



Reaching your unique goals with trust planning strategies

Opportunities to preserve wealth

White paper

OVERVIEW

Trusts are not exclusively for the ultra-affluent. They can play a vital role in outcomes-based planning for many individuals. This paper reviews planning opportunities, investments owned by trusts, and tax rules influencing trust ownership of life insurance and annuities.

- **The benefits of trusts**

As important planning tools, trusts can offer you asset control, legacy protection, financial privacy, probate avoidance, and estate tax mitigation.

- **Planning flexibility**

Trusts can help you meet your unique goals including marital estate planning to protect wealth for your spouses and children, family estate planning for tax-efficient asset transfer, and charitable planning to help you make the most of your bequests.

- **Trust ownership of annuities and life insurance**

These investments can offer a number of advantages including tax deferral, diversification, death benefits, volatility protection and guaranteed income.

Beyond wealth accumulation — trusts play a vital role in outcomes-based planning

Money is a means to an end. Behind the accumulation of wealth lie personal objectives and values as unique to individuals as their fingerprints. Whether the goal is to fund a comfortable retirement, take care of children or grandchildren or make a meaningful social impact, trusts can play a valuable role in helping to achieve those objectives.

Understanding the fundamentals of trusts and the benefits they can provide to you

A trust is an entity created under the law that is empowered to take title to assets and manage them in accordance with the terms spelled out in the trust document. For a trust to exist, it must be in writing and, in most cases, have property to which it holds title.

A trust is an important tool that can be used to help protect and transfer wealth and meet a wide variety of estate planning objectives.

The benefits of trusts include:

Control—A trust allows an individual to dictate when and to whom distributions from the trust may be made.

Legacy protection—A trust may help protect an individual's wealth from creditors or the spendthrift behavior of beneficiaries.

Privacy—The transfer of trust assets occurs outside the public record, maintaining the privacy of financial affairs.

Probate savings—Assets passed by operation of a trust avoid the delays and fees associated with probating them through the court.

Estate tax savings—Trusts may be used to reduce future estate taxation.

The general purpose of a trust is to manage assets on behalf of one or more individuals. The interests of the parties can be split contemporaneously (i.e., pay the income in equal amounts to John and Mary) or over time (i.e., pay income to a spouse, then distribute to the children). Since there is always someone who will take title to the trust assets when the trust ends, the trustee is almost always managing assets with more than one party in mind. An exception might be a minor's trust (i.e., manage the assets until John is 30, then distribute to John).

Trusts are not just for the Carnegies or Rockefellers. Many people have the same concerns about protecting wealth.

Types of trusts

Trusts are either testamentary (i.e., created as part of a will) or inter vivos (i.e., created by a living person as a stand-alone document and not part of a will). In the case of a testamentary trust, the trust does not come into existence until the death of the individual.

Trusts may be revocable or irrevocable.

As the name implies, a revocable trust may be revoked or modified at any time during the life of the grantor (the individual creating the trust), but becomes irrevocable at the grantor's death. Because it is revocable, it does not remove any assets from the individual's estate.

An irrevocable trust is a trust that cannot be modified or terminated without the agreement of the beneficiary. The primary reason a grantor creates an irrevocable trust is to remove assets from his or her estate by severing all incidents of ownership in those assets. The removal of such assets is designed to save on current taxation, as well as reduce the grantor's taxable estate.

Trusts can also be grantor or nongrantor for income tax purposes. Whether a trust is a grantor trust or a nongrantor trust is determined by the relationship the grantor has with the other individuals involved with the trusts, e.g., the beneficiaries

who receive income from the trust or the remainderman who receives the trust assets when the trust is dissolved.

In a grantor trust, the grantor retains certain powers, such as the power to revoke the trust or control the assets inside the trust. Because the grantor retains ownership interests in the trust's assets, the trust is not considered a separate entity and all trust income, deductions and credits are reported on the grantor's individual tax return.

In a nongrantor trust, the grantor forfeits all rights to the property and any income generated by that property. A nongrantor trust is treated as a distinct taxable entity. The assets are owned by the trust, and as such, all income, deductions and credits are filed on a separate tax return on behalf of the trust. (Trusts are subject to a taxation structure that mirrors the individual tax rate schedule but reaches the higher marginal tax brackets at lower income thresholds.)

A third form is the intentionally defective grantor trust, which shares the characteristics of a grantor and nongrantor trust. In an intentionally defective grantor trust, the grantor makes an irrevocable gift of property but reserves the right to substitute other property of equal value at a later date.

Life events trigger the need for trusts



TRUSTS

AN INHERITANCE OR WINDFALL

THE SALE OF A BUSINESS

THE OPPORTUNITY TO EXERCISE STOCK OPTIONS

MARRIAGE

THE PURCHASE OF A FAMILY VACATION HOME

The flexibility to achieve a number of goals

Trusts can serve a wide range of objectives. Summarized below are the more common uses of trusts.

Marital estate planning strategies to protect wealth for married couples and their children

Marital trust—shelter assets for a surviving spouse

A marital trust is designed to pass assets that qualify for the unlimited marital deduction. With the exception of QTIP trusts, assets given to a marital trust will qualify for the marital deduction if the spouse who benefits from the trust is vested with the power to appoint the assets in one of the following ways:

- While alive, to anyone
- While alive, to creditors of the beneficiary spouse
- To anyone at the death of the beneficiary spouse
- To creditors of the beneficiary spouse at his or her death

Credit shelter trust—provide income and asset control to a surviving spouse and a tax-advantaged legacy to a couple's heirs

The credit shelter trust, also known as a family trust or B trust, allows certain amounts to pass from one individual to another at death without an estate tax.

Married couples will establish a credit shelter trust to ensure that both spouses take full advantage of the estate tax exemption available to each. To understand why this is valuable, it's essential to understand basic estate tax rules. Any individual may pass on up to \$5.34 million (in 2014) in assets to anyone estate-tax-free. Spouses may pass an unlimited amount of assets tax-free to the surviving spouse.

Through the use of a credit shelter trust, the first-to-die spouse can transfer up to \$5.34 million estate-tax-free to a credit shelter trust and transfer any remaining assets to the surviving spouse—also free of any estate taxation.

In the past, a credit shelter trust was utilized to ensure that both spouses took full advantage of their individual estate exemption. Due to a recent change in the law, the credit shelter trust is no longer necessary to accomplish this. Now, the executor of the first-to-die spouse's estate may make an election to use the deceased spouse's unused exclusion amount via Form 706 within the prescribed time period.

Even though a credit shelter trust is no longer necessary to secure the deceased spouse's estate exemption, it may still be useful for sheltering asset appreciation and protecting assets from creditors. A credit trust will also preserve the exemption for residents of the 22 states (and Washington D.C.) that have their own separate estate tax and do not recognize this federal provision.

With a credit shelter trust, the surviving spouse retains certain benefits in the trust assets without treating that spouse as the owner. In this way the assets can be used to help support the surviving spouse without wasting the estate tax exemption of the first-to-die spouse. Specifically, the trust may (but does not have to) allow the spouse access to:

- All income
- Principal as needed according to an ascertainable standard at the discretion of the trustee (e.g., as needed for health, maintenance, welfare, support, etc.)
- An unrestricted right to withdraw the greater of 5% of trust value or \$5,000, on an annual noncumulative basis

Spousal limited access trust—shelter a couple's estate assets while providing income for a spouse

A spousal limited access trust (SLAT) or spousal lifetime access trust is a variation of a credit shelter trust. Unlike a credit shelter trust, which is funded by a bequest when a spouse passes away, a SLAT provides married couples a way to pass wealth tax-efficiently to their children, grandchildren, and future generations while giving a spouse access to trust assets during and after their spouse's lifetime.

A SLAT is an irrevocable trust established by one spouse (the grantor), who transfers assets from the couple's taxable estate to the trust. This transfer is considered a gift, and the grantor can shelter up to the individual lifetime gift allowance, or \$5.34 million (in 2014) from estate tax exposure.

The trust can be structured to provide distributions to a spouse during the grantor's lifetime for education, health or financial support (if needed). It can also be drafted to give an independent trustee control of making trust assets available to the spouse. To protect the grantor spouse in the event of divorce, the trust document can specify that the trust terminates upon divorce.

Couples can benefit from a SLAT because it provides:

- A way to protect wealth from state and federal estate taxes
- The ability to transfer legacy assets and their appreciation to heirs tax-efficiently
- Financial protection from future uncertainty because a spouse can access trust funds if something unforeseen happens

Family estate planning strategies for tax-efficient wealth transfer

Trusts may also be used to accomplish a variety of estate planning objectives related to family and legacy planning.

QTIP trust—establish flexibility to minimize future estate tax exposure and legacy control for couples in second marriages

As a general matter, to qualify for the marital deduction, a gift from one spouse to the other must allow the recipient spouse control of where the assets go or how they can be used. If the donor spouse tries to have too many strings on the gift or “rule from the grave,” then the marital deduction will be denied.

An exception to this is the qualified terminable interest property (QTIP) trust. Here, assets can be placed into trust and the spouse making the gift can determine where the assets go after the death of the surviving spouse. The trust is created and funded either while living or at the death of the first-to-die spouse. An election is then made to treat the trust as a QTIP trust. If this election is made, then:

- The assets given away qualify for the unlimited marital deduction.
- At the death of the second-to-die spouse, all assets in the trust will count as part of the second-to-die spouse’s taxable estate. The assets do not escape any potential estate tax; the tax is just delayed until the second spouse dies. A key requirement is that the trust generates a reasonable amount of income for the surviving spouse and if it does not, then the surviving spouse can compel the trustee to change investments so a reasonable level of income is produced.

A QTIP trust is most commonly used in second marriage situations. If one spouse brings assets to a second marriage and he or she left those assets to their spouse, the surviving spouse might then disinherit the children from the first-to-die spouse’s previous marriage. Absent the QTIP election, the only way to prevent this would be to forgo the marital deduction. Thus, the QTIP trust will provide income to a surviving spouse, but typically makes the children from a prior marriage its beneficiaries upon the death of the second-to-die spouse.

Generation-skipping trust—maximize tax-efficient wealth transfer to grandchildren

The estate tax system presumes that parents want to leave assets to their children, though social policy has sought to mitigate concentrated wealth from passing through multiple generations.

Generally speaking, when generation 1 leaves assets to generation 2, the federal government will levy estate taxes, depending upon the size of the estate. As assets move from generation 2 to generation 3, more taxes will be paid. But what happens if generation 1 leaves assets directly to generation 3? Skipping a generation might appear to be one way to avoid asset transfers from being taxed twice. However, the federal government does not easily surrender potential tax revenues. To prevent this, the generation-skipping tax or GST was born. This tax is imposed when one generation makes gifts that skip a generation to a younger generation. The tax can be imposed on lifetime gifts or on transfers at death, and it is in addition to the normal estate or gift tax. Each person is granted a lifetime exemption from the tax (\$5.34 million in 2014).

A GST trust is designed to transfer assets from the grantor’s estate to his or her grandchildren. Because the grantor’s children never take title to the assets, it avoids one generation of potential estate tax exposure. A GST trust may be constructed to provide income to the grantor’s children during their lifetime, while still leaving the assets to the grantor’s grandchildren.

Special needs trust—provide sufficient income to the beneficiary without affecting their government benefits

Special needs trusts are designed to supplement the income and lifestyle of those who are incapable of taking care of themselves. A special needs trust’s income and principal is used for the beneficiary at the discretion of the trustee. The beneficiary has no right to the income or principal, which protects the beneficiary’s eligibility for Medicaid. If the beneficiary qualifies for Medicaid benefits, the trustee can then use trust assets and income for expenses Medicaid does not cover.

A special needs trust can be funded with assets in the individual’s name (a self-settled trust) or with assets from a third party (a third-party trust). In the former case, the trust must provide that the Medicaid authorities will be the primary beneficiary of any trust assets at the death of the trust beneficiary up to amounts that Medicaid has provided. Third-party trusts do not have this requirement.

A third-party trust can spring out of a revocable trust from a will or it can be established as an irrevocable trust with a lifetime gift, usually from the parents or grandparents.

Charitable planning strategies to help you make the most of your contributions

In addition to caring for family, many individuals wish to leave a legacy for charities that align with their passion and values. Aside from a simple donation of cash or securities, individuals can use trusts to contribute to charities of their choice.

Charitable remainder trusts—create tax-efficient income for the benefactor and a tax-advantaged endowment

Charitable remainder trusts, or CRTs, are a special creation of the income tax code. CRTs are designed to encourage charitable giving by providing certain planning benefits for the donor, including:

- An income stream back to the donor or others
- A charitable deduction when assets are given to the trust
- The removal of assets from the taxable estate
- A tax-free environment for trust asset growth

A common strategy is to donate assets with a low cost basis, which if otherwise sold by the owner would result in a large capital gains tax. By donating the appreciated asset to a charity or a charitable trust, the donor receives a charitable deduction in the amount of the asset's current value (subject to certain limitations), while eliminating a personal income tax liability.

The trust that receives the asset can then sell it free of any taxation.

The charitable deduction is not dollar for dollar since an income stream benefit is retained by individuals. As a result, if \$1 is donated, the deduction will be some amount less than \$1. The higher the income retained by the donor, the lower the deduction. The longer the trust term (often the life expectancy of the donor), the lower the deduction. To prevent abuse, the IRS has tests imposed when the trust is established to make sure that the charity will receive some meaningful benefit from the gift. The practical impact of these tests is to limit charitable trusts to individuals of certain ages and/or to place a ceiling on how much income can be received.

Even though the trust is tax exempt, that does not mean the income received by the individual is tax exempt.

It does bear mentioning that the donor has given away assets that his or her heirs will never receive when donating to a charitable trust. As a consequence, some donors who receive income from a CRT elect to use some portion of that income to purchase life insurance to replace the value of the assets donated.

A CRT can take three forms:

- 1. Charitable remainder annuity trust (CRAT):** A CRAT, once funded, will pay the donor or other individual a flat dollar amount based on the value of the original contribution. Every year the payment is the same whether the trust goes up or down in value—even if the result is that the trust must be liquidated to make the payment.
- 2. Charitable remainder unitrust (CRUT):** A CRUT pays the donor or other individual a stated percentage of the trust value, resulting in income payments that may change from year to year. For instance, if the trust value goes up, the income payment goes up. If the value falls, the income payment falls.
- 3. Net income with make-up provision charitable remainder unitrust (NIMCRUT):** The NIMCRUT is a special type of CRUT. This trust is the same as a CRUT with one exception—instead of paying income at a stated percentage of trust value, it pays either that amount or the net income received in the year, whichever is smaller. Thus, if the trust has no income, then there is no payment. In years where the payment does not reach the stated percentage payout, the unpaid amount is carried forward to be paid in some future year when there is sufficient income.

The goal of the NIMCRUT is to allow the trustee to have control over when a distribution is made and the amount of that distribution.

Charitable lead trust (CLT)—minimize current tax exposure with a gifting strategy that creates a legacy for the donor's heirs

A charitable lead trust works differently than a CRAT or CRUT in that rather than the trust income going to the donor or other named individual, the trust income is donated to a charity. After a specified period of time, the trust will transfer the remaining assets to the trust's beneficiaries. The primary use of a CLT is to reduce a donor's current income, while retaining the ability to transfer assets to the donor's heirs.

The advantages of life insurance and annuities within trusts

Life insurance and annuities within a trust maintain a number of important advantages, including tax deferral, diversification and death benefits.

However, there are some unique considerations a trustee should be aware of, including tax, financial and legal issues.

Assets that can be held within a trust



Common stocks



Life insurance



Bonds



Annuities



Real estate



Some gas and oil leases



Precious metals

The importance of understanding tax laws and regulations regarding trust ownership of life insurance and annuities

When life insurance and annuities are coupled with trusts, the unique tax rules and regulations of each must be satisfied. This discussion does not cover every possible issue arising from the use of life insurance and annuities in trusts, but serves as an overview of key considerations and as a peek into the complexities they present.

Broadly speaking, a trustee should ask itself three important questions:

1. Does the trust qualify as a “natural person” under IRC Section 72(u)?
2. How will annuity distributions be taxed during the lifetime of a trust’s beneficial owners?
3. How will the death distribution be treated under the IRC 72(s) rules?

1. When is a trust a natural person under IRC Section 72(u)? An annuity held by a “natural person” or the “agent of a natural person” will be treated as an annuity contract for income tax purposes. The obvious example of a “natural person” is any individual. A corporation is an example of an entity not considered a “natural person” or an “agent of a natural person.”

When it comes to trusts, some trusts are deemed to be a “natural person” or “agent of a natural person” while others are not.

Since the grantor retains control over a grantor trust’s assets, most grantor trusts would be considered a “natural person” or “agent of a natural person” and receive the same income tax treatment as any individual owning an annuity directly. (In the case of any grantor trust in which substantial beneficial interests are held by nonnatural persons, the trust may not qualify for treatment as a “natural person.”)

Nongrantor trusts may be more problematic. Because these trusts are treated as a distinct entity, they could be viewed as a nonnatural person for purposes of annuity income tax treatment. However, there may be instances where the beneficiaries are considered natural persons, and an annuity might work. There have been a number of private letter rulings that serve as guidance on when a nongrantor trust might qualify for annuity tax protections, but there remains some ambiguity.

For charitable remainder trusts, it seems clearer. A deferred annuity owned by a CRT would not benefit from the favorable tax-deferred treatment. However, the charitable trust would receive the tax benefits of an immediate annuity.

2. How are lifetime distributions taxed? If it has been determined that the trust will be viewed as a “natural person” or “agent of a natural person,” then distributions from that annuity should be taxed as one.

For the revocable trust, the grantor is considered the owner of the annuity, and as such, the withdrawals would be subject to ordinary income tax and, if the grantor is under age 59½, then an additional 10% tax may be applied.

3. How are distributions at death treated under IRC 72(s) rules? One of the requirements of an annuity is that distributions must begin when the annuity owner dies, unless the surviving spouse is the beneficiary.

In the case of grantor trusts, the grantor’s death will create an income tax event, though it appears that an actual distribution may not be required. For all trusts, the death of the primary annuitant is the trigger for required death distributions, and it appears that an actual distribution would be required.

It is important to remember that the annuity death distribution rules may conflict with the terms of the trust, which could lead to the trustee violating its fiduciary duty. Consequently, trustees will normally require that the trust be the designated beneficiary. This means that death distributions will be paid out in a lump sum or over five years to the trust, which will, in turn, make payments to the trust beneficiaries. The spousal continuation option typically connected with an annuity contract is unavailable.

Special considerations for using life insurance in trusts

One of the key advantages of using life insurance in trusts is that, when properly structured, the proceeds may avoid estate taxation, unlike life insurance proceeds owned by the insured outside of a trust. Accomplishing this requires that the insured have no “incidents of ownership” in the policy. Thus, the trust must be drafted so that the insured has none of the powers that define incidents of ownership (e.g., outright ownership, right to change the beneficiary of the policy, ability to borrow against the policy or use it as collateral for a loan). This is the reason that the insured cannot be the trustee on a trust that holds a life insurance policy. The trust should also avoid requiring that the proceeds be used to meet the insured’s estate obligations, leaving that decision to the trustee’s discretion.

The funding of life insurance in a trust may come either through the transfer of an existing policy or the purchase of a new one, funded by gifts made to the trust.

Both funding methods represent a taxable gift. Generally speaking, because such gifts are of a future interest, they do not qualify for the annual federal gift tax exclusion, unless the trust’s beneficiaries are given *Crummey* powers. A *Crummey* power allows the trust’s beneficiaries to withdraw the gift of funds or existing policy within some prescribed period of time—typically 30 days.

In the case of a transfer of an existing policy to an irrevocable trust, the insured must be the grantor for income tax purposes in order to avoid subjecting the death proceeds to income tax under the “transfer-for-value” rules.

The knowledge and experience to protect wealth with trust planning expertise

Two of the most fundamental objectives of creating a trust—preserve wealth and provide income—dovetail very well with the primary benefits of life insurance and annuities: asset protection and guaranteed income.

While the symmetry of individual need and financial solution makes life insurance and annuities a natural fit for a range of trust vehicles, the complexity of trusts requires working with a provider who has the understanding and expertise to help individuals navigate these complex waters.

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