

Working With Trusts From Another Tax Era

USING 20/20 HINDSIGHT TO “UPDATE” THESE TRUSTS

WORKING WITH IRREVOCABLE TRUSTS

Whether we advised the client to establish the trust or we “inherit” the client with a trust that we would not advise be adopted as part of a current plan, we need to advise on how to deal with such trusts.

WORKING WITH IRREVOCABLE TRUSTS

Some trusts are just no longer needed as the trust's main purpose is no longer a concern, as when the purpose was to avoid estate tax at the surviving spouse's death, but with the increased Federal Exemption, this is often a non-issue, but the income tax basis step-up at death is lost.

WORKING WITH IRREVOCABLE TRUSTS

Some trusts have restrictive provisions for beneficiaries such as limitations on access to principal, and/or generation skipping provisions that are no longer desired as beneficiaries have matured.

WORKING WITH TRUSTS HOLDING LOW BASIS ASSETS

- These trusts include the following:
 - Irrevocable (Grantor) Trusts funded during the Grantor's lifetime
 - Trusts, now irrevocable, funded at the Grantor's death
- Typically, these trusts are designed to not be included in the estate of the current beneficiary when he or she dies. Designed to avoid Federal Estate Tax, which may not be an issue now, these trust assets also do not receive a "step-up" in basis when the current beneficiary dies. Note: in a more rare case, they also don't receive a "step-down" in basis either.

WORKING WITH TRUSTS HOLDING LOW BASIS ASSETS

- Is the Income Tax Basis really that low?
 - If the Trust holds a portfolio of Marketable Securities, portfolio turnover will have increased the basis from the original starting basis.
 - If the Trust holds an interest in a “pass through” entity, the basis is constantly changing. For example: The Trust’s income tax basis for an entity taxed as an “S” Corporation or Partnership is generally the following:
 - Original Basis
 - Plus Income Allocated
 - Less Losses Allocated
 - Less Distributions Received

SHOULD THE TRUST BE MAINTAINED OR TERMINATED, ETC.

- Non-Tax Considerations:
 - Creditor Protection
 - Comply with Grantor's Wishes
 - Costs of Terminating, Modifying, etc.
 - Family Dynamics
 - Fiduciary's Role
 - Maintenance/control of distributed assets – e.g. post-termination, is a Shareholders' (Business Owners') Agreement now needed?
 - Actuarial considerations

SHOULD THE TRUST BE MAINTAINED OR TERMINATED, ETC.

Tax Considerations:

- S Corporation ownership rules (if relevant) must be followed pre and post termination.
- Is the Termination a “Taxable Event”? Generally, it should not be.
- In the year of termination, are there special tax issues (e.g. expiring Carryovers, etc.) ?
- Note that for years 2018 to 2025, Excess Deductions on Termination and Capital Loss Carryovers are not passed out on termination.

LIFE INSURANCE TRUSTS

Non-Tax Considerations

Assuming the Insured is still alive:

- Is the policy still needed?
- Would the need for life insurance return if current provisions “sunset”?
- How much of a “nuisance” does the trust really present?
- What about post-death of the insured(s)?
- Does the ILIT play a greater role in the overall plan?
- Should the policy be sold?
- What are the Trustee’s fiduciary duties?

LIFE INSURANCE TRUSTS

Estate/Gift Tax Considerations

Assuming the insured is alive:

- Will the insured acquire the policy? Estate inclusion is now an issue.
- If the insured acquires the policy, the three year rule of Section 2035 will then apply to any potential subsequent transfers.
- Note that “Incidents of Ownership” of Section 2042 are broad tests.
- If the insured acquires the policy, gifts are made to the insured.
- Funding the premiums will no longer constitute a gift.

LIFE INSURANCE TRUSTS

Tax Considerations

Assuming the insured is alive:

- If the policy is transferred to the beneficiaries, the actuarial interests of the beneficiaries must be respected, or gifts will be made.
- There is no gift made by the insured when the policy is transferred to the beneficiaries, in most cases.
- If the parties sell the policy to one or more beneficiaries, the Transfer for Value provisions of Section 101 will apply – barring an exception.

LIFE INSURANCE TRUSTS

Income Tax Considerations

- If the trust sells the policy, if the trust is a Grantor Trust for federal income tax purposes, as most ILITs are, the Grantor will pay the tax on any gain. Where does the Grantor get the dollars to pay the tax?
- Pennsylvania income taxation of trusts does not follow the federal regime – the trust is a separate entity, on whom the income tax liability is imposed.
- If post-sale proceeds are invested, the Grantor Trust status means the Grantor will continue to pay the federal income taxes, typically without reimbursement by the trust.

DOES IT EVER MAKE SENSE TO TERMINATE AN ILIT WHEN YOU INTEND TO MAINTAIN THE POLICY?

- Unless the cost of administering the trust is too high, or a beneficiary whose rights will be terminated agrees to the termination, terminating an ILIT seems counter-intuitive when the policy will be maintained.
- If there are to be multiple owners of the policy after the trust termination, we might propose a partnership or LLC to own the policy. If so, we're essentially just replacing the trust structure with another structure.

WORKING WITH FUNDED CREDIT SHELTER TRUSTS, ETC.

Pennsylvania Inheritance Tax Considerations:

- If the trust assets are distributed, they are now potentially subject to Pennsylvania Inheritance Tax.
- If the election under 72 P.S. Section 9113 (a) to prepay the Inheritance Tax was made, any distribution to the surviving spouse will increase the total Pennsylvania Inheritance Tax, if the surviving spouse's estate is subject to Pennsylvania Inheritance Taxation.
- If the election under 72 P.S. Section 9113 (a) to prepay the Inheritance Tax was not made, the Pennsylvania Department of Revenue reserves the right to tax the trust assets at the time of trust termination. [See Pa Code Section 94.3]

WORKING WITH FUNDED CREDIT SHELTER TRUSTS, ETC.

- Should the Trust be modified to give the current beneficiary (often the surviving spouse) a General Power of Appointment?
- Per Section 2041 of the Internal Revenue Code, a General Power of Appointment over assets subjects those assets to inclusion in the Federal Taxable Estate of the Power Holder.
- Note that a testamentary power to appoint to the beneficiary's creditors is a General Power for purpose of the Federal Estate Tax, [Section 2041 (b)(1)] which yields Federal Estate inclusion (now often meaningless), but also allows a basis step-up at the beneficiary's death, even if the power is not exercised.

MODIFYING TRUSTS WHILE THE GRANTOR IS ALIVE

In this discussion, we assume the trust is irrevocable whether the grantor is alive or not.

- Per THE PROBATE, ESTATES AND FIDUCIARIES CODE, [20 PA. C.S. “PEF Code”] Section 7740.1 (a), the Settlor - with the consent of the beneficiaries, may modify or terminate a non-charitable trust, regardless of whether the modification violates a material purpose of the trust.
- In this setting, the Settlor may not represent a beneficiary.

MODIFYING TRUSTS WHILE THE GRANTOR IS ALIVE

Note the Requirements of PEF Code Section 7740.1(a):

- Must be a Non-Charitable Trust
- Settlor (Grantor) must be alive
- Settlor (Grantor) must obtain the consent of all beneficiaries
- Settlor (Grantor) may not represent beneficiaries

MODIFYING TRUSTS WHILE THE GRANTOR IS ALIVE

- Note that this provision, Section 7740.1 (a), appears to be the ultimate ability to make an Irrevocable Trust, “Revocable” - by modification or termination, in spite of the title of the trust.
- However, if the Settlor [Grantor] wants to change the trust’s provisions to delete or reduce a beneficiary’s share or interest, that beneficiary’s consent is required. *Good luck in most cases!*
- At best, this provision of the PEF Code allows a “second look” at the irrevocable trust’s provisions, *assuming the beneficiaries agree.*

MODIFYING OR TERMINATING A TRUST WHEN THE GRANTOR IS DECEASED

MODIFICATION

Per PEF Code Section 7740.1 (b), the beneficiaries may modify a non-charitable trust, *with court approval*, only if the court determines that modification is not inconsistent with a material purpose of the trust. A spendthrift provision is deemed to constitute a material purpose of the trust.

MODIFYING OR TERMINATING A TRUST WHEN THE GRANTOR IS DECEASED

TERMINATION

Per PEF Code Section 7740.1 (b), the beneficiaries may terminate a non-charitable trust, *with court approval*, only if the court determines that continuation of the trust is not necessary to achieve any material purpose of the trust. A spendthrift provision is deemed to constitute a material purpose of the trust.