may be excludible), contributions bear to the total balance of the IRA at the time of the distribution is made.

Because the beneficiary is often in a lower tax bracket, but for the penalty amount (and absent a distribution to the parent), there is a lower tax rate and the burden of the distributions does not fall on the parent setting up the Education IRA.

5. Ten Percent Penalty. Any taxpayer who receives a payment or distribution from an Education IRA that is not tax free is subject to a 10 percent tax on the distribution taxable portion.

6. Exceptions. The 10 percent tax does not apply to distributions:

a. Death. Paid to a deceased designated beneficiary's estate;

b. Disability. Attributable to the designated beneficiary being disabled (as defined under Code Sec. 72(m)(7));

c. Scholarship. Made on account of a scholarship or allowance (as defined under new Code Sec. 25A(g)(2)) received by the account holder to the extent the amount of the distribution does not exceed the amount of the scholarship or allowance; or

d. Excessive. Returning excess contributions and earnings thereon.

7. Disadvantages of the Education IRA. Educations IRAs are useful. Like a regular IRA, there is the right to self-direct investments and earnings are tax deferred. But, Education IRAs have had many disadvantages recognized by Congress.

a. Low Contribution Limit. The $500 maximum annual contribution limit is not indexed for inflation. The $500 limit applies to all accounts funded for the beneficiary that year regardless of who sets it up making it difficult to save enough for college by way of an Education IRA.

b. No Combining Exclusion Incentives. Distributions, even for qualified use, are not tax free during any year that the HOPE credit or the lifetime learning credit is claimed.

c. Phase-Out. The $500 contribution limit phases out for the well-to-do. A husband and wife earning more than $150,000 are subject to the phase-out rule.

d. No Combining Contributions Incentive. A contribution to an Education IRA is subject to an annual 6 percent excise tax penalty if, in the same year, a contribution is made to a qualified state tuition program (see below).

e. Room and Board. Only $2,500 could be spent for room and board expenses off-campus.

f. Termination. The Education IRA must terminate when the beneficiary reaches age 30 or upon the death of a designated beneficiary.

8. 2001 Tax Act Changes. The 2001 Tax Act addressed the foregoing concerns and others:

a. Annual Contribution Limit. The 2001 Tax Act increases the annual limit or contributions to education IRAs from $500 to $2,000. By expanding the contribution amount, Congress believed that this program will be more useful to many taxpayers. As before, the $2,000 limit is based on the total amount that may be given by all persons to any one beneficiary within a year.

> NOTE: Any contribution to an Education IRA is treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Annual contributions are eligible for the $10,000 gift tax exclusion under Code Section 2503(b) and are excludible for purposes of the generation-skipping transfer tax.

b. Distributions. Education IRAs, distributions can only be paid to the designated beneficiary named on the account. If distributions are used to pay for "qualified higher education expenses," these distributions are tax free. Previously, these expenses could only be used for higher education (post-high school) at an accredited college, university or vocational school. Qualified Higher Education Expenses include a beneficiary's tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible education institution. Under the 2001 Tax Act, Education IRAs are substantially expanded. Beginning January 1, 2002, Education IRAs may provide distributions for education at all levels of schooling, including elementary and secondary education. The 2001 Tax Act expands the definition of qualified education expenses to include "qualified elementary and secondary school expenses," namely, expenses for: (i) tuition, fees, academic tutoring, special need services, books, supplies, computer equipment (including related software and services), and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12), and (ii) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary.

NOTE: Home schooling programs are specifically contemplated where the program is recognized as providing educational value. Many home school programs rely heavily on the use of computer software for education. Committee reports clarify that computer software involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

c. Married Couple's Contribution Limit Removed. The 2001 Tax Act removes the marriage penalty gradually with respect to the phase-out for married spouses who wish to fund Education IRAs. The 2001 Tax Act increases the phase-out range for married taxpayers filing a joint return so that it is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing a joint return is $190,000 to $220,000 of modified adjusted gross income. Thus, the change is as follows:

| Education IRA Phase-Out Range | | |
|---|---|---|
| | 2001 | 2002 |
| Single | $95,000 - $110,000 | $95,000 - $110,000 |
| Married – Joint | $150,000 - $160,000 | $190,000 - $220,000 |

d. Contributions Permitted Until April 15. Previously, contributions to an Education IRA had to be made by December 31 with respect to determining the contribution limit for any year. Under the 2001 Tax Act, individual contributors generally may make contributions for a year until April 15 of the following year. While no deduction is allowed for contributions to an Education IRA, apparently the confusion in the name of this savings plan caused confusion as to the timing of contributions.

e. Coordination with Qualified Tuition Programs. The 2001 Tax Act removes a barrier to Education IRAs by repealing the 6 percent excise tax on contributions to an Education IRA where in the same year on behalf of a beneficiary a contribution is made to a qualified state tuition plan (Section 529 plan). Thus, taxpayers need no longer worry about which program to choose, Education IRAs or Section 529 programs (i.e., ScholarShare). Taxpayers may choose to fund both in the same tax year.

i. Coordination with HOPE and Lifetime Learning Credits. The 2001 Tax Act liberalizes the use of Education IRAs and education credits in the same tax year and allows a taxpayer to claim in the same year both: (i) a HOPE credit or Lifetime Learning credit, and (ii) to exclude from gross income amounts qualifying for distribution from an Education IRA (on behalf of the same student). The only limit is that the Education IRA distribution exclusion may not be claimed on the same educational expenses for which an education credit was claimed. In other words, to claim a credit, either (i) other monies must be used for educational expenses to claim a credit or (ii) if funds come from an education IRA, those funds upon which the credit is claimed cannot be excluded from income.

f. Contribution After Age 18, Termination Age 30. While, generally, it remains true that contributions may not be made after the designated beneficiary reaches age 18, an exception has been

created. Under the 2001 Tax Act, the rule prohibiting contributions to an education IRA after the beneficiary attains 18 does not apply in the case of a special needs beneficiary (to be defined by Treasury Department regulations). In addition, a deemed distribution of any balance in an education IRA does not occur when a special needs beneficiary reaches age 30.

> WARNING: Most special needs children will not qualify. Children with high functioning autism, PDDNOS and attention deficit disorder will not qualify if they can timely complete their education. Congress intends that the Treasury will only find a special needs beneficiary to include an individual who, because of a physical, mental, or emotional condition (including learning disability), requires additional time to complete his or her education.

g. Change Beneficiaries. There has been no change to the rule that amounts held in an Education IRA may also be rolled over into another Education IRA for the benefit of the same beneficiary (e.g., to change the investment vehicle). A participant may also change or roll over an Education IRA for a member of the beneficiary's family. Provided the rollover occurs within sixty (60) days of the distribution, the amount will not be included in the distributee's gross income. This power to change beneficiaries will not be treated as a retained power causing estate tax inclusion of the Education IRA for estate tax purposes. If a beneficiary's interest is rolled over to another beneficiary or there is a change in beneficiary, no gift or generation-skipping transfer tax consequences result, provided that two beneficiaries are of the same generation. If a beneficiary's interest is rolled over to a beneficiary in a lower generation (e.g., parent to child or aunt to niece), the five-year averaging rule may be applied to exempt up to $50,000 of the transferred amount.

h. Room and Board. Prior to the 2001 Tax Act, qualified higher education expenses also include room and board to the extent of the minimum room and board allowance applicable to the student as determined by the institution or a meager $2,500 for students living off campus. Room and board expenses will be considered qualified higher education costs only if (1) the designated beneficiary is enrolled in a degree, certificate or program leading to a recognized educational credential at an eligible educational institution and (2) the student carries at least one-half the normal, full-time work loan for the course of study pursued.

Under the 2001 Tax Act, it appears that the $2,500 amount will be increased to the amount allowable for student financial aid.

i. Excess Contributions. With the extension to April 15 of the following year for contributions, any excess contribution must be returned by June 1st that later year.

j. Effective Date. All new provisions for education IRAs commence January 1, 2002.

B. State Tuition Programs. A small change has been made to State Tuition Programs which will transfer revenue from states to the federal government.

1. Present Law. Under the 1997 Tax Act, taxpayers may avail themselves of qualified state tuition programs ("Section 529 Program"). Presently many states have adopted programs to provide a tax-favored savings program for college.

a. For example, under the Golden State ScholarShare Trust Act (Chapter 851, Statutes of 1997 (AB 530)), California allowed the implementation of a Section 529 Program released October 4, 1999. The program is co-administered by the Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF). ScholarShare is a state-sanctioned savings plan available to all persons, whether or not a California resident. Funds put into ScholarShare may be spent to attend any accredited college or university whether or not located in California.

b. Like an Education IRA, the earnings from the section account accumulate tax free. No tax applies to the earnings before the time of disbursement. If disbursements are used for college education costs, no distributions are taxable as income to the beneficiary.

2. 2001 Tax Act.

a. Penalty. Previously, each state program was required to provide a non-de minimis monetary penalty (typically 10%) on non-qualifying distributions, i.e., not for qualified education. For example, if funds are returned to the parent or used for the child for transportation, the penalty would apply. The funds lost could be retained by the state or redistributed however agreed by the plan.

Under the 2001 Tax Act, beginning after December 31, 2003, the penalty forfeiture is removed and instead an additional 10 percent tax is assessed (and paid to the IRS) on the amount of non-qualifying distributions after December 31, 2003. The effect of this change is that the benefits of the penalty forfeitures are not given to the states or other investors but go to the IRS. There is no longer a requirement that Section 529 accounts provide an administrative forfeiture penalty.

b. Exceptions to Penalty. The same exceptions that apply to non-qualifying distributions from Education IRAs also apply to these programs.

c. Parallel Changes to Section 529 Programs. Unlike Education IRAS, Section 529 plans are intended only to provide for higher education (post-secondary education), but other changes conform to Education IRAs or provide technical clarifications, including:

i. Exclusion from Gross Income. Beginning after December 31, 2001, instead of taxing the beneficiary on distributions, a complete exclusion from gross income is provided for qualified distributions from qualified State tuition programs.

ii. Qualified Higher Education Expenses. To be a qualified distribution a distribution must be used to pay for qualified higher education expenses. While the definition remains mostly unchanged (most college expenses qualify), instead of the meager $2,500 allowance for off-campus room and board, the 2001 Tax Act provides that the maximum room and board allowance excluded will equal the amount allowed by the student in calculating costs of attendance for federal financial aid programs under Section 472 of the Higher Education Act of 1965 (as in effect on the date of enactment). In the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board is allowed.

iii. Coordination with HOPE and Lifetime Learning Credits. The 2001 Tax Act will now allow a taxpayer to claim in the same tax year both (i) a HOPE credit or Lifetime Learning credit and (ii) an exclusion from gross income of qualified distributions from a qualified tuition program on behalf of the same student. So long as the distribution is not used for the same expenses for which a credit was claimed, both benefits may be claimed.

iv. Rollovers for Benefit of Same Beneficiary. The 2001 Tax Act clarified that a rollover of tuition credits (or account amounts) out of a qualified state tuition program for the benefit of one designated beneficiary to another qualified tuition program for the benefit of the same beneficiary will not be considered a taxable distribution. This tax-free rollover treatment is allowed only once every three months with respect to the same designated beneficiary.

v. Member of Family. The 2001 Tax Act provides that, for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes first cousins of the original beneficiary.

vi. Special Needs Beneficiary. The definition of qualified higher education expenses is modified to include expenses of a special needs beneficiary which are necessary in connection with his or her enrollment or attendance at the eligible education institution. A special needs beneficiary would be defined as under the provisions relating to education IRAs, described above.

d. Private Tuition Programs. While private colleges and educational institutions cannot set up private college savings plans, many have already established prepaid tuition credit programs. Under the 2001 Tax Act, tuition programs are expanded to have Section 529 include private educational institutions after they obtain a ruling or determination that their program meets the requirements. Effective with contributions after 2001 and distributions after 2003.

In order for a tuition program of a private eligible education institution to be a qualified tuition program, assets of the private college program must be held in a trust created or organized in the United States for the exclusive benefit of designated beneficiaries that complies with the requirements under Section 408(a)(2) and (5). Under these rules, the trustee must be a bank or other person who demonstrates that it will administer the trust in accordance with applicable requirements and the assets of the trust may not be commingled with other property except in a common trust fund or common investment fund.

NOTE: Without this provision, nonconforming private colleges will continue to fall outside of Section 529 for determining the tax treatment of contributions and tuition credits. Tax advisors must review these plans carefully.

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[1] A trust in California is presumed to be revocable unless it is expressly made irrevocable by the trust instrument. Probate Code Section 15400.

[2] As the gross income amounts increase, the benefits can be significant but will gradually decline. Current distributions from such a trust would probably be appropriate due to the condensed rate schedule applicable to trusts.

[3] The advantage of the GRAT diminishes as the length of the term increases, because each year added to the term of the retained annuity interest reduces the gift by fewer dollars then the addition of the previous year.

[4] The IRS has not provided a sample calculation for the actuarial value of a unitrust interest for the shorter of a fixed period or the grantor's earlier death, so the use of commercial computer software program is necessary.

[5] The GST tax is a tax (55%) on a transfer of property by gift or death that is considered to have skipped a generation. For example, a gift by a grantor to his grandchild would be considered generation-skipping transfer and may be subject to GST tax.

[6] This can be particularly valuable if the turst is realizing significant income which might occur, for example, by transferring the full amount of the $1,000,000 unified credit by gift to the trust and investing those funds in high income assets.

[7] See §§671-678.

[8] §2038(a)(1).

[9] §2038(a)(1).