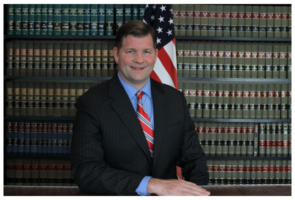

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Estate, Gift, and GST Taxation and Trusts

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How are trusts treated for federal estate, gift, and GST tax purposes?

A trust is created when you (the grantor) transfer property to a trustee for the benefit of a third person (the beneficiary). The act of transferring property to a trust is generally treated no differently than if it were transferred to an individual outright. That is, transfers of property (whether into a trust or otherwise) may be subject to excise taxes known as transfer taxes. There are three types of transfer taxes: (1) estate tax, (2) gift tax, and (3) generation-skipping transfer (GST) tax. Estate tax may be imposed on transfers of property made after death (these are called bequests). Gift tax may be imposed on transfers of property made during life (these are called gifts). GST tax is imposed on transfers of property made to "skip persons." A "skip person" is someone who is more than one generation younger than you (e.g., a grandchild or great-nephew).

Estate taxation of trusts

Trust property may be included in your gross estate for estate tax purposes if you have retained certain rights in the trust or if the trust is created at your death. The estate representative (executor) is responsible for filing an estate tax return on Federal Form 706 within nine months of your death (or at a later time if an extension is granted) and paying any estate tax owed from the estate proceeds.

Grantor retained interest

In general, a trust may be includable in your gross estate if you (the grantor) have retained an interest in the trust at the time of death — or given such interest away within three years of death. Such interests include:

- Life estate — A life estate is the right for life to (1) receive trust income, (2) use trust property, or (3) specify who gets to enjoy the trust income or use of trust property. If any of these rights are retained, the entire value of the property is includable in your gross estate.
- Reversionary interest — A reversionary interest means that the trust property will revert to you (the grantor) if the beneficiary does not survive you (i.e., dies before you). A reversionary interest is includable in your gross estate if, immediately before your death, the value of the interest exceeds 5 percent of the value of the trust.
- Rights of revocation — The right to revoke (i.e., terminate or end), amend, or alter the trust brings the trust back into your estate for estate tax purposes.
- "Incidents of ownership" in life insurance — The value of life insurance proceeds is includable in your gross estate if, either at the time of your death or within the three years prior to your death, the proceeds were payable to your estate, either directly or indirectly, or you owned the policy, or you possessed any "incidents of ownership." "Incidents of ownership" is a legal term and means any right to benefit economically. Incidents of ownership include the right to change the beneficiary, the right to surrender or cancel the policy, the right to assign the policy, the right to revoke an assignment, the right to pledge the policy for a loan, and the right to obtain a policy loan.
- Annuity interests — If you (the grantor) retain an interest in annuities in the trust, part or all of the trust may be includable in your gross estate.

General power of appointment

A power of appointment is the right to say who gets the trust property. The person holding the power is called the powerholder. The powerholder can be the grantor (creator of the trust) or anyone the grantor names. A general power of appointment is one that is exercisable in the powerholder's favor directly or in favor of the powerholder's creditors, estate, or estate's creditors. In other words, there are no restrictions on the powerholder's choice of appointees (i.e., beneficiaries), and the powerholder can use the trust for his or her own benefit.

A general power of appointment held by the powerholder on the date of his death is subject to estate taxes. Because the general powerholder has the right to declare himself or herself as the owner of the property, the IRS deems that he or she is, in fact, the owner of that property. That means that the entire value of the property over which the power is held is includable in the powerholder's gross estate for federal estate tax purposes.

Trusts created at death

A trust that is created upon your death (i.e., a testamentary trust) is generally includable in your gross estate for estate tax purposes.

Tip: *If the transfer has already been treated as a gift (subject to gift tax), adjustments may be made in the estate tax calculations to avoid double taxation.*

Tip: *There are exclusions and deductions available that may help to reduce your gross estate (e.g., annual gift tax exclusion, unlimited marital deduction, and applicable exclusion amount).*

Gift taxation of trusts

A gratuitous transfer of property to a trust during life may be a taxable gift, just as if you had given the property outright. However, with respect to a trust, the taxable event may occur either at the time the property is transferred or at some later time. You (the grantor) are responsible for filing Federal Form 709 and paying any gift taxes owed. The taxes are due on April 15 of the year following the year in which the transfer is made.

Taxable gift occurs immediately upon transfer

Transfers made into an irrevocable trust in which the grantor (the creator) is not a beneficiary or retains no interest are taxable upon transfer.

Caution: *Some transfers of property to a trust for the benefit of a spouse or lower-generation family members in which the grantor has retained an interest may be treated as a taxable gift at the time of the transfer.*

Taxable gift occurs upon distributions to beneficiary

A transfer made to a revocable trust, a trust in which the grantor is a beneficiary, or a trust in which the grantor has retained an interest is not a taxable gift at the time the transfer is made. Think of it this way: A grantor cannot make a gift to himself or herself. Therefore, the gift cannot occur until distributions are made to other beneficiaries.

Taxable gift occurs upon powerholder's exercise, release, or lapse of the power

A taxable gift may occur if a powerholder (either the holder of a power of appointment or the holder of Crummey withdrawal powers) exercises or releases the power or allows the power to lapse. These are considered gifts made by the powerholder to the beneficiary. These gifts are not being made by the grantor but by the powerholder and are thus taxable to the powerholder.

There are exclusions and deductions available that may help to reduce your gross taxable gifts (e.g., annual gift tax exclusion, unlimited marital deduction, and applicable exclusion amount).

GST tax taxation of trusts

Generation-skipping transfer (GST) tax may be imposed if the beneficiaries of the trust are skip persons (i.e., persons who are two or more generations below you). The GST tax is imposed in addition to gift and estate tax. GST tax transfers are taxed at the maximum gift and estate tax rate in effect at the time the transfer is made. Whether a transfer to a trust is subject to GST tax depends upon who the transferor is and how the transfer is classified (i.e., a direct skip, taxable termination, or taxable distribution). GST tax is reported on Federal Form 706 if the transfer is a lifetime gift or Federal Form 709 if the transfer is a bequest.

Who is the transferor?

Whether a transfer to a skip person has occurred necessarily depends upon who the transferor is.

Direct skips

A direct skip is a transfer made to a skip person that is subject to federal gift and estate tax. A transfer to a trust is considered a direct skip if all the beneficiaries with an interest in the trust are skip persons.

A direct skip is taxable when the transfer is made. The trustee is liable for the tax. If the direct skip is made at death, your personal representative pays the tax from your estate. The amount subject to tax is the value of the property or interest in the property transferred (reduced by the amount paid for the property, if any).

Caution: *The tax you or your trustee pays on direct skip gifts increases the amount of the taxable gift for gift tax purposes by the amount of the tax. Likewise, the tax is part of your gross estate if you make a direct skip at death.*

Example(s): *Hal dies in 2022. Hal's will provided that $1,000 goes to his grandson, Fred, a skip person. Hal's bequest is a taxable transfer that is subject to gift and estate tax. Hal's bequest is also a direct skip, which is subject to the GST tax (assume no GST exemption is available for this transfer). Hal's executor is liable for the GST tax of $400 ($1,000 x 40 percent, the maximum estate tax rate in 2022).*

Taxable termination

A taxable termination is a termination of an interest in a trust, which results in the skip person(s) holding all the interests in the trust. Termination can result from death, lapse time, release of a power, or otherwise. A taxable termination is taxable at the time the termination occurs.

Example(s): *Phil creates a trust and funds it with $1 million. The terms of the trust provide that Phil's daughter, Marlene, a nonskip person, receives the income from the trust for 10 years, and then the principal (the remainder) goes to Phil's granddaughter, Susan, a skip person. A taxable termination occurs after 10 years, when Marlene's interest in the trust terminates* *and only Susan's interest remains.*

But, there is no taxable termination if gift and estate tax is imposed on the nonskip person.

Example(s): *Assume the same facts as described, except that Marlene has an income interest for life. Marlene dies. The value of the trust is includable in Marlene's gross estate for gift and estate tax purposes. A taxable termination has not occurred.*

The taxable amount of a taxable termination is the net value of all property that goes to the skip person. As opposed to the direct skip, a taxable termination is tax inclusive. That means that the skip person receives the property after tax. For instance, in the above example, the tax due is $400,000 (40 percent of $1 million) (assuming no GST exemption is available for this transfer). Susan would receive $600,000 ($1 million - $400,000). The trustee is liable for the tax. Certain partial taxable terminations are treated as taxable terminations. If a property interest in a trust terminates because of the death of your lineal descendant (e.g., a child), and if a specified portion of the trust is distributed to at least one skip person, then such partial termination is a taxable termination with respect to that portion.

Example(s): *Bill sets up a trust that provides that income be paid to his children, Joan and David. The terms of the trust further provide that when the first child dies, half the trust principal is distributed to Bill's grandchildren. The other half of the principal is paid to Bill's grandchildren after the second child dies. Joan dies. The distribution to Bill's grandchildren is a taxable termination (not a taxable distribution) because it is only a partial distribution that occurs as a result of Joan's death (Bill's lineal descendant).*

Tip: *A taxable termination can also be a direct skip. A taxable termination that is also a direct skip is treated as a direct skip.*

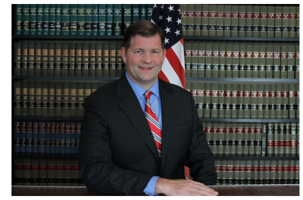
Taxable distributions

A taxable distribution is any distribution (other than a direct skip or a taxable termination) of income or principal from a trust to a skip person (or from a trust to another trust if all interests in the second trust are held by skip persons) that is not otherwise subject to gift and estate tax. Generally, gift and estate tax is owed when the trust is funded, not when the funds are distributed. The taxable event occurs when the distribution is made. The amount subject to the GST tax is the net value of the property received by the distributee (the recipient) less anything the distributee paid for the property. Like a taxable termination, a taxable distribution is tax inclusive (i.e., the distributee receives the property after tax). The distributee is obligated to pay the tax. If the trust pays the tax, the payment will be treated as an additional taxable distribution.

Example(s): *Jane creates a trust and funds it with $1 million. Jane pays gift and estate tax on $1 million at the time she funds the trust (assume no other variables). The terms of the trust provide that the trust income be distributed, at the trustee's discretion, among Jane's husband, Hal, her son, Ken, her daughter-in-law, Sue, and her granddaughter, Jill. Any distributions made to Hal, Ken, and Sue are not subject to the GST tax because Hal, Ken, and Sue are not skip persons. Any distributions made to Jill are subject to the GST tax, and Jill is liable for the tax.*

Tip: *There is an exemption ($12,060,000 in 2022) and there are exclusions available that may help to reduce your gross taxable transfers subject to GST tax.*

IMPORTANT DISCLOSURES This presentation is not intended to and does not provide investment, tax, legal, or retirement advice or recommendations. The information presented here is not specific to any individual's personal circumstances. To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances. These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable — we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.



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