Source: Estate Planning/Drafting California Irrevocable Trusts/Contents

Contents

Preface

Introduction

About the Third Edition Authors

About the 2010 Update Authors

About the Consulting Editors

Acknowledgments

Selected Developments

Cutoff Dates and CEB Citation

Volume 1

1 Overview of Irrevocable Trusts

John R. Cohan

2 Estate and Gift Tax: A Drafter's Guide

Ann C. Harris

3 Income Tax: A Drafter's Guide

Ann C. Harris

4 Generation-Skipping Tax Problems of Irrevocable Trusts

Jon J. Gallo

5 Trust Planning: Permanent Trusts

John R. Cohan

6 Valuing Interests in Property

Belan K. Wagner

Paul E. Hoelschen, Jr.

7 Structuring the Trust Instrument

Jeffrey A. Dennis-Strathmeyer

8 Introductory and Basic Clauses

Sandra J. Chan

Diana Hastings Temple

9 Dispositive Clauses

John R. Cohan

10 Trust Administration and Trustee's Powers

Sandra J. Chan

Diana Hastings Temple

11 Life Insurance Trusts

Jon J. Gallo

12 Trusts for Minors

Monica Dell'Osso

Betty J. Orvell

13 Special Needs Trusts 653

Sterling L. Ross, Jr.
Ruth A. Phelps

13A Dynasty Trusts

Richard S. Kinyon

Volume 2

14 Grantor Retained Income Trusts (GRITs)

Marc M. Stern

15 Grantor Retained Annuity Trusts (GRATs)

Marc M. Stern

16 Grantor Retained Unitrusts (GRUTs)

Marc M. Stern

17 Qualified Personal Residence Trusts (QPRTs)

Bruce Givner

Owen Kaye

Bruce D. Whitley

18 Charitable Remainder Trusts

Lynda S. Moerschbaecher

18A Nongrantor Charitable Lead Annuity Trusts

Jeffrey A. Dennis-Strathmeyer

19 Issues Related to Nature of Trust Assets

Diana Hastings Temple

Sandra J. Chan

20 Multistate Trusts

Joseph L. Wyatt, Jr.

Patrick R. McCabe

Appendix A: Long-Term Family Pot Trust; Independent Trustee

Appendix B: Trusts for Minors

Appendix C: Separate Trusts for Children or Grandchildren (Skip Persons); Sensitive Trustee Permitted

Appendix D: Irrevocable Life Insurance Trust for Children

Appendix E: Life Insurance Trust for Spouse and Issue

Appendix F: Charitable Remainder Unitrust

Appendix G: IRS Charitable Remainder Unitrusts for One and Two Lives or a Term of Years

Appendix H: IRS Charitable Remainder Annuity Trusts for One and Two Lives or a Term of Years

Appendix I: Inter Vivos QTIP Trust

Appendix J: Inter Vivos QDOT Trust

Appendix K: Nongrantor Charitable Lead Annuity Trust

Appendix L: Grantor Retained Annuity Trust

Appendix M: Third Party Special Needs Trust

Appendix N: Generation-Skipping Dynasty Trust

Appendix O: Charitable Remainder Annuity Trust

Appendix P: Qualified Personal Residence Trust (QPRT)

Table of Statutes, Regulations, and Rules

Table of Cases

Table of References

Table of Forms

Index

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Preface

As a stand-alone product, the third edition of this book completes the evolution of the first and second editions, which were published as companions to prior versions of Drafting California Revocable Living Trusts (3d ed Cal CEB 1994). The scope of the third edition has been expanded to include coverage of modern irrevocable trust instruments, including GRITs, GRATs, GRUTs, QPRTs, and special needs trusts. The tax coverage in this edition has been expanded to include a separate chapter on generation-skipping transfer tax, as well as comprehensive GST discussion as applicable to other chapters and forms. The book has been reorganized to reflect the actual structure and sequence of trust drafting, with chapters on trust planning, trust structure, introductory provisions, dispositive provisions, and trust administration and trustee powers.

The late John R. Cohan, a retired senior partner of Irell & Manella LLP, Los Angeles, and Marc M. Stern, a partner of Greenberg Glusker Fields Claman Machtinger & Kinsella LLP, Los Angeles, served as consulting editors for this book. Mr. Cohan also served as consulting editor for the previous editions of this volume, as well as the three editions of Drafting California Revocable Living Trusts. The consulting editors' dedication and diligence will be apparent to attorneys who use this book as a guide to drafting. Their hard work and expertise are appreciated by the CEB staff.

Janette Tom was the CEB research attorney in charge of this project. She was assisted by CEB research attorneys Mary Gerber, Hale Kronenberg, Jean Magistrale, Carol Sanders, Jeffrey Dennis-Strathmeyer, and Jane Fassett Thakar. Copyediting was handled by CEB's editorial staff. Cheryl Ventimiglia designed the book. Phyllis Hartke prepared the index. Legal research was provided by Jess Alvarado, Maria Borje-Bonkowski, Robert Denham, Tom Hogan, Sue Homer, Lucinda Igarashi, Mujahidun Sumchai, and Amy Wheat. Composition was performed by CEB's Electronic Publishing staff.

August 2010 Update

CEB wishes to thank Bruce Givner, Esq., and Owen Kaye, Esq., of Givner & Kaye, Los Angeles, for their contributions as co-authors of revised chapter 17 (Qualified Personal Residence Trusts (QPRTs)). CEB also wishes to thank Ruth A. Phelps of Phelps, Schwartz & Phelps, in Pasadena, for her contributions as update author of chapter 13 (Special Needs Trusts), Richard S. Kinyon of Morrison & Foerster, San Francisco, for his contributions as update author of chapters 3 (Income Tax: A Drafter's Guide) and 18 (Charitable Remainder Trusts).

CEB Attorney Editor Robert Denham and Legal Editor Christine Day contributed to this title. Administrative support was provided by Kenya Denman and Nila Kanzaria. Paul Green handled copyediting and production. Robert W. Burke, Jr. and Kathryn Te Selle updated the index. Composition was performed by CEB's Electronic Publishing staff.

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Source: Estate Planning/Drafting California Irrevocable Trusts/Introduction

Introduction

The introduction to the Second Edition states that because of its looseleaf form, "A third edition is unlikely." Then why has a third edition been published? In the 10 years since publication of the Second Edition, major legislative changes, including the high income taxation of trusts, have required a change in focus and approach in every chapter of the book. In addition, the scope of the book has been broadened to add chapters on special needs trusts, grantor retained annuity trusts, grantor retained unitrusts, and grantor retained income trusts. Finally, a number of format changes have been introduced to make the Third Edition more user friendly.

The drafter must consider new treasury regulations and rulings, as well as judicial developments. More important, the drafter must keep informed about pending legislation, which constantly swirls about like the angry clouds of a thunderstorm. As of March 25, 1997, there are 160 tax legislative proposals, such as proposals to abolish the estate tax (unlikely); to increase the lifetime exemption; to liberalize the relief given farmers and other landowners under IRC §2032A; to forgive tax on the profit from the sale of a house; and to increase the limit on IRA contributions.

The Third Edition permits the drafter to build flexibility into irrevocable trusts to accommodate to new circumstances, *e.g.,* by giving independent special or independent regular trustees powers to adapt to changing circumstances, or possibly to terminate the trust.

I hope this book will continue to fill a unique need: that of the drafter concerned primarily with community property. Thus, in general, the *settlors* are discussed in this book, and discussion of the problems of the *settlor* is left to the excellent authors from separate-property states! (Of course, the problems created by separate property are discussed to a substantial extent.) This handbook is designed for the drafter, so that detailed discussions of applicable law are avoided whenever possible. As in all legal matters, the question of where to draw the line has been vexing.

I am indebted to the authors who contributed only to the First Edition of this book: Paul T. Quinn, Harold Weinstock, Louis M. Castruccio, Joseph R. Lowenstein, Albert J. Fink, and Geraldine S. Hemmerling.

I continue to be indebted to Robert D. Burch and Ronald E. Gother for their contribution to the original edition. My sincere appreciation to my deceased partner Louis M. Brown, whose creativity and many extracurricular activities over the years have been an inspiration to me since the first days of my law practice, continues unabated. And, finally, I want to express my admiration and thanks to Arthur Manella, recently departed, who had the unique ability of convincing anyone of almost anything, and who was kind enough to teach me a little bit of that skill.

Finally, the profound gratitude and admiration expressed in the introduction to the First Edition of this book to the editors and staff at CEB, including the unsung heroes known as the production editors, is incorporated into this introduction.

John R. Cohan

For the first time, the Third Edition of Drafting California Irrevocable Trusts begins with chapter 1. Both earlier editions of this text started with chapter 7 because the Drafting Revocable Trusts book had ended with chapter 6. Whereas the preface to the Second Edition indicates that the "book is a companion volume to Drafting California Revocable Living Trusts," the Third Edition now stands on its own.

The book has been greatly expanded from its origins to cover the myriad of irrevocable trusts that are currently authorized under the Internal Revenue Code and regulations, including GRITs, GRATs, GRUTs and QPRTs. Hopefully, the practitioner using this book will be able to draft these types of trusts relatively easily based on the discussions and forms in the text. As with any tool, however, improper use can result in significant problems. I therefore urge those using this book not to turn directly to the forms to begin drafting irrevocable trusts but instead to develop an understanding, even if only a cursory understanding, of the issues associated with the particular type of irrevocable trust being considered.

Along with John Cohan, I hope that the Third Edition will continue to fill a unique need by providing a comprehensive overview of irrevocable trusts in a community-property jurisdiction. As Congress and the California legislature continue to tinker with the taxation of trusts and the law governing trusts generally, CEB will continue to update the Third Edition. I look forward to being a part of that process.

John Cohan's involvement with this book from inception to its current form is to be commended. It was John's interest in this and other CEB projects that spurred my interest and involvement with CEB. Even though John has been retired from the active practice of law for several years, he has remained an active participant in the evolution of this book. When the decision was made

to completely reorganize and restructure this book, the first person who agreed to work on the project was John. Although I no longer have the pleasure of practicing with John, he remains my mentor, and I have enjoyed the opportunity to work with him in editing this Third Edition.

I would also like to thank the authors and consultants who have devoted countless hours to writing, editing, revising, and restructuring the text from the Second Edition. Finally, I echo John's sentiments of profound gratitude and admiration to the unsung staff and editors at CEB who have diligently worked to produce an exceptional product.

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Selected Developments

August 2010 Update

As of this writing, the estate tax and generation-skipping transfer (GST) tax do not apply to transfers in 2010, and the gift tax applies to lifetime transfers in excess of $1 million with a tax rate of 35 percent. In 2011, the estate tax and GST tax are restored with an estate tax applicable exclusion amount of $1 million and GST exemption of approximately $1,340,000, and a maximum tax rate of 55 percent. The restoration of the GST tax in 2011 makes outright gifts to grandchildren in 2010 advantageous even at the cost of paying gift tax on the gift because, unlike gifts in trust, there will be no future transfer to which the GST tax might apply. Outright gifts are necessary because it is uncertain whether GST exemption can be applied to trust transfers in 2010. See chap 4. To hedge against the possibility that the GST tax and the 45-percent gift tax rate may be retroactively restored, married settlors can make transfers to inter vivos QTIPs that will pass outright to remainder beneficiaries if the beneficiary spouse makes a qualified disclaimer with respect to the trust. See §2.39.

The update has revised valuation calculations in chapter 6 reflecting the higher IRC §7520 interest rates applicable to transfers in 2010 as compared with 2009. For example, the applicable federal rate for March 2010 is 3.2 percent as compared with 2.2 percent for March 2009, although the rate is still low compared with 5.8 percent for March 2007 and 5.4 percent for March 2006 (the applicable federal rate for March 2008 was 3.6 percent). The current historically low IRC §7520 interest rates that must be used to value remainder interests may have a profound effect on tax-saving trust strategies.

As illustrated by these examples, and further examples in chapters 14-17, the lower rates generally reduce the attractiveness of GRITs and QPRTs by increasing the gift tax value of remainder interests following income interests retained by the grantor for the life of the grantor or for a term of years, but this effect is more than offset for GRATs by the fact that the lower rates also increase the present value of annuity payments of a given dollar amount or percentage of trust assets. However, the attractiveness of GRATs would be reduced by pending legislation (HR 4899) that would require a minimum term of 10 years and would preclude the creation of zeroed-out GRATs. See §15.5.

Despite these difficulties, the update has an expanded and completely revised chapter 17 on QPRTs, which remain arguably underused even in the current interest rate environment. The revised chapter includes a discussion of a QPRT alternative joint purchase technique that eliminates the risk of inclusion in the grantor's estate. The revised chapter also has a detailed discussion of techniques that allow for continued possession of a residence by the grantor after the end of the trust term.

The lower rates also make it difficult for a charitable remainder trust with a younger life interest beneficiary making the minimum 5-percent annuity or unitrust payment to satisfy the requirement that the actuarial value of the remainder interest must be at least 10 percent of the initial fair market value of trust assets, as described in chapter 18.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

Conversely, the lower rates generally increase the attractiveness of generation-skipping dynasty trusts as an alternative to GRATs for trusts with grandchildren or other skip persons as remainder beneficiaries by reducing the interest rate needed to eliminate any taxable gift in connection with an installment sale of assets by the grantor to the trust, as described in chapter 13A. The form of dynasty trust contains a new provision designed to enable real property to qualify for the parent-child or grandparent-grandchild exclusion for a "change in ownership" for property tax purposes. See §13A.15.

With its continued and intensified focus on tax-saving techniques, the update has a reduced and completely revised chapter 13 on special needs trusts (SNTs), with detailed discussion and forms limited to third party SNTs. First party SNTs, including litigation special needs trusts (LSNTs), are now covered in Special Needs Trusts: Planning, Drafting, and Administration (Cal CEB 2008).

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Cutoff Dates and CEB Citation

Cutoff Dates

We completed legal editing and analysis of authorities cited in this publication as of May 15, 2010, and monitored developments through June 15, 2010.

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1

Overview of Irrevocable Trusts

John R. Cohan

I. DRAFTING IRREVOCABLE TRUSTS

A. Overview of Trust Planning §1.1

B. Types of Irrevocable Trusts §1.2

C. Relationship Between Revocable and Irrevocable Trusts §1.3

II. OBJECTIVES IN CREATING IRREVOCABLE TRUSTS §1.4

A. Reconciling Beneficiary Needs With Management Concerns §1.5

B. Obtaining Tax Savings

1. Transfer Tax §1.6

2. Income Tax §1.7

3. Effect of Circular 230 §1.7A

C. Asset Protection §1.8

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I. DRAFTING IRREVOCABLE TRUSTS

§1.1 A. Overview of Trust Planning

This book is a basic practice guide to drafting various kinds of irrevocable trusts. Because tax factors play a major role in irrevocable trusts, this book extensively discusses estate and gift taxes (see chap 2), income taxes (see chap 3), and generation-skipping transfer taxes (see chap 4) as they relate to the drafting of irrevocable trusts. Although the irrevocable trusts discussed in this book are generally unique, independent documents, some planning and drafting considerations are relevant to most kinds of irrevocable trusts. This book discusses such factors as trust planning (see chap 5), valuing interests in property (see chap 6), and trust structuring (see chap 7).

When possible, this book uses a modular approach under which clauses common to all trusts (*e.g.,* introductory and basic clauses (see chap 8), dispositive clauses (see chap 9), and trust administration and trustee's clauses (see chap 10)) are discussed in discrete chapters and alluded to by cross-reference in subsequent chapters. Complete forms of the most common kinds of irrevocable trusts are contained in the appendixes to this book.

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§1.2 B. Types of Irrevocable Trusts

There are many types of irrevocable trusts, and they are used for a variety of purposes. The irrevocable trusts discussed in this book are as follows:

- *Permanent trusts*. The so-called permanent trust is a trust designed for the prolonged management of permanently and irrevocably transferred assets. The trust objectives include immediate removal of the transferred property from a settlor's estate for estate tax purposes (accomplished at the price of making an immediate gift for gift tax purposes). The trust terms are usually designed to ensure that the income from trust corpus will no longer be includable in the settlor's taxable income for income tax purposes. See chap 3, which discusses the income taxation of irrevocable trusts. However, irrevocable trusts are sometimes drawn intentionally to cause the trust income to be taxed to the grantor to further reduce the settlor's estate. See §§3.22-3.48, 5.9-5.10. See also chap 13A on generation-skipping dynasty trusts, which are usually drafted as grantor trusts.

- *Life insurance trusts*. An irrevocable life insurance trust is typically used to remove the proceeds of life insurance from the insured's gross estate, while making those proceeds available as a source of liquid funds for the payment of estate taxes and other obligations. See chap 11.

- *Trusts for minors.* Trusts for minors are specialized forms of permanent trusts that more narrowly focus on the specialized circumstances and requirements of minors. See chap 12.

- *Grantor retained interest trusts*. A grantor retained interest trust allows the settlor to retain an interest in trust assets for a limited period of time, with the remainder interest passing to another person. These trusts include grantor retained income trusts (GRITs; see chap 14), grantor retained annuity trusts (GRATs; see chap 15), grantor retained unitrusts (GRUTs; see chap 16), and qualified personal residence trusts (QPRTs; see chap 17). These trusts, carefully drafted to avoid the valuation restrictions imposed by IRC §2702, are designed to minimize taxes by incurring a gift tax only for the remainder interest that follows the settlor's retained interest.

- *Charitable remainder trusts*. A charitable remainder trust is designed to provide benefits to named individuals for a specified period of time, with the remainder interest passing to charity. To obtain desired tax benefits, including an income tax deduction for the gift to charity, the drafter must ensure that these trusts meet specific requirements imposed by the Internal Revenue Code. See chap 18.

- *Charitable lead annuity trusts*. A charitable lead annuity trust is designed to provide benefits to charity for a specified period of time, with the remainder interest passing to named individuals. The transfer tax benefits are similar to those of a charitable remainder trust, but there is no income tax deduction for the gift to charity. See chap 18A.

- *Special needs trusts*. The principal purpose of a special needs trust is to preserve government benefits for a disabled or aged beneficiary. Although the terms of the other kinds of irrevocable trusts discussed in this book are frequently influenced by the tax laws, the terms of a special needs trust are principally controlled by the public benefit laws. See chap 13.

- *Estate balancing trusts*. If one member of a married couple is wealthy and the other has few assets, an inter vivos qualified terminable interest property (QTIP) trust can be used to provide the less wealthy spouse with a taxable estate, thereby making it possible to take advantage of that spouse's unified credit upon his or her death. An outright gift would accomplish this, but the QTIP trust permits the grantor to retain control of the trust estate. IRC §2056(b)(7). Because the QTIP trust will be treated as established by the less wealthy spouse once that spouse dies, the trust can provide the original transferor with interests in the trust, if the original transferor is the survivor, without the trust being included in the original transferor's estate. Treas Reg §25.2523(f)-1(f), Example (11). See §§2.39A-2.39B. See also §2.36A (nonmarital spousal trust).

- *Surviving spouse created qualified domestic trust* (QDOT). Generally, no estate tax deduction is allowed for transfers to a surviving spouse who is not a citizen of the United States. IRC §2056(d). See §2.80. A variation of the marital deduction can be obtained if the transferred property is put in a qualified domestic trust (QDOT). If the transferor does not do this, the survivor can create an inter vivos QDOT for the survivor's own benefit. Primarily, the QDOT secures an obligation to the federal government to pay additional estate taxes on the QDOT property when the spouse dies or the principal of the QDOT is otherwise distributed. See §§2.81-2.81G.

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§1.3 C. Relationship Between Revocable and Irrevocable Trusts

Revocable trusts and irrevocable trusts have many similarities. Both types of trusts provide for the transfer of property to a trustee who administers and eventually distributes the property as provided in the trust instrument. Most revocable trusts become irrevocable on the death of a settlor or cosettlor. Not surprisingly, many trust clauses used in drafting revocable trusts are also appropriate for various types of irrevocable trusts.

Despite these similarities, there are fundamental differences between revocable and irrevocable trusts. Most notably, the creation of an irrevocable trust has more immediate consequences in terms of property rights and taxes. Thus, for example, a settlor who transfers property to an irrevocable trust for children almost invariably relinquishes most rights to control the property. The transfer may also result in an immediate gift for gift tax purposes under IRC §2501, an immediate generation-skipping transfer under IRC §2601 for generation-skipping transfer tax, and a change in the taxpayer taxable on the income generated by the transferred property. Among other consequences, the latter may cause an S corporation to lose its S corporation status if the transferred property is S corporation stock and the trust does not meet the qualifications for owning the stock of such a corporation under IRC §1361(c)(2), §1361(d), or §1361(e).

Because they typically have immediate and significant tax consequences, irrevocable trusts involve major planning and drafting issues that do not commonly exist for revocable trusts. Thus, for example, it is often inappropriate for a settlor to serve as trustee of an irrevocable trust, whereas this would be common in the case of a revocable trust.

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§1.4 II. OBJECTIVES IN CREATING IRREVOCABLE TRUSTS

Clients generally desire one or more of the tax benefits described in §§1.6-1.7 without giving up control of the property placed in trust. The tax law will not permit them to escape estate and income taxes, however, if they refuse to part with the economic benefit or absolute control of trust corpus. See §§2.16-2.17; 3.25-3.29. Thus, trust drafting frequently becomes an attempt to reconcile the clients' tax objectives with their other wishes. Before permitting clients to part irrevocably with a portion of their property, the attorney must ensure that the clients will be economically secure and emotionally comfortable after the transfer and that they have thoroughly considered the nontax effects of irrevocability. When a client doubts whether the tax benefits are worth the consequences of establishing the trust, the trust should not be implemented until the client has thoroughly considered the matter. Establishing an irrevocable trust is not difficult; undoing one is almost impossible, although it is sometimes possible to modify one to secure its intended tax benefits. See Godshall, *Reforming and Modifying Irrevocable Trusts: Navigating the Waters and Avoiding the Shoals*, Estate Planning 2005, chap 6 (Cal CEB 2005).

The impact on the personal relationship between the settlors and the beneficiaries should also be carefully considered. A trust that creates marital discord or destroys a child's incentive to strive for success in a career does not serve the clients' best interests, no matter how much tax is saved. However, an irrevocable trust may solve family problems by assuring the settlors that children of a prior marriage will be provided for after a second spouse's death or that assets set aside to care for a disabled child or aged relative will not be squandered by the beneficiary or others.

The drafter and client should also consider the tangible and intangible costs of a more complicated plan using irrevocable trusts. For example, by establishing several trusts for different combinations of beneficiaries, the income tax savings may be greater than with a single trust for the same beneficiaries. Before adopting such a plan, however, the parties should consider whether administrative costs and the difficulty of working with several trusts will offset the tax savings. Tax savings notwithstanding, a client may feel trapped by a successful tax plan.

An impaired client may also achieve tax and other objectives through the use of an irrevocable trust. For example, California law permits a conservator to use the substituted-judgment doctrine to formulate or carry out an estate plan for the conservatee, including making gifts and establishing revocable or irrevocable trusts for the benefit of the conservatee and others. See Prob C §§2580-2586; California Conservatorship Practice, chap 18 (Cal CEB 2005).

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§1.5 A. Reconciling Beneficiary Needs With Management Concerns

Although many gift-giving objectives (and many tax objectives) can be satisfied by outright gifts, outright gifts have many limitations. An outright gift to a young or irresponsible person may risk mismanagement or waste. Further, outright gifts are frequently ill-suited to the commonly held desire to provide financial security for a group of persons whose financial needs may be different at different times. Thus, for example, outright gifts may not be suitable for a settlor who wishes to provide security to an older person during that person's lifetime and to provide benefits to others after that person dies. Similarly, an outright gift might not be suitable for a settlor who wishes to preserve funds for the college education of a grandchild years in the future.

In many cases, a settlor may be unwilling to make gifts of property because of concerns about the future management of the property. This can be particularly true regarding transfers of interests in family businesses to persons with little business experience. Tax considerations significantly limit a settlor's ability to control property transferred to a trust, but there are modest exceptions to this rule. See analysis of these exceptions in the discussions of transfer taxes and income taxes in chaps 2 and 3. In addition, a settlor's concerns can often be satisfied by the selection of a trustee whom the settlor trusts and whose relationship to the grantors and powers over the trust do not create unintended tax consequences.

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B. Obtaining Tax Savings

§1.6 1. Transfer Tax

The transfer tax system is comprised of the estate tax, the gift tax, and the generation-skipping transfer (GST) tax, which are discussed at length in chaps 2-4. These taxes operate in a manner that highly favors transfers by gift (regardless of whether the gift is made to a trust) rather than transfers at death. Generally, the earlier the gifts are made, the better.

The potential advantages of gifts—particularly early gifts—include the following:

- *Valuation freezing*. The term "valuation freezing" is used to describe any strategy that avoids transfer tax on future increases in the value of an asset. If an asset is expected to increase in value, it is usually preferable to transfer it before the appreciation occurs. The same concept applies to an asset that generates substantial income: If the asset is transferred immediately, future unconsumed income is never subject to transfer tax.

- *Greater use of annual exclusion.* Internal Revenue Code §2503(b) excludes from "taxable gifts" the first $13,000 (plus further cost-of-living adjustments) in gifts that a donor makes to any particular donee in any particular calendar year. Failure to make annual exclusion gifts each year results in the permanent loss of a tax-saving opportunity.

- *Tax-inclusive/exclusive calculation.* If a donor makes substantial gifts, the gift tax will become significantly lower than the estate tax because the money used to pay the gift tax is never included in the tax base used to calculate the amount of the gift (as long as the donor survives the gift for three years). The gift tax is said to be determined on a tax-exclusive basis. In contrast, a decedent's gross estate includes the money that will be used to pay the estate tax (a tax-inclusive calculation). For discussion of the computation of these two taxes, see §2.4.

For a variety of practical or emotional reasons, including those described in §§1.4-1.5, an individual may be unwilling to make substantial outright gifts. In such cases, an irrevocable trust may provide tax savings by enabling the individual to make a gift to a trust rather than an outright gift.

Less commonly, irrevocable trusts are also used in tax-savings strategies that are not necessarily directly related to the simple facilitation of early gifts. This is particularly the case with qualified personal residence trusts (see chap 17) and grantor retained annuity trusts (see chap 15), which satisfy detailed IRC §2702 requirements for avoiding otherwise harsh gift tax valuation rules for a gift of a remainder interest following a term of retained benefits.

The tax consequences of irrevocable trusts are not always favorable. A notable risk for such trusts arises from the fact that allocation of a taxpayer's generation-skipping transfer (GST) tax exemption is not necessarily automatic if, *e.g.*, the trust has both skip and nonskip beneficiaries such as children and grandchildren. If a gift is made to such a trust, a gift tax return must be filed to allocate the exemption unless the trust is a GST trust or the grantor has elected to have automatic allocation apply to the trust. This step is required even when a return is not required for gift tax purposes. Failure to allocate the exemption can result in a GST tax even when the amount transferred is small and the transferor has a low net worth. Conversely, if the trust is a GST trust, the automatic allocation rules may result in a waste of GST exemption unless the grantor has elected to have automatic allocation not apply to the trust. See §§4.17-4.29.

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§1.7 2. Income Tax

For income tax purposes, the income from trust assets may be taxable to the settlor, the beneficiaries, or the trust itself. In general, the income will be taxable to the settlor as long as a settlor or the settlor's spouse retains any rights to receive economic benefits from the trust or retains significant ability to control the trust. IRC §§671-677. If that is not the case, the trust income may be taxable to the beneficiary if the beneficiary has significant control over the trust. IRC §678. If neither the settlor nor the beneficiary has the required benefits or control, the trust income will be taxable to the trust except to the extent that the income is distributed (or should have been distributed) to the beneficiary in accordance with the terms of the trust instrument. IRC §§641, 643, 651-664. See §§3.12, 3.15, 3.39.

Thus, trusts can provide income tax savings if the terms of the trust and the distribution decisions of the trustee result in income being taxed to a taxpayer in a tax bracket lower than the settlor's. The opportunity to save taxes by causing income to be taxed to the trust itself is severely limited by the IRC §1(e) income tax rates applicable to trusts that allow only modest amounts of income to be taxed at less than the maximum rate.

These rates not only limit tax-savings opportunities but also result in the risk that trust income will be taxed at punitive rates. The drafter should design and administer irrevocable trusts in such a way that substantial ordinary income is not taxed to the trust itself, either by giving an appropriate trustee discretion to distribute additional income or by intentionally making the trust a grantor trust. See §§3.40-3.44, 5.9-5.10.

The use of trusts to shift income to low-bracket taxpayers is also limited by IRC §1(g), which imposes the "kiddie" tax, essentially taxing the investment income of a child under age 19 (age 24 in the case of a dependent student) at the tax rates of the child's parents. However, the maximum tax rate on trust income that consists of capital gains and qualified dividends (15 percent) is the same for trusts and individual beneficiaries. IRC §1(h). Combined state and federal taxes might even be less on undistributed income because California tax rates on ordinary income or capital gains are the same for trusts and single taxpayers at the same income levels. See §3.7.

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§1.7A 3. Effect of Circular 230

In recommending the tax-saving strategies described in §§1.6-1.7, the attorney must consider the effect of Circular 230 (31 CFR pt 10). Circular 230 imposes practice standards on attorneys, accountants, and enrolled agents who represent taxpayers before the Internal Revenue Service. The definition of "practice before the IRS" covered by Circular 230 includes "rendering written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion." 31 CFR §10.2(a)(4).

Under 31 CFR §10.34(b), applicable to documents that are not tax returns, practitioners may not advise a client to take a position on a document submitted to the IRS unless the position is not frivolous. Under 31 CFR §10.34(c), practitioners are required to inform clients of penalties that are likely to apply on a position taken on tax returns and other documents submitted to the IRS. With respect to tax returns, a practitioner may not sign a return as a preparer (which may include preparation of a document used in connection with the preparation of a return under IRC §7701(a)(36) and Treas Reg §301.7701-15(b)) unless there is substantial authority for each position taken on the return or there is a reasonable basis for each position and each position is adequately disclosed to the IRS. 31 CFR §10.34(a), (e). The "substantial authority" standard is consistent with tax return preparer penalty provisions in IRC §6694(a)(2). See Notice 2009-5, 2009-3 Int Rev Bull 309, discussed in 30 CEB Est Plan Rep 91 (Feb. 2009). See also *Tax Return Preparer Penalties: New Proposed Regulations and a Possible Statutory Change*, 30 CEB Est Plan Rep 5 (Aug. 2008).

Circular 230 also imposes standards in connection with written opinions on tax matters. Under 31 CFR §10.35(b)(2), a "covered opinion" includes written advice (including e-mail) concerning federal tax issues arising from any plan or arrangement if the advice concludes that it is more likely than not that the taxpayer will prevail on the issue (reliance opinion) and a significant purpose of the transaction is the avoidance or evasion of any tax. Under 31 CFR §10.35(c), advice in the form of a covered opinion must comply with detailed requirements relating to the use of reasonable factual assumptions and the need to provide a conclusion with respect to each significant issue considered in the opinion.

Cautious practitioners should avoid writing opinions that directly or indirectly state that it is "more likely than not (a greater than 50-percent likelihood)" that one or more tax issues will be resolved in a client's favor. In the context of tax shelters, the taxpayer may not have protection from accuracy-related tax penalties in the absence of an opinion containing such a "more likely than not" assessment, but in other than tax-shelter cases the opinion will normally provide such protection even without a likelihood estimate, provided it states that there is "substantial authority" for the specified tax treatment as discussed above. IRC §6662(d)(2)(B)(i), (d)(2)(C); Treas Reg §1.6664-4(f). Protection from penalties assumes good-faith reliance on the opinion. See *Bradley J. Bergquist* (2008) 131 TC 8 (despite taxpayers' claimed reliance on attorneys, accountants, and appraisers, they were liable for understatement penalties in connection with charitable gifts of stock in medical corporation when it was foreseeable on date of gifts that corporation would cease to do business). Under IRC §6662(h), the taxpayer may be liable for a 40-percent accuracy-related penalty on the portion of an underpayment attributable to a gross valuation misstatement.

Alternatively, the practitioner may include a prominent disclosure that the opinion was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. For example, the disclosure may state: "The tax advice, if any, contained in this communication does not meet Treasury Department standards for legal opinions that can be relied on by a taxpayer for the purpose of avoiding tax penalties." If such a disclosure is used, the advice is not a reliance opinion, and therefore it will not be a covered opinion unless the plan or arrangement is a listed transaction under Treas Reg §1.6011-4(b)(2) or the transaction has the "principal purpose" of tax avoidance or evasion as defined in Treas Reg §1.6662-4(g)(2)(ii). Under that definition, a plan or arrangement does not have the principal purpose of tax avoidance or evasion if it has as its purpose the claiming of exclusions from income or other tax benefits in a manner consistent with the statute and Congressional purpose. Even in the absence of a prominently disclosed penalty disclaimer, an opinion is not a reliance opinion unless the IRS has a "reasonable basis" for a successful challenge to the proposed transaction. 31 CFR §10.35(b)(3). For further discussion, see *The New Circular 230 Regulations: Keeping the Tempest in the Teapot*, 26 CEB Est Plan Rep 97 (Feb. 2005); *"Revised Revised" Final Regulations and Continuing Debate—The Ongoing Circular 230 Controversy*, 26 CEB Est Plan Rep 157 (June 2005); *Proposed Amendments to Circular 230 Concerning Practice Before the IRS*, 27 CEB Est Plan Rep 98 (Feb. 2006).

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§1.8 C. Asset Protection

An asset protection trust is designed to allow the settlor to retain a beneficial interest in the trust while protecting trust assets from the claims of the settlor's creditors. In some states, such as Alaska and Delaware, the fact that a settlor is a beneficiary of an irrevocable trust does not necessarily result in creditors being able to reach trust assets in attempts to satisfy a judgment against the settlor. See Shaftel, *Alaska's Experience With Self-Settled Discretionary Spendthrift Trusts*, 29 Est Plan 506 (Oct. 2002). See also Nenno & Sullivan, *Delaware Asset Protection Trusts Create Obstacles for Creditors*, 33 Est Plan 3 (Dec. 2005). On additional advantages of Delaware trusts, see Levin & Pulsifer, *The Delaware Personal Trust Advantage is Useful in Many Scenarios*, 36 Est Plan 14 (June 2009). This assumes that the transfers to the trust are not transfers that can be set aside as transfers in fraud of creditors. Under the Uniform Fraudulent Transfer Act, transfers are fraudulent if made with actual intent to hinder, delay, or defraud a creditor. A transfer without consideration is fraudulent if a debtor is engaged in a business and the transfer leaves the debtor with remaining assets that are unreasonably small in relation to the business, or if the debtor believed or reasonably should have believed that he or she would incur debts beyond his or her ability to pay. CC §3439.04(a). The transfer may be considered fraudulent if there is evidence of traditional "badges of fraud" such as retained possession or control of trust assets. See CC §3439.04(b)(2). In *U.S. v Townley* (ED Wash, July 29, 2004, No. CS-02-0384-RHW) 2004 US Dist Lexis 29722, aff'd (9th Cir 2006) 97 AFTR2d 2484, the court held that irrevocable trust assets could be reached to satisfy a judgment against the settlers even though they were not beneficiaries of the trust and there were no creditors at the time of the transfer. The court first concluded that there was direct evidence of intent to defraud creditors in the form of a settlor's statement that the transfers were intended to protect the transferred assets "from the claims" of future judgment creditors. The court further concluded that the settlors retained possession and control of trust property because they continued to reside in a residence after it was transferred to the trust and did not pay rent. The transfer also may be considered fraudulent if the debtor transfers substantially all of the debtor's assets. See CC §3439.04(b)(5).

Under 11 USC §548(e), transfers made to a "self-settled trust or similar device" within 10 years before filing a bankruptcy petition may be avoided by the trustee in bankruptcy if the transferor is a beneficiary of the trust or device and the transfer was made with actual intent to hinder, delay, or defraud any creditor or the transfer was made in anticipation of a monetary judgment, settlement, civil penalty, or fine incurred by specified securities law violations. However, the application of this provision is unclear, and a restriction on the transfer of a beneficial interest in a trust that is enforceable under applicable nonbankruptcy law is generally enforceable in bankruptcy. 11 USC §541(c)(2). See Nenno & Sullivan, *Delaware Asset Protection Trusts Should Survive Bankruptcy*, 33 Est Plan 31 (Jan. 2006).

NOTE: An attorney advising clients with respect to asset protection needs to be careful that the client's problem does not become the attorney's problem. In *Morganroth & Morganroth v Norris, McLaughlin & Marcus, P.C.* (3d Cir 2003) 331 F3d 406, the court held that a judgment creditor stated various causes of action against the judgment debtor's attorneys who participated in the client's unlawful conduct to hinder, delay, or fraudulently obstruct the enforcement of a judgment. For a case involving a civil conspiracy cause of action in connection with a fraudulent conveyance, see *Monastra v Konica Bus. Machines, U.S.A., Inc.* (1996) 43 CA4th 1628, 1644, 51 CR2d 528. See also *Gutierrez v Givens* (SD Cal 1997) 989 F Supp 1033.

In IRS Letter Ruling 200944002, the IRS ruled that an irrevocable trust established in Alaska by an Alaska resident settlor will not be included in the settlor's estate even though the settlor is a permissible distributee of the trust property. The ruling noted that there were no circumstances in which the trustee is required to make distributions to the settlor, his estate, his creditors, or the creditors of his estate. The trust agreement provided that the trustee may distribute income and principal in its sole and absolute discretion to a class consisting of the settlor, his spouse, and his descendants. On the death of the survivor of the settlor and his spouse, the trust estate will be distributed to his descendants then living or to charity. Under Alaska law, the settlor's creditors cannot reach the trust property.

In contrast, Prob C §15304 provides that the assets of a trust are subject to the claims of the settlor's creditors to the extent that the settlor is a permissible beneficiary of the trust. It is possible, however, to create trusts that are not subject to the claims of creditors of either the settlor or beneficiaries who may receive discretionary distributions as long as the settlor is not a beneficiary of the trust. Prob C §15303. As a rule, trusts for children or other natural objects of the settlor's bounty can satisfy the legitimate needs of the settlor. Generally, a person who furnishes the consideration for the creation of a trust is the settlor. *McColgan v Walter Magee, Inc.* (1916) 172 C 182, 155 P 995; *Parscal v Parscal* (1983) 148 CA3d 1098, 1104, 196 CR 462. Practitioners should be aware that a beneficiary arguably may become the settlor with respect to a portion of a trust to the extent that the trust gives the beneficiary a withdrawal power (such as a *Crummey* power) that the beneficiary fails to exercise. See §12.80. For this reason, withdrawal powers should be used cautiously if asset protection is a serious concern for a particular beneficiary.

Some practitioners have sought greater protection from creditors' claims by creating offshore trusts in foreign jurisdictions such as Saint Vincent and the Grenadines, Nevis, or the Cook Islands. (The trust laws in all three jurisdictions are similar because both

Saint Vincent and Nevis based their trust laws on the laws of the Cook Islands.) In at least two cases, courts have ordered settlors to repatriate assets of foreign trusts and pay creditors or be held in contempt of court. See *FTC v Affordable Media, LLC* (9th Cir 1999) 179 F3d 1228 (often referred to as the "Anderson" case). See also *Lawrence v Goldberg (In re Lawrence)* (11th Cir 2002) 279 F3d 1294, 1300. For further discussion, see Stein, *Importance of Trusts in Asset Protection*, 12 Cal Trusts & Est Q 17, 22 (Winter 2007).

Complete protection from creditors (and spouses) of beneficiaries other than the settlor is more difficult to achieve, but is often a goal of trust planning. The basic idea is that the trust document provides for only discretionary distributions, with the consequence that a creditor "standing in the shoes" of the beneficiary cannot compel distributions by the trustee. At least one California court decision has ordered the trustee of a discretionary trust to exercise its discretion to make distributions to satisfy a beneficiary's child support obligations. *Ventura County Dep't of Child Support Servs. v Brown* (2004) 117 CA4th 144, 11 CR3d 489. However, the case may be distinguishable from one involving a fully discretionary trust with a broadly defined class of beneficiaries (*e.g.*, issue of the settlor and spouses) because the child in *Ventura County* was a named beneficiary of the trust.

Another concern is to balance the settlor's desire to control the trust with the need to name a third party trustee to avoid giving the settlor the power to designate who will enjoy the trust income or the ability to make distributions that satisfy a support obligation of the settlor, which could result in estate tax inclusion under IRC §2036 or §2038. See §§9.34, 12.12. The basic idea is to name a person who is not related or subordinate to the settlor as trustee and give the settlor the power to remove the trustee. See §10.2. The power to remove and replace the trustee may be assumed by a designated trust protector or one to be named by the beneficiaries following the death of the settlor. The power to remove the trustee may even be given to a beneficiary without causing inclusion of the trust in the beneficiary's estate, although this is less common. See §10.29.

Note that the trust must be created and administered in a state other than California, such as Alaska, Delaware, Nevada, or South Dakota, if the trust is intended to last longer than the 90 years provided by the "look-and-see" provisions of the Uniform Statutory Rule Against Perpetuities (USRAP) (Prob C §§21200-21231). See §9.58.

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2

Estate and Gift Tax: A Drafter's Guide

Ann C. Harris

I. TAXABLE TRANSFERS
- A. Unified System of Estate and Gift Taxation; Estate Tax Repeal §2.1
  - 1. Pre-1977 Gifts §2.2
  - 2. Removing Post-Gift Appreciation From Tax Base §2.3
  - 3. Tax-Exclusive Versus Tax-Inclusive Tax Base §2.4
- B. Computing Gift and Estate Taxes
  - 1. Gift Tax §2.5
  - 2. Estate Tax §2.6
  - 3. Sample Computations of Gift and Estate Taxes §2.7

II. TAX CONSEQUENCES OF LIFETIME TRANSFERS
- A. Determining Transfer of Property Interest for Gift Tax Purposes §2.8
  - 1. Indirect Transfers §2.9
  - 2. Below-Market Rate Loans §2.10
  - 3. Powers of Appointment §2.11
    - a. Powers Limited by Ascertainable Standard §2.12
    - b. Powers Held Jointly With Person Having Adverse Interest §2.13
  - 4. Transfers of Less Than Entire Interest §2.14
- B. Determining When Transfer Is Completed
  - 1. Definition of Completed Transfer §2.15
  - 2. Retained Power Over Disposition §2.16
  - 3. Consequences of Subsequent Incompetence §2.17
  - 4. Powers Exercisable With Third Party §2.18
  - 5. Powers Held by Trustee §2.19
- C. Valuing Transferred Property Interest
  - 1. General Rules
    - a. When Property Should be Valued §2.20
    - b. Willing Buyer-Willing Seller Standard §2.21
    - c. Valuing Life Estates, Terms of Years, and Remainder Interests §2.22
    - d. Discounts and Premiums §2.23
      - (1) Blockage Discount and Control Premium §2.23A
      - (2) Minority Interest, Lack of Marketability, Lack of Control §2.23B
      - (3) Low-Basis Assets §2.23C
      - (4) Assets Transferred to Family Limited Partnerships (FLPs) §2.23D
      - (5) Undivided Interests in Real Property and Tangible Personal Property §2.23E
    - e. Swing Votes §2.24
  - 2. Special Valuation Rules
    - a. Overview of Chapter 14 §2.25
    - b. Interest in Corporation or Partnership §2.26
    - c. Interests in Trust
      - (1) Qualified Interests §2.27
      - (2) Exceptions to Qualified-Interest Rules §2.28
    - d. Options, Buy-Sell Agreements, Rights of First Refusal, and Leases §2.29
    - e. Treatment of Certain Lapsing Rights and Restrictions §2.30
  - 3. Determining Gift Tax Liability
    - a. Donor Is Primarily Liable §2.31
    - b. Donee Must Pay Gift Tax as Condition of Receiving Gift §2.32
- D. Payment of Consideration in Exchange for Transfer §2.33
- E. Annual Exclusion From Gift Tax
  - 1. Number of Donees Unlimited §2.34
  - 2. Present-Interest Requirement §2.35
  - 3. Trusts in Which Entire Interest Is Present Interest
    - a. *Crummey* Trust Withdrawal Powers §2.36

b. Nonmarital Spousal Trust §2.36A
c. IRC §2503(c) Trusts §2.37
4. Reciprocal Trust Doctrine §2.37A
F. Exclusion for Direct Payments of Tuition and Medical Expenses §2.38
G. Deductions Available To Determine Taxable Amount of Transfer
1. Unlimited Marital Deduction §2.39
a. Inter Vivos QTIP Trust §2.39A
b. Form: Inter Vivos QTIP Trust §2.39B
c. Form: Inter Vivos Unitrust QTIP Trust §2.39C
d. Estate and Gift Taxation of QTIP Trust §2.39D
2. Charitable Deduction
a. In General §2.40
b. Combining Unlimited Marital Deduction With Charitable Remainder Trusts §2.41
c. Charitable Gifts of Remainder Interests Not in Trust §2.42
H. Split-Gift Election §2.43
I. Considerations in Making Gifts §2.44
1. Advantages of Gifts §2.45
2. Disadvantages of Gifts §2.46
3. Adequate Disclosure of Gifts §2.46A

III. TAX CONSEQUENCES OF TRANSFERS OCCURRING AS RESULT OF DEATH
A. Determining Decedent's Gross Estate for Federal Estate Tax Purposes §2.47
B. Transfers in Which Decedent Retains Enjoyment or Control of Property §2.48
1. Retained Life Estate §2.49
a. Direct or Implied Right to Use or Occupy Real Property §2.50
b. Indirect Benefits That Constitute Retained Right to Income
(1) Assets Available to Creditors §2.51
(2) Trustee's Power to Use Income or Corpus for Decedent's Benefit §2.52
(3) Right to Have Income Used for Support of Dependents §2.53
c. Reciprocal Trusts §2.54
d. Transfer in Exchange for Annuity §2.55
2. Retained Voting Rights §2.56
3. Retained Reversionary Interest §2.57
4. Retained Right to Designate Person Who Will Possess or Enjoy Property §2.58
5. Retained Right, Through Exercise of Power, to Alter, Revoke, or Terminate Transferred Interest §2.59
6. Right to Designate Person Who Will Possess Property Compared With Right to Alter, Revoke, or Terminate Transferred Interest §2.60
7. Administrative Powers §2.61
8. Trustee's Discretionary Power §2.62
C. Life Insurance on Decedent's Life §2.63
D. Transfers Within Three Years Before Death §2.64
E. General Powers of Appointment §2.65
F. Annuities §2.66
G. Joint Tenancies §2.67
H. Exclusion to Extent of Consideration Furnished §2.68
I. Determining Value of Assets for Federal Estate Tax Purposes
1. General Rule §2.69
2. Minority Discounts for Community Property Interests §2.70
3. Problems in Applying Premiums or Discounts to Charitable Gifts or Marital Gifts §2.71
4. Special-Valuation Provisions for Certain Assets Included in Gross Estate §2.72
J. Deductions From Gross Estate to Arrive at Taxable Estate
1. Deductions to Arrive at Adjusted Gross Estate §2.73
2. Charitable Deduction §2.74
3. Marital Deduction
a. In General §2.75
b. Exceptions to Terminable Interest Rule
(1) Estate Trust §2.76
(2) Six-Month Survivorship §2.77
(3) General Power of Appointment Trust §2.78
(4) Qualified Terminable Interest Property (QTIP) Trust §2.79
4. Marital Deduction for Noncitizens §2.80
a. Requirements of Qualified Domestic Trust (QDOT) §2.81

(1) Inter Vivos Qualified Domestic Trust §2.81A
(2) Form: Construction of Trust §2.81B
(3) Form: Compliance With Security Requirements §2.81C
(4) Form: United States Trustee §2.81D
(5) Form: Designated Filer §2.81E
(6) Form: Distributions of Principal and Income §2.81F
(7) Form: Designation of Successor Trustees §2.81G
(8) Alternative Spousal Access Trust §2.81H
b. Credit for Prior Transfer Property (PTP) §2.82
c. Applicability of Customary Marital Deduction Rules When Spouse Becomes United States Citizen §2.83
K. Credits Applicable to Estate Tax
1. Credit for State Death Taxes §2.84
2. Credit for Gift Taxes Paid §2.85
3. Credit for Prior Transfer Property (PTP) §2.86
L. Payment of Estate Tax
1. General Rule §2.87
2. Extension of Time for Reasonable Cause §2.88
3. Extension of Time for Tax Attributable to Interest in Closely Held Business §2.89
4. Extension of Time for Tax Attributable to Vested Remainder Interest §2.90
5. Stock Redemptions to Pay Estate Tax §2.91

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I. TAXABLE TRANSFERS

§2.1 A. Unified System of Estate and Gift Taxation; Estate Tax Repeal

Legislation enacted in 1976 unified into one comprehensive system the taxation of taxable transfers occurring:

- During an individual's lifetime (see §§2.8-2.46); and
- As a result of the death of an individual (see §§2.47-2.91).

A single, progressive rate schedule applies to all transfers, whether by gift or at death. Current transfers are taxed at rates that take into account the value of previous taxable transfers. See §§2.2-2.4. On computation of gift and estate tax, see §§2.5-2.7. Although the unified system of transfer taxation was adopted to eliminate differences in the taxation of lifetime gifts and of transfers occurring at death that had existed before 1977, there is less than total parity of the two tax systems. Further, legislation enacted in 2001 limits the gift tax applicable exclusion amount to $1 million and retains the gift tax as the estate tax is repealed for decedents dying in 2010. Under the legislation, the unified system is restored in 2011 with an applicable exclusion amount of $1 million. A reduced unified credit equivalent to an applicable exclusion amount of $60,000 applies with respect to the estate tax on U.S. situs assets of nonresident aliens, and there is no gift tax applicable exclusion amount for gifts of U.S. situs assets by nonresident aliens. IRC §§2102, 2106(a)(3), 2505. Gifts and bequests in excess of the IRC §2503(c) gift tax annual exclusion amount received on or after June 17, 2008, from covered expatriates that are not otherwise subject to estate or gift tax are subject to a transfer tax that is not reduced by the unified credit. IRC §2801.

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§2.2 1. Pre-1977 Gifts

The calculation of federal *estate* tax payable by a decedent's estate takes into account only gifts made on or after January 1, 1977. IRC §2001(b). In contrast, the calculation of federal *gift* tax takes in account all gifts made after June 6, 1932. IRC §2502(b).

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§2.3 2. Removing Post-Gift Appreciation From Tax Base

Generally, the value of a gift for gift tax purposes is the fair market value of the transferred asset on the date the transfer is deemed complete for gift tax purposes. Once the gift is complete, subsequent growth in the value of the transferred asset is not taken into account in calculating the donor's estate and gift taxes unless the transferred property is included in the donor's estate. See §§2.48-2.64. Estate planners describe this tax benefit as a "valuation freeze." Assuming the donor would have invested the transferred assets if they had not been given away, a valuation freeze can save substantial taxes when gifts are made long before death.

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§2.4 3. Tax-Exclusive Versus Tax-Inclusive Tax Base

The gift tax is calculated by applying the rate schedule to the value of the *transferred asset*, ignoring the value of the money needed to pay the tax. Thus, the gift tax is calculated on a very beneficial *tax-exclusive* basis. In contrast, the estate tax is calculated by applying the rate schedule to the entire value of the taxable estate, including the money to be used to pay the tax. Thus, the estate tax is calculated on an undesirable *tax-inclusive* basis. Accordingly, it is ordinarily better to pay gift taxes than estate taxes.

An exception to this rule concerns gifts made within 3 years of death. Taxes on such gifts are calculated in the usual manner, but the gift taxes are added back into the estate for purposes of computing the estate tax. IRC §2035(b). See §2.64. Consequently, the normal benefit of the tax-exclusive nature of the gift tax calculation is eliminated.

EXAMPLE: Assume that all gift and estate tax transfers made by the donor are subject to a flat tax rate of 50 percent and that the donor has assets of $1.5 million that are available to make a gift and pay taxes. The donor can make a gift of $1 million, generating a gift tax of $500,000, *i.e.,* 50 percent of the net amount given to the donee. The effective tax rate is 33.3 percent ($500,000 tax on $1.5 million in assets). If the donor instead waits until death, the estate tax on the same $1.5 million will be $750,000, which is 50 percent of the entire $1.5 million. Note that the gift tax benefit will disappear if the donor fails to survive 3 years, because the $500,000 gift tax will be included in the donor's estate, thereby generating another $250,000 of tax.

WARNING: Once a client's gifts exceed the IRC §2505 gift tax applicable exclusion amount of $1 million, resulting in actual payments of gift tax, the client's estate plan should expressly state the source of funds to be used to pay the estate tax on the "phantom asset" that consists of nothing more than the gift tax already paid.

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B. Computing Gift and Estate Taxes

§2.5 1. Gift Tax

The federal gift taxes are computed on the United States gift and generation-skipping transfer tax return (Form 709). There are no California gift taxes. To compute the federal gift tax due in any calendar year (IRC §2502):

(a) Calculate the tentative tax on the sum of the taxable gifts made by the donor during the current taxable year, plus the value of all previous taxable gifts made by the donor since June 6, 1932, using the current estate and gift tax rate schedule in IRC §2001(c). For gifts in 2010, when the estate tax is repealed, a separate gift tax schedule is provided by IRC §2502(c). The gift tax schedule is the same as the current estate and gift tax schedule for taxable gifts of less than $1 million except that the maximum rate is reduced to 35 percent. For gifts in 2010, the resulting effective tax rate on assets used to make the gift and pay the tax is approximately 26 percent. See §2.4.

(b) Calculate the tentative tax on previous gifts alone using the same schedule, even though the current rates may differ from the rates originally used to tax those gifts.

(c) Subtract the amount determined in paragraph (b), above, from the amount determined in paragraph (a), above, to arrive at the tentative gift tax.

(d) Subtract any remaining portion of the IRC §2010(c) unified credit or IRC §2505 lifetime gift exemption that has not been used for gifts in prior years (but not exceeding the amount needed to reduce the tax to zero). Then subtract any credit for foreign gift taxes to arrive at the gift tax payable by the donor.

As a practical matter, no gift tax is due and payable until the aggregate amount of taxable transfers (*i.e.,* pre-1977 and post-1976 transfers) made by the donor exceeds $1 million, equal to the gift tax applicable exclusion amount. IRC §§2505, 2010(c).

Once aggregate gifts exceed the amount "shielded" by the gift tax applicable exclusion amount, the gifts are taxed at rates beginning at 41 percent (on amounts exceeding $1 million) and climbing to 45 percent (on amounts exceeding $2 million). In 2010, when the estate tax is repealed, gifts in excess of the $1 million gift tax applicable exclusion amount are taxed at a flat rate of 35 percent.

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§2.6 2. Estate Tax

Under the unified system of estate and gift taxation, the decedent's death is the last transfer subject to taxation except in 2010, when the estate tax is repealed. The federal estate tax is computed on the United States estate and generation-skipping transfer tax return (Form 706). The federal estate tax, before taking into account appropriate credits, is calculated as follows (IRC §2001(b)):

(a) The decedent's taxable estate is calculated by reducing the gross estate (see §2.47) by appropriate exclusions and deductions (such as the marital and charitable deductions, debts, and expenses, or losses of administration as discussed in §§2.73-2.83).

(b) The decedent's estate tax base is then calculated by increasing that taxable estate by the aggregate value of those adjusted taxable gifts made after December 31, 1976, which are not required to be included in the decedent's gross estate under the rules discussed in §§2.48-2.64 and 2.67 (IRC §§2035-2038, 2040, 2042).

(c) A "tentative tax" is then calculated with respect to the resulting total by applying the rate table in IRC §2001(c)(1).

(d) The tentative tax is then reduced by the amount of gift tax payable on lifetime taxable gifts made after December 31, 1976, using the rates in effect at death, not those in effect when the gifts were made.

(e) The tentative tax is then reduced by the IRC §2010 unified credit against estate tax. This unified credit allows each decedent to pass aggregate property worth up to the applicable exclusion amount without being subject to estate or gift tax. The applicable exclusion amount was $3.5 million in 2009. See IRC §2010(c). The following table shows the applicable exclusion amounts for the years 1999-2009 and thereafter (assuming restoration of the estate tax in 2011, as provided by legislation enacted in 2001), and a calculation of the tax credit amount that applies to each exclusion amount.

Year	*Applicable Exclusion Amount*	*Applicable Credit Amount*
1999	$650,000	$211,300
2000-2001	$675,000	$220,550
2002-2003	$1,000,000	$345,800
2004-2005	$1,500,000	$555,800
2006-2008	$2,000,000	$780,800
2009	$3,500,000	$1,455,800
2010	(repealed)	(repealed)
2011 and thereafter	$1,000,000	$345,800

In 2011 and thereafter, the resulting estate tax is further reduced by the IRC §2011 credit for state death taxes. See §2.84. California imposes a tax exactly equal to the amount of the credit. Rev & T C §13302. Less commonly, the tax may be reduced by the IRC §2013 prior transfer property credit if the decedent inherited property within 10 years before death (see §2.86) or, quite rarely, the IRC §2012 credit for gift taxes paid on pre-1977 gifts that are included in the estate (see §2.85).

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.7 3. Sample Computations of Gift and Estate Taxes

§2.7 3. Sample Computations of Gift and Estate Taxes

To illustrate the computation of gift and estate taxes, assume that *D* makes taxable gifts exceeding the IRC §2503(b) gift tax annual exclusion (see §2.34) totaling $150,000 in 2006, $100,000 in 2007, and $250,000 in 2008. The federal gift taxes payable by *D* in 2006, 2007, and 2008 are determined as follows:

Year 2006	
Start with:	
Net taxable gifts during year	$ 150,000
Taxable gifts from prior years	- 0 -
Tentative gift tax	$ 38,800
Subtract (Tentative gift tax on prior gifts):	(- 0 -)
Equals (Tentative tax payable):	$ 38,800
Subtract (Lesser of tax due or remaining gift tax applicable credit available in 2006 ($345,800-0 = $345,800)):	(38,800)
Equals (Gift tax actually due and payable):	-0 -
Year 2007	
Start with:	
Net taxable gifts during year	$ 100,000
Add (Prior taxable gifts):	150,000
Equals (Taxable base):	$ 250,000
Tentative gift tax on cumulative gifts	$ 70,800
Subtract (Tentative gift tax on prior gifts):	38,800
Equals (Tentative tax payable):	$ 32,000
Subtract (Lesser of tax due or remaining gift tax applicable credit available in 2007 ($345,800 - $38,800 = $307,000)):	(32,000)
Equals (Gift tax actually due and payable):	-0 -
Year 2008	
Start with:	
Net taxable gifts during year	$ 250,000
Add (Prior taxable gifts):	250,000
Equals (Taxable base):	$ 500,000
Tentative gift tax on cumulative gifts	$ 155,800
Subtract (Tentative gift tax on prior gifts):	(70,800)
Equals (Tentative tax payable):	$ 85,000
Subtract (Lesser of tax due or remaining gift tax applicable credit available in 2008 ($345,800 - $70,800 = $275,000)):	(85,000)

Equals: (Gift tax actually due and payable):	-0 -

Assume further that *D* dies in 2009, leaving a taxable estate (*i.e.,* gross estate minus deductions) of $3,500,000. (In 2007-2009, the tentative tax is less than the amount provided in the rate schedule because the maximum estate tax rate is 45 percent. IRC §2001(c)(2).) The federal estate tax is determined as follows:

Start with:	
D's taxable estate	$3,500,000
Add (Adjusted taxable gifts after 12/31/76):	500,000
Equals (Estate tax base):	$4,000,000
Tentative estate tax	$1,680,800
Subtract (Gift tax payable by *D*):	(- 0 -)
Subtract (Unified credit available in 2009):	(1,455,800)
Equals (Federal estate tax actually due and payable):	$ 225,000

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II. TAX CONSEQUENCES OF LIFETIME TRANSFERS

§2.8 A. Determining Transfer of Property Interest for Gift Tax Purposes

A gift tax is imposed on all completed transfers of interests in property for less than full and adequate consideration. IRC §§2501, 2511, 2512(b). In 2010, a transfer to a trust is a completed gift unless the trust is treated as owned by the transferor under the grantor trust rules of IRC §§671-679. IRC §2511(c). Normally, to constitute a gift, a transaction must include the standard elements of a gift, including the following (*Scott v Self* (8th Cir 1953) 208 F2d 125, 128):

- A competent donor;
- The donor's clear, voluntary, and unequivocal intent to make a gift, usually evidenced by less than adequate consideration;
- A conveyance, assignment, or transfer adequate to vest title in the donee, with no power to revoke by the donor;
- The donor's complete divestment of dominion and control over the property; and
- The donee's acceptance.

For purposes of the gift tax, however, there is one variation from the usual elements of a gift: The donor need not intend to make a gift for a transfer to be a taxable gift. See Treas Reg §25.2511-1(g)(1). Intrafamily transactions are subject to rigid scrutiny, and transfers between family members are presumed to be gifts. *Estate of Carl V. Van Anda* (1949) 12 TC 1158, aff'd (2d Cir 1951) 192 F2d 391. In *Estate of Costanza v Commssioner* (6th Cir 2003) 320 F3d 595, the court held that a sale of property to the decedent's son in exchange for a self-canceling installment note (SCIN) was not a gift, however, because evidence rebutted the presumption against the enforceability of an intrafamily SCIN. The court remanded the case to determine whether there was a bargain sale because the provision for cancellation on death resulted in the note having a value lower than the value of the property. See Huffaker, *Appellate Court Upholds SCIN As Bona Fide Sale: Planning Opportunities Enhanced*, 98 J Tax 292 (2003). In *Lane v U.S.* (4th Cir 2002) 286 F3d 723, the court held that transfers to the decedent's secretary reported on gift tax returns signed by the decedent were gifts and therefore the payments were not compensation deductible for income tax purposes, as claimed by the decedent's executor.

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§2.9 1. Indirect Transfers

Taxable transfers may include indirect, as well as direct, transfers. Indirect transfers may not be obvious. For example, in *Kincaid v U.S.* (5th Cir 1982) 682 F2d 1220, the court found an indirect gift when the donor had transferred property to a corporation but did not receive shares of the corporation's stock of equivalent value.

The court determined that the donor made a gift to the remaining shareholders of the corporation, whose shares were deemed to have increased in value as a result of the transfer.

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§2.10 2. Below-Market Rate Loans

When a lender makes either an interest-free loan or one that bears interest at a below-market rate, the lender is treated as if he or she had received interest at a market rate, for federal income tax purposes. IRC §7872. For federal gift tax purposes, the lender also is treated as if he or she had transferred to the borrower an amount equal to the difference between the interest the lender would have received if the market rate of interest had applied to the loan and the interest the lender actually received. The market rate of interest is the applicable federal rate (AFR) as established monthly by the IRS. IRC §7872(f).

The two exceptions to the general rule are:

- During any period when aggregate loans between the lender and borrower do not exceed $100,000, the lender recognizes interest income only to the extent that the borrower has net investment income greater than $1000 per year. IRC §7872(d)(1).
- Generally, IRC §7872 does not apply if aggregate loans between the lender and the borrower do not exceed $10,000 and the loan proceeds are not used to purchase or carry income-producing assets. IRC §7872(c)(2).

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§2.11 3. Powers of Appointment

The exercise or release of a general power of appointment is a transfer for both federal gift tax purposes (IRC §2514(b)) and federal estate tax purposes (IRC §2041(a)(2)). See §2.65 for estate tax issues. An inter vivos *lapse* of a general power is usually treated as a taxable *release* of the power, but only to the extent that in the calendar year the property that could have been appointed by exercise of the lapsed powers exceeds in value the greater of $5000 or 5 percent of the value of assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied. IRC §2514(e). A general power of appointment is any power possessed by the donee to appoint assets in favor of the donee (unless limited by an ascertainable standard), the donee's creditors, the donee's estate, or the creditors of the donee's estate. A power may constitute a general power of appointment even though it is exercisable by the donee only in the capacity as a trustee if (a) the donee-trustee has the power to appoint the income or principal of a trust to himself or herself, and (b) the power is not limited by an ascertainable standard. Treas Reg §25.2514-1. See §§2.12-2.13.

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§2.12 a. Powers Limited by Ascertainable Standard

A power held by the donee to appoint assets to himself or herself that is limited by "an ascertainable standard relating to the health, education, support, or maintenance of the possessor" is not a general power of appointment. IRC §2514(c)(1). Generally, a power will not be sufficiently limited if distributions may be made for such things as happiness or comfort. See Treas Reg §25.2514-1(c)(2) for examples of provisions that satisfy and fail to satisfy the statute.

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§2.13 b. Powers Held Jointly With Person Having an Adverse Interest

A power that is otherwise a general power usually will remain a general power, even though it can only be exercised with the consent of one or more other persons. However, a power is not a general power of appointment when it is exercisable by the donee only in conjunction with the creator of the power. IRC §2514(c)(3)(A). Similarly, a power is not a general power of appointment when it is exercisable only in conjunction with a person who has a substantial adverse interest in the property, and the interest is adverse to the exercise of the power in favor of the donee. IRC §2514(c)(3)(B). See §2.18 for discussion of what constitutes an adverse interest.

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§2.14 4. Transfers of Less Than Entire Interest

Generally, if the donor transfers less than his or her entire interest in an asset, the value of the gift for gift tax purposes will be the value of the interest actually transferred. However, if the transferred and retained interests are not simple fractional share interests or stock (or other business interests) having the same rights per share, the general rule is subject to important exceptions contained in IRC §§2701 (pertaining to transfers of interests in business entities) and 2702 (pertaining to transfers to retained interest trusts).

These provisions are designed to prevent gift-giving strategies that attempt to undervalue gifts by overvaluing the interests retained by the donor. For example, a donor might make a gift to a trust giving the donor the right to the income for 10 years. If the donor could deduct the value of the supposed income interest in calculating the value of the gift, but have the trust invest in assets that would benefit the remainderman while generating little immediate income, then the net result would be undervaluation of the gift to the remainderman.

The statutes compel valuation of such gifts by using a "subtraction method" in which the gift's value is the value of all involved property, reduced only by the value of specific retained interests that must be valued in particular ways. For further discussion, see §§2.25-2.28. As a result of IRC §2702, trusts providing donors with retained interests generally must be carefully designed as grantor retained annuity trusts (GRATs), grantor retained unitrusts (GRUTs), or qualified personal residence trusts (QPRTs). See chaps 15-17. Charitable remainder trusts also must be designed as annuity trusts or unitrusts under IRC §664. See chap 18. A grantor retained income trust (GRIT) can be used in limited circumstances, particularly if the remaindermen are not members of the donor's family. See chap 14.

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B. Determining When Transfer Is Completed

§2.15 1. Definition of Completed Transfer

A taxable gift occurs when the donor makes a completed transfer of an interest in property. A transfer is complete for gift tax purposes when the donor relinquishes dominion and control over the transferred property. Treas Reg §25.2511-2(b). Thus, a transfer may not be completed in the following situations:

- A donor reserves the right either to revoke a trust or to alter the amount of income or principal that beneficiaries may receive. Treas Reg §25.2511-2(c). See §2.16.
- A grant deed transferring absolute ownership of property is neither delivered nor recorded.
- A check has not yet cleared the donor's bank and is therefore still subject to a possible stop-payment order.
- A donor makes a gift by delivering the donor's own promissory note, but under state law a note given without consideration is not enforceable unless and until the note is transferred for value to a third party. Rev Rul 84-25, 1984-1 Cum Bull 191; Rev Rul 67-396, 1967-2 Cum Bull 351.
- A donor makes a gift to a trust that grants the trustee discretion to make payments to the donor-grantor under terms that cause the gift to remain subject to the claims of the donor's creditors under state law. *Estate of Mary M. Outwin* (1981) 76 TC 153, acq 1981-2 Cum Bull 2; *Estate of Alice Spaulding Paolozzi* (1954) 23 TC 182, acq 1955-1 Cum Bull 6, withdrawn 1957-2 Cum Bull 8, reinstated 1962-1 Cum Bull 4; Rev Rul 76-103, 1976-1 Cum Bull 293. See also Rev Rul 77-378, 1977-2 Cum Bull 347 (gift in trust complete when trustee given discretion to pay income and principal to grantor because, under state law, grantor could not force trustee to distribute funds and grantor's creditors could not reach trust assets). But see *Estate of Vak v Commissioner* (8th Cir 1992) 973 F2d 1409, 1413 (no completed gift when beneficial certificates were initially vested in grantor).

In *Estate of German v U.S.* (Cl Ct 1985) 85-1 USTC ¶13,610, 55 AFTR2d 1577, a gift in trust was held complete, even though the trustee was given absolute discretion to pay the net income or principal to the grantor, because, under Maryland law, the deceased grantor's creditors could not have reached that portion of the income or corpus over which the trustee had not exercised discretion in favor of the grantor. Note that, in California, assets held in a spendthrift trust for the benefit of the grantor are fully reachable by the grantor's creditors. Prob C §15304. See discussion in §1.8.

When the donor initially retains a power sufficient to avoid a completed gift, a subsequent termination or release of the power during the donor's lifetime completes the gift and subjects the donor to gift tax. Treas Reg §25.2511-2(f); *Estate of Sanford v Commissioner* (1939) 308 US 39, 84 L Ed 20, 60 S Ct 51; *Burnet v Guggenheim* (1933) 288 US 280, 77 L Ed 748, 53 S Ct 369. In *Estate of Jane deP. Webster* (1976) 65 TC 968, acq 1977-2 Cum Bull 2, the donor retained the power to terminate the trust with the consent of two of her four children. When only one of her children remained living, the termination power ended and the gift was complete.

Whether a transfer is considered complete or incomplete may have important consequences with respect to the lapse of a *Crummey* withdrawal power. See *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82, discussed in §2.36. Note that even though a transfer is completed for gift tax purposes, the gifted property may still be included in the donor's gross estate for federal estate tax purposes because of the donor's retained powers over interests in the property. See §§2.48-2.62.

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§2.16 2. Retained Power Over Disposition

If a donor reserves any power over the disposition of transferred property, such as a power to control the distributions from a trust, the transfer may be incomplete or partially incomplete for gift tax purposes. The regulations illustrate this point with an example in which the donor makes a transfer to a trust that authorizes the trustee to pay the income to the donor or accumulate it, in the trustee's discretion, and the donor retains a testamentary power to appoint the remainder among his descendants. According to the regulation, no portion of the gift is complete. If, on the other hand, the donor does not retain the appointment power the entire gift will be complete, except where the donor retains power to compel the trustee to make income distributions to the donor. Treas Reg §25.2511-2(b).

Each interest in the trust must be analyzed. The donor may make a completed gift of an annuity or income interest in an asset while retaining a reversionary interest or a power to appoint the remainder (see *Smith v Shaughnessy* (1943) 318 US 176, 87 L Ed 690, 63 S Ct 545), even though the retention of the reversionary interest or power may cause the entire asset to be included in the donor's gross estate for federal estate tax purposes under IRC §§2036-2038. See, *e.g.,* §2.57. The donor also may make a completed gift of a remainder interest in an asset while not making a completed gift of an income or similar interest that has been retained or made subject to a disposition power. The latter possibility also means that retention of the income interest or power will cause the entire asset to be included in the donor's gross estate for federal estate tax purposes if the interest or power still exists at death (IRC §2036(a)(1)), or is released by the donor during the three-year period before his or her death (IRC §2035(a)).

When a donor reserves the right either to revoke a trust or to alter the amount of income and principal that each beneficiary may receive, a transfer by the donor to the trust is not a completed transfer. Treas Reg §25.2511-2(c). See also Rev Rul 77-275, 1977-2 Cum Bull 346; *Estate of Sanford v Commissioner* (1939) 308 US 39, 84 L Ed 20, 60 S Ct 51; *Burnet v Guggenheim* (1933) 288 US 280, 77 L Ed 748, 53 S Ct 369. A power to vary the beneficial interests among a limited class of donees, even if exercisable by the donor only by will, is sufficient to avoid a completed gift of the interest affected. Treas Reg §25.2511-2(b).

A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment. Treas Reg §25.2511-2(d).

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§2.17 3. Consequences of Subsequent Incompetence

A donor's subsequent incompetence in itself does not constitute a termination or relinquishment of any retained power for tax purposes. See *Estate of Gilchrist v Commissioner* (5th Cir 1980) 630 F2d 340. See also California Conservatorship Practice §§11.6-11.15 (Cal CEB 2005). Thus, for example, a revocable trust remains revocable following the settlor's incompetence in the absence of an express provision in the trust instrument terminating the revocation power. (Such a provision is generally undesirable.)

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§2.18 4. Powers Exercisable With Third Party

A gift is not complete for federal gift tax purposes when the power to alter or control the beneficial enjoyment of the transferred property is exercisable by the grantor only in conjunction with another person who does not have a substantial adverse interest in the property subject to that power. Treas Reg §25.2511-2(e). The tax law assumes that a person who does not have a substantial interest will be amenable to the donor's wishes. When the third party has a substantially adverse interest in the property subject to the joint power, however, the gift is considered complete and subject to the gift tax. *Camp v Commissioner* (1st Cir 1952) 195 F2d 999.

A substantial adverse interest is one that is not likely to be given up lightly. Thus, a beneficial interest in the property subject to the joint power that would be defeated by the exercise of the joint power would be an adverse interest. Spouses, however, are not considered adverse to each other respecting gifts of property to their children. See *Commissioner v Prouty* (1st Cir 1940) 115 F2d 331. Nor does a trustee, as such, have an adverse interest. Treas Reg §25.2511-2(e).

By consenting to a change that reduces his or her interest, the adverse party may have made a taxable gift. See, *e.g.*, *Cerf v Commissioner* (3d Cir 1944) 141 F2d 564.

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§2.19 5. Powers Held by Trustee

For gift tax purposes, as with the estate tax, the significant issue is the *donor's* retained enjoyment or control. Even a power held by the donor as a trustee to alter or control beneficial enjoyment prevents the transfer from being a completed gift unless the retained power is a fiduciary power limited by a fixed or ascertainable standard. Treas Reg §25.2511-2(g). If the donor resigns as trustee of a trust in which the trustee's powers are not so limited, however, the donor relinquishes power to alter or control the beneficial enjoyment and the transfer is then a completed gift for federal gift tax purposes, regardless of whether the new trustee is an adverse party. Treas Reg §25.2511-2(f). Even if a gift is complete because an independent trustee holds powers not limited by a fixed or ascertainable standard, the full value of property held in the trust may still be included in the donor's gross estate for federal estate tax purposes under IRC §2036 if the donor has retained overbroad powers to change the trustee. See §§2.49-2.65.

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C. Valuing Transferred Property Interest

1. General Rules

§2.20 a. When Property Should be Valued

The value of a gift is determined when the gift becomes a completed transfer for federal gift tax purposes. Thus, the value of the transferred property must be determined as of the date on which the donor relinquishes dominion and control over the property. If the occurrence of a contingency would cause the gift to lapse, however, and the contingency is not susceptible to conventional actuarial valuations, the taxation of the gift may be deferred until the date on which the amount of the gift first becomes susceptible to valuation. See Rev Rul 69-346, 1969-1 Cum Bull 227. But see *Estate of Anthony F. Di Marco* (1986) 87 TC 653, acq in result 1990-2 Cum Bull 1 (transfers are not incomplete simply because "no realistic value can be placed" on transferred property at the time transfer occurs; transfers do not become complete only when value of transferred property can be easily ascertained); Action on Decision 1990-026 (explanation of acquiescence in *Di Marco*).

Some commentators have suggested that the value of a gift to an irrevocable trust can be fixed as of the date the donor relinquishes dominion and control despite the formula-gift limitations of *Procter v U.S.* (4th Cir 1944) 142 F2d 824, cert denied (1944) 323 US 756, and Rev Rul 86-41, 1986-1 Cum Bull 300, if within 9 months of the gift the beneficiaries of the trust make a qualified disclaimer of the portion of the gift that exceeds a specified amount and the trust provides that the disclaimed property will be returned to the donor. See Handler & Chen, *Formula Disclaimers:* Procter-*Proofing Gifts Against Revaluations by the IRS*, 96 J Tax'n 231 (2002). A variation on this approach is to provide in the trust that the disclaimed property will pass to charity, although the percentage of taxpayers who would rather give valuation increases to charity than pay transfer tax on those increases may be relatively small. See *Estate of Helen Christiansen* (2008) 130 TC 1, aff'd (8th Cir 2009) 586 F3d 1061 (formula disclaimer clause providing that amounts in excess of estate tax reported value would pass in part to a charitable lead annuity trust did not violate public policy by reason of reducing the Service's incentive to audit the estate tax return). See also *Estate of Anne Y. Petter*, TC Memo 2009-280 (court upheld defined value formula clause that limited the values of gifts to trusts for children and effectively increased the value of property passing to charity when it was determined that the transferred property was more valuable than reported on the gift tax return). For further discussion of *Christiansen* and *Petter*, see Bowman, *Defined Value Clauses—Better Defined*, 149 Trusts & Estates 14 (Feb. 2010). For further discussion of *Procter* and Rev Rul 86-41, see McCaffrey, *Transferring Hard to Value Assets—Shielding Your Client From Valuation Risk,* Estate Planning 2009, chap 7 (Cal CEB 2009); Shaftel, *How to Use an Escrow Trust to Implement a Defined Value Formula Clause*, 31 Est Plan 124 (Mar. 2004).

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§2.21 b. Willing Buyer-Willing Seller Standard

The value of a gift for gift tax purposes generally is the price at which a willing buyer would sell the transferred property to a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of all relevant facts. Treas Reg §25.2512-1. This is the same standard used for valuing property for federal estate tax purposes. See Treas Reg §20.2031-1(b).

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§2.22 c. Valuing Life Estates, Terms of Years, and Remainder Interests

Values of gifts of life estates, terms of years, or remainder interests are generally calculated using actuarial and other tables in accordance with IRC §7520 and various regulations. In making the calculations the taxpayer is required to assume that the transferred property will generate a return equal to 120 percent of the applicable federal rate (AFR) under IRC §1274(d) for the month in which the transfer occurs, rounded to the nearest 0.2 percent. The procedures for making these calculations are described in chap 6. Commercial estate-planning computer software also may be used to determine the value of the interests. Alternative valuation methods may be used if the tables produce an unrealistic and unreasonable value, *e.g.,* in the case of lottery payments subject to a statutory transfer restriction. See *Shackleford v U.S.* (9th Cir 2001) 262 F3d 1028. See also *Estate of Gribauskas v Commissioner* (2d Cir 2003) 342 F3d 85. But see *Negron v U.S.* (6th Cir 2009) 553 F3d 1013; *Cook v Commissioner* (5th Cir 2003) 349 F3d 850; *Davis v U.S.* (D NH 2007) 491 F Supp 2d 192. See also *Anthony v U.S.* (5th Cir 2008) 520 F3d 374 (applying *Cook* to commercial annuities). In *Shackleford*, the Ninth Circuit upheld a departure from the tables in valuing nonassignable lottery winnings, but it is not clear whether the court would have reached the same result if confronted with the legal arguments and expert reports presented by the government in *Davis*. The result in *Davis* is similar to the Tax Court decision in *Estate of Paul C. Gribauskas* (2001) 116 TC 142, rev'd (2d Cir 2003) 342 F3d 85, which concluded that case law offered no justification for taking into account marketability in valuing annuities. Note that *Davis* may be significant in contexts other than the valuation of annuity payments because the case calls into question whether liquidity is a significant factor in determining value for all types of property. For another case that raises this question, see *Stone v U.S.* (ND Cal 2007) 2007-2 USTC ¶60,545, 100 AFTR2d 5512, aff'd (9th Cir 2009) 103 AFTR2d 1379, discussed in §2.23E. However, alternative valuation methods are seldom available in the case of transfers of property interests to irrevocable trusts.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.23 d. Discounts and Premiums

§2.23 d. Discounts and Premiums

Assuming the relevant considerations are not already reflected in comparable sales data used to value a transferred asset, the value of a gift for gift tax purposes (*i.e.,* the price a willing buyer would pay a willing seller; see §2.21) often must reflect discounts for factors like blockage (sometimes called market absorption), lack of marketability, minority interests, or lack of control. Similarly, comparable sales information may need to be adjusted upward to reflect special positive attributes of a holding. Such adjustments are commonly called premiums. For example, a block of stock may have an extra high value if the block is large enough to guarantee control of the enterprise. Valuation discounts can be sizable. As a result, gift tax planning often centers on techniques to maximize discounts applicable to a transferred interest. These discounts arise when the transferred interest is in a family limited partnership or limited liability company, or is an undivided interest in real property.

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§2.23A (1) Blockage Discount and Control Premium

When the size of a block of transferred stock is so large that it cannot be sold in an orderly manner without causing a drop in the price per share of all the company's stock, the donor may take a blockage discount. See *Estate of Dorothy B. Foote,* TC Memo 1999-37 (3.3-percent discount allowed for 2.2-percent block of stock in a publicly traded company). See also *Estate of Eldon L. Auker,* TC Memo 1998-185 (6.189-percent discount allowed for estate owning three large apartment complexes in the same geographic area). In *Estate of Georgina T. Gimbel,* TC Memo 2006-270, the court allowed a 14.4-percent discount for restricted shares of a publicly held company to take into account SEC regulations limiting the number of restricted shares that could be sold in any 3-month period—with the consequence that the stock needed to be sold over several years in "dribble-out" fashion. In *Estate of Murphy v U.S.* (WD Ark 2009) 2009-2 USTC ¶60,583, 104 AFTR2d 7703, the court allowed a 5-percent discount for restricted shares held in a family limited partnership that represented a 2.67-percent block of stock in a publicly traded company, and the court allowed an additional valuation discount for the limited partnership interests. See §2.23B.

If the block of stock is so large as to represent a controlling interest in the issuing company, however, the stock is valued at a premium over the normal price per share because of the control feature (*i.e.,* control premium). Treas Reg §25.2512-2(e). In IRS Letter Ruling 200648028, the IRS ruled that the value of an irrevocable trust's stock that was included in the settlor's estate under IRC §2036 must be aggregated with the settlor's other stock for valuation purposes, with the consequence that the aggregated block will have a majority of the voting power and will be valued with a control premium.

In *Estate of Simplot v Commissioner* (9th Cir 2001) 249 F3d 1191, the court held that a premium did not apply to a 24-percent block of voting stock held by a decedent with 3 percent of nonvoting stock. In *Estate of Helen Bolton Jameson,* TC Memo 1999-43, vacated on other grounds (5th Cir 2001) 267 F3d 366, the court rejected the application of a nuisance discount to a 96-percent controlling interest for the existence of a 4-percent minority interest.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.23B (2) Minority Interest, Lack of Marketability, Lack of Control

§2.23B (2) Minority Interest, Lack of Marketability, Lack of Control

Because the holder of a minority voting interest in a business or enterprise cannot direct the payment of dividends or distributions, compel the entity's dissolution, or control the management of the business or the use of its funds, a minority-interest discount may be applied to the prorata value of the interest. Treas Reg §25.2512-2(f). For example, a 10-percent interest in a $1-million entity would typically have a value of less than $100,000 (10 percent of $1 million). In *Estate of James Barudin,* TC Memo 1996-395, the court allowed a 45-percent total discount to reflect the lack of marketability and minority interest features of a 1/95th interest in a general partnership owning two commercial buildings. For publicly traded securities, the market takes this minority-interest discount into account. In *Estate of Murphy v U.S.* (WD Ark 2009) 2009-2 USTC ¶60,583, 104 AFTR2d 7703, the court allowed a 12.5-percent discount for lack of control and a 32.5-percent discount for lack of marketability (effectively a combined 41-percent discount) in valuing limited partnership interests, concluding that there were significant nontax reasons for formation of the partnership. See §2.48.

A discount for lack of marketability applies when the interest is not readily marketable because of the nature of the interest (*i.e.,* an undivided interest in land) or the limited ability to realize the full value of the interest through the unilateral act of the interest holder. See *Louise B. Barnes,* TC Memo 1998-413 (40- and 45-percent marketability discounts allowed for gifts of stock of closely held telecommunications companies). See also *Estate of Bernard Mandelbaum*, TC Memo 1995-255, aff'd (3d Cir 1996) 91 F3d 124 (unpublished opinion) (30-percent marketability discount applies to closely held corporate stock). Marketability discounts and control premiums depend on the method used to value the corporation. *Estate of William J. Desmond,* TC Memo 1999-76. In *Donald J. Janda,* TC Memo 2001-24, the court allowed a 40-percent combined discount for marketability and lack of control for four gifts of 5-percent blocks of stock in a holding corporation that owned 95 percent of the stock of a rural bank, rejecting a 65-percent discount calculated by the taxpayer's expert using the Quantitative Marketability Discount Model (QMDM). In *Estate of Etta H. Weinberg,* TC Memo 2000-51, the court allowed a 50-percent discount for a 25-percent limited partnership interest in a partnership owning a 188-unit apartment building with a net asset value of $10 million, rejecting a 15-percent discount calculated by the IRS's expert using the QMDM.

In *Estate of Helen A. Deputy,* TC Memo 2003-176, the court held that a capitalization-of-income approach rather than a net asset/liquidation value approach should be used to value a long-established profitable corporation engaged in manufacturing aluminum boats. The court allowed a 30-percent combined discount for lack of marketability and minority interest. The opinion is modestly noteworthy because the court used "as a guide" a six-factor "matrix" that attempts to calculate a combined discount for lack of marketability and minority interest by, in effect, weighting six factors:

- The quality and reliability of the company financial information available to the buyer;
- The size of the investment (reflecting the assumption that the more the purchaser must invest, the higher the discount);
- Financial outlook, management, and growth potential;
- Ability to control the business;
- Restrictions on transfer and anticipated holding period; and
- Dividend history.

The court rejected the estate expert's use of his own matrix, which led to the conclusion that a 44-percent discount was appropriate, but nevertheless used the listed considerations as a guide in determining the 30-percent discount.

In *Estate of Mitchell v Commissioner* (9th Cir 2001) 250 F3d 696, the court reversed a Tax Court decision that determined an estate tax value for a 49-percent block of stock in a closely held corporation that supposedly reflected a 35-percent combined discount for marketability and lack of control, based on incorrectly stated expert testimony, but still found a deficiency. The court held that, once the taxpayer rebuts the validity of the IRS's value determination, the government has the burden of proving the existence and amount of any deficiency. On remand, however, the Tax Court

again calculated the same value, and the court of appeals affirmed. *Estate of Paul Mitchell*, TC Memo 2002-98, aff'd sub nom *Fujeki v Commissioner* (9th Cir 2003) 2004-1 USTC ¶60,475, 93 AFTR2d 362.

In *Estate of Godley v Commissioner* (4th Cir 2002) 286 F3d 210, the court affirmed a Tax Court decision that refused to allow a lack-of-control discount for a 50-percent general partnership interest. The partnership rented housing to elderly persons under government contracts that assured partnership income. The partnership agreement mandated annual distribution of net cash flow, which could not be changed without a vote of 75 percent of the partnership shares.

Family control of a business entity is not considered when valuing transferred interests under IRC §2512. A minority discount is not disallowed solely because a transferred interest, when aggregated with interests held by all family members, would be part of a controlling interest, whether the donor held 100 percent or some lesser percentage of the stock immediately before the gifts. Rev Rul 93-12, 1993-1 Cum Bull 202. Under *Estate of Harriet R. Mellinger* (1999) 112 TC 26, acq 1999-2 Cum Bull xvi, the surviving spouse's property will not be aggregated with QTIP property for purposes of valuing the property to be taxed on the survivor's death when the QTIP property is included in the survivor's estate under IRC §2044. However, a surviving spouse's property will be aggregated with general power of appointment (GPA) trust property included in the survivor's estate under IRC §2041. *Estate of Aldo H. Fontana* (2002) 118 TC 318. Similarly, the willing buyer-willing seller formula does not take into account the donee's gaining control of the entity through the transferred interest.

Often, both the minority-interest discount and the lack-of-marketability discount apply. See *John R. Moore,* TC Memo 1991-546 (minority-interest discount applied to partnership interests). See also *Estate of Virginia Z. Harwood* (1984) 82 TC 239, aff'd (9th Cir 1986) 786 F2d 1174 (unpublished opinion) (50-percent discount for a minority interest, lack of marketability, and restrictions on free transferability of interest). In *McCord v Commissioner* (5th Cir 2006) 461 F3d 614, the court allowed a 22-percent minority interest discount and a 35-percent marketability discount for gifts of limited partnership interests on the basis of a professional appraisal of the gifted interests that was used to determine the respective percentages of a block of limited partnership interests received by each donee under a "defined-value" gift provision. See §2.20. The practitioner should not overlook the impact of IRC §§2703-2704, however, when valuing interests in limited partnerships and closely held businesses. See §§2.26, 2.29-2.30.

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§2.23C (3) Low-Basis Assets

Courts have allowed discounts in valuing the stock of C corporations owning assets having a low income tax basis. See, *e.g., Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, acq 1999-1 Cum Bull xix; *Estate of Artemus D. Davis* (1998) 110 TC 530. See also *Estate of Jelke v Commissioner* (5th Cir 2007) 507 F3d 1317, cert denied (2008) 172 L Ed 2d 43, 129 S Ct 168; *Estate of Dunn v Commissioner* (5th Cir 2002) 301 F3d 339; *Estate of Marjorie deGreeff Litchfield*, TC Memo 2009-21. In *Estate of Elma Middleton Daily,* TC Memo 2001-263, the court allowed a 40-percent discount for gifts of limited partnership interests when the IRS failed to challenge the assumption that built-in capital gains on publicly traded stock could be taken into account in valuing the interests. In *Smith v U.S.* (5th Cir 2004) 391 F3d 621, however, the court agreed with the IRS that the value of an individual retirement account (IRA) could not be discounted to reflect the beneficiaries' future income tax liability. The court noted that there is no market for retirement accounts and found that the potential tax to be incurred by the seller, while significant to the seller, would not affect the sales price of the securities in the account. See also *Estate of Doris F. Kahn* (2005) 125 TC 227; Rev Rul 2008-35, 2008-29 Int Rev Bull 116 (no discount for interest in restricted management account). In *Robert Dallas,* TC Memo 2006-212, the court rejected the contention that the negative tax consequences of a possible loss of S corporation status should be taken into account in valuing S corporation stock.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.23D (4) Assets Transferred to Family Limited Partnerships (FLPs)

§2.23D (4) Assets Transferred to Family Limited Partnerships (FLPs)

In *Ina F. Knight* (2000) 115 TC 506, the court allowed discounts for assets transferred to a family limited partnership (FLP) in valuing purported gifts of limited partnership interests on the ground that a willing buyer would not disregard the existence of the partnership but limited the discounts to 15 percent. In *Jane Z. Astleford,* TC Memo 2008-128, the court allowed lack of control and lack-of-marketability discounts at both levels on gifts of limited partnership interests in an FLP funded with a 50-percent real estate general partnership interest and ownership interests in real property. Assets may be transferred to a family limited liability company (LLC) as an alternative to an FLP. In *Suzanne J. Pierre* (2009) 133 TC No. 2, the court held that a single-member LLC that is a disregarded entity for income tax purposes will not be treated as a disregarded entity for purposes of valuing gifts and sales of interests in that entity.

Courts have also rejected the IRS argument that the loss of control when assets are transferred to a family limited partnership in exchange for limited partnership interests results in a gift on formation before any gifts are made of the limited partnership interests. See *Estate of W.W. Jones II* (2001) 116 TC 121; *Estate of Albert Strangi* (2000) 115 TC 478, aff'd in part and rev'd in part on other grounds sub nom *Gulig v Commissioner* (5th Cir 2002) 293 F3d 279; *Church v U.S.* (WD Tex 2000) 2000-1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 2001-2 USTC ¶60,415, 88 AFTR2d 2001. In *Gulig*, the Fifth Circuit upheld a Tax Court ruling that an FLP was to be honored for estate tax purposes despite the lack of a business purpose, but remanded the case to the Tax Court to consider the alternative IRS argument that the FLP assets were includable in the decedent's estate under IRC §2036. In *Keller v U.S.* (SD Tex 2009) 2009-2 USTC ¶60,579, 104 AFTR2d 6015, the court allowed valuation discounts of more than 47 percent for interests in an FLP that was funded with $250 million in bonds. Decedent's desire to protect family assets from depletion by ex-spouses through divorce proceedings provided a nontax reason for formation of the FLP. Because the interests of partners were proportionate to contributions, the formation of the FLP was a bona fide sale for an adequate and full consideration for purposes of IRC §2036. See §2.48.

In *Senda v Commissioner* (8th Cir 2006) 433 F3d 1044, however, the court suggested that a transfer of property to a partnership followed by a gift of partnership interests can be characterized as a gift of the property transferred to the partnership if the two actions were part of a single "integrated transaction." The consequence of such a recharacterization would be loss of entity-level valuation discounts when valuing the gift for gift tax purposes. The statement is dictum because the Eight Circuit decision affirmed a Tax Court decision that disallowed the claimed valuation discounts on the alternative ground that the donor failed to prove that he made his contributions to the partnership before making gifts of partnership interests. *Mark W. Senda*, TC Memo 2004-160, aff'd (8th Cir 2006) 433 F3d 1044. Applying the rule of Treas Reg §25.2511-1(h)(1) that a gift to a business entity is a gift to its shareholders or other owners, the Tax Court held that the donor had made gifts of stock to the partnership and not gifts of partnership interests. Nevertheless, the Eighth Circuit decision in *Senda* was cited with approval in *Suzanne J. Pierre*, TC Memo 2010-106, in which the court determined that a gift to each of two trusts of a 9.5-percent interest in a single-member LLC, followed moments later by the sale to each trust of a 40.5-percent interest in the LLC in exchange for a promissory note, should be treated as transfers of 50-percent interests in the LLC. The application of the step-transaction doctrine in *Pierre* resulted in only a trivial adjustment in the value of the interests. Consistent with Rev Rul 93-12, 1993-1 Cum Bull 202, the IRS did not attempt to aggregate the transfers to different donees. See §2.23B.

The *Senda* case serves as a reminder of the need for caution in making contributions to FLPs when other persons own interests in the entity. At the very least, the donor must receive consideration for the transfer in the form of additional partnership units or capital account allocations. See *Heckerman v U.S.* (WD Wash 2009) 2009-2 USTC ¶60,578, 104 AFTR2d 5551; *Linton v U.S.* (WD Wash 2009) 2009-2 USTC ¶60,575, 104 AFTR2d 5176 (donors made indirect gifts of assets transferred to a limited liability company (LLC) when donors failed to show that transfers to the LLC occurred before transfers of LLC units, and similarly failed to show that those transfers were credited solely to the donors' capital accounts). See also *Shepherd v Commissioner* (11th Cir 2002) 283 F3d 1258, in which the court held that the donor made gifts of undivided interests in bank stock that was transferred to a partnership after the donor made gifts of partnership interests. But see *Thomas H. Holman* (2008) 130 TC 170, aff'd (8th Cir 2010) 601 F3d 763,

and *Bianca Gross*, TC Memo 2008-221, in which the Tax Court allowed modest discounts for gifts of partnership interests made 6 days and 11 days, respectively, after the donor transferred stock to the partnership, although the Tax Court decision in *Holman* disregarded transfer restrictions in the partnership agreement as discussed in §2.29.

In *Clarissa W. Lappo,* TC Memo 2003-258, the court allowed a 15-percent minority interest discount and a 24-percent marketability discount for gifts of interests in an FLP holding real estate and marketable securities. The original notice of deficiency contended that: (1) there was no economic substance to the partnership's formation and operation; (2) the interests should be valued without regard to restrictions on the right to use or sell the property under IRC §2703(a) (see §19.76); and (3) the donor made a gift on formation. These contentions were withdrawn before trial. In *Peter S. Peracchio,* TC Memo 2003-280, the court allowed a 6-percent minority interest discount and a 25-percent marketability discount for gifts of interests in an FLP funded with cash, money market funds, and publicly traded securities. Initially the IRS made a variety of attacks on the partnership, but later abandoned them, leaving only the issue of the size of the discounts. In each case, however, the taxpayer agreed with the IRS that the minority interest discount for the partnership should equal the weighted average of separate minority-interest discount factors determined for each type of asset held. See Riebe, *Don't Accept Defeat*, 143 Tr & Est 47 (Mar. 2004).

In *Estate of Webster E. Kelley*, TC Memo 2005-235, the Tax Court allowed 32-percent valuation discounts for interests in a family limited partnership funded entirely with cash and certificates of deposit. The IRS withdrew the IRC §2036 argument before trial, but published reports suggest that the decedent did not need the transferred funds for his support. Accordingly, there was little evidence of an implied agreement that the transferred funds would remain available for the decedent's use. Failure to prove such an agreement would have left the IRS with the need to convince the court that the decedent retained the right to control the possession or enjoyment of the property under IRC §2036(a)(2). The Tax Court cited §2036(a)(2) as an alternative ground for the decision in *Estate of Albert Strangi*, TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468, which held that the partnership assets in question were included in the decedent's estate, but the Fifth Circuit decision in *Strangi* did not discuss the §2036(a)(2) issue.

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§2.23E (5) Undivided Interests in Real Property and Tangible Personal Property

Minority-interest discounts and lack-of-marketability discounts also may be available when valuing undivided interests in real property. See *Samuel J. LeFrak,* TC Memo 1993-526 (both 20-percent minority-interest discount and separate 10-percent lack-of-marketability discount allowed). The IRS and the courts, however, sometimes limit discounts to the cost of partition. See *Andrew K. Ludwick*, TC Memo 2010-104 (17-percent discount for time and selling costs, perhaps including cost of partition, for tenants-in-common interests transferred to QPRTs); *Estate of Bonnie I. Barge*, TC Memo 1997-188 (25-percent discount for cost and time of partition). See also *Estate of Ellie B. Williams*, TC Memo 1998-59 (44-percent discount for undivided ownership in land). But see *Adams v U.S.* (ND Tex 2001) 2001-2 USTC ¶60,418, 88 AFTR2d 6057, in which the court allowed a 20-percent minority interest discount, 10-percent portfolio discount, and 35-percent discount for lack of marketability for a 25-percent assignee interest in a partnership owning ranch land, among other assets, when local law provided that the assignee could compel the remaining partners to either liquidate the partnership or pay the assignee 25 percent of its net asset value and the IRS would have allowed only a 5.4-percent discount for selling expenses. In *Estate of William Busch,* TC Memo 2000-3, the court allowed only a 10-percent discount for a 50-percent interest in potential subdivision land, owing to the relatively low cost of partition compared with the value of the property. In *Estate of Eileen Kerr Stevens*, TC Memo 2000-53, however, the court held that the fractional-interest discounts allowed for income-producing commercial properties were not limited to the cost of partition. The court allowed a 25-percent discount for one-half undivided interests in three parcels of real property. In *J.C. Shepherd* (2000) 115 TC 376, aff'd (11th Cir 2002) 283 F3d 1258, the court allowed a 15-percent discount for gifts of two 25-percent undivided interests in real property. The court held that the purported transfer of the parcels to a partnership resulted in indirect gifts of the transferred property rather than gifts of partnership interests, for which the parties had agreed that a 33.5 percent discount would have been allowed. In *Estate of John L. Baird,* TC Memo 2001-258, rev'd on other grounds (5th Cir 2005) 416 F3d 422, the court allowed a 60-percent minority interest discount for a 14/65 interest in Louisiana timberland, finding that partition suits are expensive, often take several years, and are fraught with uncertainty. On appeal, the Fifth Circuit held that the IRS's position that discounts should be limited to the supposed costs of partition was not substantially justified and awarded the estate attorney fees and costs under IRC §7430. In *Temple v U.S.* (ED Tex 2006) 423 F Supp 2d 605, the court allowed a 60-percent discount for a gift of a California LLC interest that had the power to dissolve the LLC. The LLC owned and operated a ranch, including vineyards. The court concluded that there was no assurance that dissolution of the LLC would result in a sale of the ranch rather than distribution of tenancy-in-common interests in a property that could not be partitioned.

However, minority-interest discounts and lack-of-marketability discounts may not be available in valuing undivided interests in tangible personal property such as artwork. In *Stone v U.S.* (ND Cal 2007) 2007-2 USTC ¶60,545, 100 AFTR2d 5512, aff'd (9th Cir 2009) 103 AFTR2d 1379, the court issued findings of fact and conclusions of law that significantly limited the fractional-share discounts for an estate's one-half interest in 19 paintings. The court stated that "the art market differs from the real estate or business market. Art is simply not fungible. For instance, an investor or collector of art may not prefer to own one painting of lesser value in its entirety." The court concluded that a hypothetical willing seller of an undivided fractional interest in art would likely seek to sell the entire work and split the proceeds rather than seeking to sell his or her fractional interest at a discount. However, the court allowed a 5-percent total discount that included 2 percent in sales fees and an approximate 1.2-percent discount for uncertainties involved in waiting for a possible partition action to be resolved.

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§2.24 e. Swing Votes

In attempting to apply discounts to the value of a gift (see §2.23), the practitioner must not overlook the possibility that what appears to be a minority interest, to which a substantial discount would apply, might instead be a swing vote, to which a premium applies.

In *Estate of Clara S. Roeder Winkler,* TC Memo 1989-231, other members of the decedent's family owned 40 percent of a corporation's stock, and an unrelated family owned the remaining 50 percent of the stock. The Tax Court found that the 10-percent interest included in the decedent's gross estate was a swing vote because a third-party purchaser, by joining with the unrelated family holding the 50-percent interest, could effect control over the corporation, and, by joining with the family of the transferor, could block action. Therefore, the 10-percent interest was subject to a valuation premium of at least 10 percent. The court did allow a 25-percent discount for lack of marketability.

In IRS Letter Ruling 9436005, the IRS found that when the donor gave 30 percent of the stock of a closely held corporation to each of his three children (*i.e.,* 90 percent total) and 5 percent to his spouse, each 30-percent block had swing-vote attributes that were required to be taken into account in determining the value of the shares. Revenue Ruling 93-12, 1993-1 Cum Bull 202, however, appears to preclude this approach. See §2.23B.

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2. Special Valuation Rules

§2.25 a. Overview of Chapter 14

Before enactment of correcting legislation, a series of planning techniques became popular as a means of reducing estate and gift tax liability. For example, corporate recapitalizations ("recaps"), were used to shift the future growth potential of a family owned and operated business to younger generations at a very modest gift tax cost. This was usually accomplished by a recapitalization that converted the corporation's common stock into a combination of common stock and fixed-value preferred stock, with the preferred stock having a value close to the entire value of the enterprise. The common stock would then be gifted to younger generation family members. Any subsequent increases in the value of the corporation would increase the value of the common stock, but not the preferred.

Partnership freezes, through the use of tiered partnership interests, accomplished results similar to corporate recaps. Other freezing devices included grantor-retained income trusts (see chap 15), joint purchases of horizontal interests in property (in which senior family members would purchase a life estate and junior family members would purchase a remainder interest in the same property), and private annuities (in which senior family member would transfer property to junior family members in exchange for an annuity, the actuarial value of which was approximately equal to the fair market value of the transferred property). For a detailed discussion of valuation freeze techniques, see California Estate Planning, chap 25 (Cal CEB 2002).

Buy-sell, option (right of first refusal), and lease agreements were also frequently used to fix the value, for estate tax purposes, of the decedent's interest in the business or other asset that was subject to the agreement or option, at a value below market. In addition, business interests held by senior family members were designed so that certain valuable powers or rights related to those interests would lapse at the death of the senior family members, thereby reducing the value of those interests for federal estate tax purposes.

In response to the perceived abuse of these planning techniques, Congress added Chapter 14 to the Internal Revenue Code. See IRC §§2701-2704. Chapter 14 establishes special valuation rules for determining the gift's value for interests in corporations or partnerships (see §2.26) and trusts (see §§2.27-2.28) and property interests subject to certain rights or restrictions (see §§2.29-2.30), at the time the initial transfer is made, if special circumstances exist at the time of the transfer.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.26 b. Interest in Corporation or Partnership

§2.26 b. Interest in Corporation or Partnership

Special valuation rules apply to transfers of interests in corporations and partnerships to family members. Under IRC §2701, the special valuation rules apply if the following conditions exist:

- Transfer of an equity interest in a corporation or a partnership that is junior to the equity interest retained by the transferor and for which there is no publicly traded market price. Such a transfer occurs when the fair market value of the senior interest held before a capital-structure transaction is increased in value as a result of the transaction, even though no actual transfer of an interest has occurred. Treas Reg §25.2701-1(b)(2).
- Transfer of a junior equity interest to the transferor's spouse or to family members in a younger generation than the transferor. "Family members" for these purposes includes only the transferor's spouse, lineal descendants of the transferor or the transferor's spouse, and the spouses of lineal descendants. IRC §2701(e)(1).
- Retention of a senior equity interest (*i.e.,* an interest with a priority as to the distribution of income, capital, or income and capital of the enterprise) by the transferor, the transferor's spouse or "applicable family members" of the transferor (*i.e*., family members in the older generation). An "applicable family member" includes the transferor's spouse, an ancestor of the transferor, and the spouse of any such ancestor. IRC §2701(e)(2).
- Control of the enterprise by any lineal descendant of any parent of the transferor or the transferor's spouse (*i.e.,* ownership of 50 percent or more of the voting power or the value of the stock, or 50 percent or more of the capital or profits of the partnership). IRC §2701(b)(2).

If IRC §2701 applies to the transfer, the value of the transferred interest is determined using the following four-step subtraction method (Treas Reg §25.2701-3(b)):

(1) Determine the fair market value of all family held interests in the entity immediately after the transfer, using normal valuation principles and assuming that all interests are held by one individual. In essence, apply the customary willing buyer-willing seller methodology (see §2.21).

(2) Subtract the value of family held senior interests from the fair market value determined in step (1). A distribution right that is not a qualified payment is valued at zero unless a special election is made to treat the distribution right as a qualified payment. Treas Reg §25.2701-2(a)(2). Any put, call or conversion right, right to compel liquidation, or similar right (extraordinary-payment right) is generally valued at zero, if the exercise or nonexercise of the right would affect the value of the transferred interest. Treas Reg §25.2701-2(a)(1).

(3) Allocate among the junior equity interests the fair market value determined under step (1) that remains after subtracting the value of the senior equity interests determined under step (2).

(4) Apply any applicable discounts to the transferred interests being valued. For example, the amount allocated to the junior equity interests in step (3) is reduced by (a) the minority-interest discount and all other appropriate discounts, such as the lack-of-marketability discount, and (b) the fair market value of any consideration paid to the transferor by the transferee.

An attorney whose client is considering a recap (see §2.25) of his or her company should pay particular attention to details of the transaction. In IRS Letter Ruling 200839029, for example, a shareholder in a privately held company failed to report an exchange of common stock for preferred stock that inadvertently triggered the special valuation rules because the shareholder's son also held common stock in the company at the time of the exchange. Fortunately, the IRS allowed the shareholder to file an amended gift tax return to make an election to treat his rights to dividends on the preferred stock as qualified payment rights under Treas Reg §25.2701-2(c)(5). As a result of the election, the distribution rights will be taken into account in valuing the preferred stock, less value will be treated as shifted to the common stock at the time of the exchange, and the shareholder will be deemed to make gifts to holders of the common stock in the future if he does not actually receive the contemplated distributions to holders of preferred stock.

If the recap occurs incident to and after the parent's death, IRC §2701 should not apply. Furthermore, if the recap occurs during the parent's lifetime and the parent transfers senior equity interests to the inactive children first, the senior equity interests owned by the children are not attributed to the transferor. The interests are valued under the

normal valuation rules and are not subject to IRC §2701. For further discussion, see Long, *Statutory Freeze Partnerships: A Useful Estate Planning Technique*, 28 Est Plan 59 (2001).

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c. Interests in Trust

§2.27 (1) Qualified Interests

Gifts to trusts for the benefit of specified family members usually must be valued according to the provisions of IRC §2702 if the transferor, the transferor's spouse, or an older family member retains an interest in property transferred to the trust. If the statute applies, the value of the gift is the value of the entire property transferred to the trust, reduced only by the value of retained interests which are "qualified" interests. IRC §2702(a)(2)(A)-(B). For purposes of the statute, a trust benefits family members if it benefits the transferor's spouse, an ancestor or lineal descendant of the transferor or the transferor's spouse, a brother or sister of the transferor, or the spouse of any of these persons. IRC §§2702(e), 2704(c)(2). The valuation provisions of IRC §2702 apply to interests transferred in trust that are:

- Transfers creating life estates or term-of-years interests (IRC §2702(c)(1), (3));
- Joint purchases (IRC §2702(c)(2); Treas Reg §25.2702-4(c)); or
- Other types of estate freeze-planning techniques, such as leases for less than full and adequate consideration (Treas Reg §25.2702-4(b)).

Generally, two kinds of interests are recognized as "qualified" interests for purposes of IRC §2702:
(1) annuity interests (the right to receive a fixed amount at least annually); and
(2) unitrust interests (the right to received a fixed percentage of the current value of the trust assets at least annually).

A noncontingent remainder interest is also a qualified interest if the other interests are qualified. IRC §2702(b). A trust designed to provide the grantor with a retained annuity is called a grantor retained annuity trust (GRAT). A trust designed to provide the grantor with a retained unitrust payments is called a grantor retained unitrust trust (GRUT). For a detailed discussion of GRATs and GRUTs, see also chaps 15 and 16.

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§2.28 (2) Exceptions to Qualified-Interest Rules

The exceptions to application of the special valuation rules of IRC §2702 are as follows:

- The rules apply only to a transfer for the benefit of a member of the transferor's family, as defined in IRC §2704(c)(2). See §2.27.
- When the grantor retains a term interest in a trust containing only tangible personal property, the interest is valued at the amount that a third party would pay for a similar term interest. Treas Reg §25.2702-2(c). The ramifications of these exceptions to the application of §2702 with respect to grantor retained interest trusts (GRITs) are discussed in chap 14.
- When an interest in the grantor's personal residence is transferred, two types of trusts permit the grantor to retain an interest in a personal residence while still qualifying for the exception from §2702: personal residence trusts (PRTs) and qualified personal residence trusts (QPRTs). See IRC §2702(a)(3)(A)(ii); Treas Reg §25.2702-5(b) (defining personal residence trusts); Treas Reg §25.2702-5(c) (defining qualified personal residence trusts). PRTs and QPRTs are discussed in chap 17.

The IRS is authorized to create additional exceptions to the application of the special valuation rules. See IRC §2702(a)(3)(A)(iii). For example, it could except a charitable remainder trust that meets the requirements of IRC §664 and does not create an opportunity for transferring property to a family member free of transfer tax. S Rep No. 104-281, 104th Cong, 2d Sess 158 (1996), reprinted in 1996 US Code Cong & Ad News 1474, 1632.

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§2.29 d. Options, Buy-Sell Agreements, Rights of First Refusal, and Leases

Under IRC §2703, the value of property is determined without regard to any option, agreement, or other right to acquire or use the property at a price less than its fair market value. Section 2703 does not apply if the following three criteria are met (Treas Reg §25.2703-1(b)(1)):

- The right or restriction contained in the agreement is a bona fide business arrangement.
- The right or restriction contained in the agreement is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration.
- The terms of the right or restriction are comparable to similar arrangements entered into by persons in arm's-length transactions. See Treas Reg §25.2703-1(b)(4). See also *Thomas H. Holman* (2008) 130 TC 170, aff'd (8th Cir 2010) 601 F3d 763 (restrictions on transfers of partnership interests disregarded when partnership never conducted any business and never engaged in any investment activity). The Eighth Circuit decision distinguished the more favorable Tax Court decision in *Estate of Charles Porter Schutt,* TC Memo 2005-126, which was based on preservation of the transferor's investment strategy as discussed in §2.48.

In addition, IRC §2703 does not apply if at least 50 percent of the value of the property subject to the right or restriction is owned by persons who are not members of the transferor's family. Reg §25.2703-1(b)(3). This exception is invalid if family members' combined interests in the enterprise exceed 50 percent. Treas Reg §25.2703-1(b)(3). For further discussion, see Business Buy-Sell Agreements, chap 2 (Cal CEB 1991).

CAVEAT: Section 2703 does not cover agreements, options, rights, or restrictions granted before October 8, 1990, unless they are substantially modified after that date. Moreover, any modification that results in other than minimal changes to the quality, value, or timing of the right or restriction is considered to be substantial. Treas Reg §25.2703-2. Because adverse tax consequences could result from a substantial modification to an agreement otherwise grandfathered under IRC §2703, it is probably best not to modify existing buy-sell agreements, or to obtain a ruling from the IRS before doing so. See §19.76.

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§2.30 e. Treatment of Certain Lapsing Rights and Restrictions

Sometimes taxpayers wish to transfer business interests to younger family members but retain substantial control. Unfortunately, the retained control rights can increase the value of the taxable retained interest in the business. A potential method for avoiding estate or gift tax resulting from the increased value had been to provide that the control rights would lapse on death of the stock's owner or partnership interest bearing those rights. Thus, for example, the family corporation might have voting and nonvoting stock; the taxpayer would retain a majority of the voting stock, but the voting rights of those shares would lapse on the taxpayer's death.

This potential strategy is addressed by IRC §2704. Under the statute, a voting or liquidation right created after October 8, 1990, is a taxable gift if it lapses during the right holder's lifetime, or the right is included in the estate if it lapses on the right holder's death. IRC §2704(a). For this provision to apply, the individual holding the right (and members of his or her family) must control at least 50 percent of the entity. The value of the gift, or the amount included in the right holder's estate as a result of the taxable lapse, is the difference between the value of all interests in the entity held by the right holder before the lapse (determined as if the voting or liquidation right is nonlapsing) and the value of all interests in the entity held by the right holder after the lapse. IRC §2704(a)(2); Treas Reg §25.2704-1(d).

For these purposes, a lapse of a voting or liquidation right occurs when a presently exercisable right is restricted or eliminated. Treas Reg §25.2704-1(c). No lapse occurs if the transfer of an interest results in the lapse of a liquidation right, but the rights in the transferred interest are not restricted or eliminated. As a result, if a controlling shareholder's or partner's transfer of a portion of his or her interest results in the loss of voting control, the transfer is not a lapse.

Voting rights include the right to vote on any matter affecting the entity, including a general partner's right to participate in partner ship decisions. Treas Reg §25.2704-1(a)(2)(iv). A liquidation right is the right or ability to compel the entity to acquire some or all of the holder's equity interest in the entity, including the right to compel a liquidation by reason of aggregate voting power, even if the individual possessing the right cannot force the liquidation of the entire entity. Treas Reg §25.2704-1(a)(2)(v).

An applicable restriction on a transferred interest is disregarded in valuing the interest when (IRC §2704(b)):

- The members of the transferor's family control the enterprise immediately before the transfer; or
- The applicable restriction either lapses after the transfer to the family member or is subject to removal, in whole or in part, after the transfer, by the transferor or any member of his or her family, either alone or collectively.

An applicable restriction includes a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the state law generally applying to the entity absent the restriction.

Obama Administration revenue proposals would modify the regulations to provide that disregarded restrictions would include limitations that are more restrictive than a standard to be identified in the regulations and would also include any limitation on the transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. See General Explanation of Administration's Fiscal Year 2011 Revenue Proposals, p 124 (Feb. 2010) ("Greenbook") (available on the Treasury Department website at http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf).

Under Treas Reg §25.2704-2(b), an applicable restriction does not include:

- Any commercially reasonable restrictions arising as part of a financing agreement with an unrelated third party to provide capital for the entity's trade or business operations;
- Any limitation that is not more restrictive than limitations applicable under state or federal law (*Estate of W.W. Jones II* (2001) 116 TC 121; *Baine P. Kerr* (1999) 113 TC 449, aff'd (5th Cir 2002) 292 F3d 490); or
- Any restriction also subject to IRC §2703.

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3. Determining Gift Tax Liability

§2.31 a. Donor Is Primarily Liable

The donor is primarily liable for payment of federal gift tax. IRC §2502(c). If the tax is not paid by the due date, the donee of any gift is personally liable for the tax up to the value of the gift (IRC §6324(b)), but the donor remains primarily liable for the tax. In addition, the transferred property is subject to a lien equal to the gift tax due for 10 years after the date on which the gift is made. IRC §6324(b). The expiration of the 10-year lien period, however, does not terminate the transferee's personal liability for unpaid gift tax. See *U.S. v Estate of Davenport* (ND Okla 2001) 159 F Supp 2d 1330, rev'd on other grounds sub nom *U.S. v Botefuhr* (10th Cir 2002) 309 F3d 1263. See also *U.S. v Davenport* (5th Cir 2007) 484 F3d 321, cert denied (2007) 552 US 1076 (despite contrary holding in *Botefuhr,* the donee in a related action could not again litigate value of same gifts or the issue of whether statute of limitations had run with respect to assessment of gift tax liability previously determined by Tax Court and affirmed by Tenth Circuit in earlier decision).

Because the donor is primarily liable for payment of the gift tax, a provision in a trust created by the donor directing the trustee to pay the gift tax from the trust may trigger the application of IRC §677, under which the grantor is taxed on trust income, or the provision may be applied to discharge the grantor's legal obligations. See *Estate of Sheaffer v Commissioner* (8th Cir 1963) 313 F2d 738, cert denied (1963) 375 US 818. The IRS takes the position that trust income used to pay the grantor's gift tax liability or to repay borrowings to pay gift tax is taxable to the grantor. Rev Rul 57-564, 1957-2 Cum Bull 328. The Tax Court, however, has held that when a trust agreement provided for the trustee to pay the gift tax and authorized the trustee to sell trust corpus or borrow for that purpose, the grantor incurred no income tax liability on trust income for years after the year in which the gift tax was paid, even though the trustee borrowed to pay the gift tax and used trust income to repay the loan. *Estate of Annette S. Morgan* (1962) 37 TC 981, aff'd (6th Cir 1963) 316 F2d 238, cert denied (1963) 375 US 825; *Victor W. Krause* (1971) 56 TC 1242.

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§2.32 b. Donee Must Pay Gift Tax as Condition of Receiving Gift

If the donee is required to pay the gift tax as a condition of receiving the gift, the value of the gift must be reduced by the amount of the tax that the donee must pay. Rev Rul 75-72, 1975-1 Cum Bull 310. Revenue Ruling 75-72 gives the formula for computing the amounts of the gift and the gift tax in this situation. Because the amount of the net gift is determined by complicated interrelated computations, special estate-planning software designed to perform the computations may be helpful. The donee's voluntary payment of the tax, however, without any agreement or obligation to do so, or the donee's payment of the tax because of his or her ultimate liability for it under IRC §6324(b), will not reduce the value of the gift.

To the extent that the donee is required to pay the gift tax as a condition of receiving the gift, the transaction will be a part gift/part sales transaction. That is, it will be a gift with respect to the net gift after deducting the gift tax, and a sale with respect to the gift tax paid by the donee. The donor will recognize gain to the extent that the gift tax paid by the donee exceeds the donor's basis for the transferred asset. *Diedrich v Commissioner* (1982) 457 US 191, 72 L Ed 2d 777, 102 S Ct 2414. The Ninth Circuit Court of Appeals has held that the donor realizes capital gains income in the year in which the donee pays the donor's gift tax liability, rather than in the year in which the transfer occurs. *Estate of Weeden v Commissioner* (9th Cir 1982) 685 F2d 1160.

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§2.33 D. Payment of Consideration in Exchange for Transfer

If the transferor receives full and adequate consideration in money or money's worth, a transfer is not subject to gift tax. IRC §2512(b). Therefore, gift taxes do not apply to a transfer made in the ordinary course of business when the transaction is bona fide, arm's length, and free of donative intent, even if the transfer is a "bad deal". Treas Reg §25.2512-8. For these purposes, consideration that is not reducible to a specific value in money or money's worth (*e.g.,* a promise of marriage) is wholly disregarded. Treas Reg §25.2512-8.

If the consideration received by the transferor does not equal the value of the transferred property, the excess of the transferred property's value over the value of the consideration that the transferor received is a taxable gift. This transfer will also be characterized as part gift/part sale: It is a gift with respect to the value of the transferred property over the consideration paid by the transferee, and it is a sale with respect to the consideration paid by the transferee. As discussed in §2.32, the transferor will recognize capital gain to the extent that the consideration received is greater than the transferor's basis for the property. See Treas Reg §1.1001-1(e).

If the transfer of the property is based on a written settlement agreement incident to a dissolution of marriage, it is considered to be for full and adequate consideration. See IRC §2516; Treas Reg §25.6019-3(b).

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E. Annual Exclusion From Gift Tax

§2.34 1. Number of Donees Unlimited

Not all completed gifts are *taxable* gifts. For example, there is an annual per donee exclusion for transfers of present interests. IRC §2503(b). The amount of the exclusion is $13,000 (plus further cost-of-living adjustments after 2010). The number of donees to whom a donor may make annual-exclusion gifts is unlimited. If the donor is married, the spouse may make identical gifts each year. As a result, if a donor implements a consistent pattern of making annual-exclusion gifts to his or her intended beneficiaries, significant transfer tax savings can be realized by the dramatic reduction of the assets that would remain in the donor's gross estate for federal estate tax purposes at the time of his or her death. Because this reduction is accomplished by making annual-exclusion gifts, no transfer taxes of any kind are incurred. The donor must take care that gifts are received by the end of the calendar year. The relation-back doctrine does not apply to noncharitable gifts. The courts treat a noncharitable gift as complete on the date the check is deposited by the donee if the donor survives until the check is paid by the donor's financial institution. *Rosano v U.S.* (2d Cir 2001) 245 F3d 212. In case the donor becomes incompetent, the power to make gifts should be included in any power of attorney for the donor. Under California law, a power of attorney does not include the power to make gifts unless that power is expressly provided. Prob C §4264. An agent who does not have the power to make gifts under a power of attorney also may not make gifts under the general law of agency based on oral authorization, and any gifts made by the agent may be included in the donor's estate under IRC §2038. *Estate of Huston* (1997) 51 CA4th 1721, 60 CR2d 217; *Estate of Swanson v U.S.* (Fed Cir 2001) 2001-1 USTC ¶60,408, 87 AFTR2d 2345.

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§2.35 2. Present-Interest Requirement

Only transfers of present interests qualify for the annual exclusion. Generally, an immediate income interest qualifies if the trust can produce current income. See Treas Reg §25.2503-3(c), Example (2); Rev Rul 79-47, 1979-1 Cum Bull 312. In such cases, the value of the annual-exclusion gift is the actuarial value of the income interest up to the transferred property's value.

But for the use of *Crummey* withdrawal powers (see §2.36), many transfers to trusts would not provide beneficiaries with present interests in the transferred property, but only future interests. A future interest is an interest that will begin in use, possession, or enjoyment at some future date. Treas Reg §25.2503-3(a). A vested right to property, even a salable interest, does not support the application of the annual exclusion without the full and immediate use, possession, and enjoyment of the property. For example, in *Estate of Stinson* (7th Cir 2000) 214 F3d 846, the donor forgave a portion of the debt on an installment sale of 267 acres of farmland to a corporation owned by the donor's children and grandchildren. The court held that the gift to the corporation was a gift to the individual shareholders, but it did not qualify for the annual gift tax exclusion, because the shareholders could not individually realize the increase in value of the corporation without liquidating the corporation or declaring a dividend. In *Hackl v Commissioner* (7th Cir 2003) 335 F3d 664, the court held that gifts of LLC units were gifts of future interests, because units could not be transferred without the manager's consent and the donors could not prove that there would be a current steady flow of income to the donees. The *Hackl* decision makes clear that the donee's ability to receive some immediate benefit is a key element of obtaining the annual exclusion for gifts of closely held entity interests. For a district court decision based on *Hackl* involving LLC units, see *Fisher v U.S.* (SD Ind 2010) 2010-1 USTC ¶60,588, 105 AFTR2d 1347. See also *Walter M. Price*, TC Memo 2010-2 (gifts of limited partnership interests did not qualify for annual exclusion because donors could not prove there would be steady flow of income to donees). For techniques designed to ensure qualification of gifts for the annual exclusion, see Mensch, *A "Gift" From the IRS: A Guide to the Gift Tax Annual Exclusion*, 33 Est Plan 16 (Dec. 2006).

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3. Trusts in Which Entire Interest Is Present Interest

§2.36 a. *Crummey* Trust Withdrawal Powers

A common strategy for satisfying the present-interest requirement when making transfers to trusts is to provide beneficiaries with an immediate power to withdraw transfers to the trust. Such withdrawal powers are normally referred to as *Crummey* powers, after a court decision that confirmed that such powers provide beneficiaries with the required present interest even when the beneficiaries are minors and cannot exercise the powers without an appointed guardian. *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82 (discussed in detail in chap 11). For a detailed discussion of *Crummey* powers, see §§12.80-12.110.

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§2.36A b. Nonmarital Spousal Trust

A special form of trust that satisfies the present-interest requirement by the use of *Crummey* trust withdrawal powers (see §2.36) may be called a "nonmarital spousal trust" in which a married settlor makes annual exclusion gifts to a trust for the benefit of the settlor's spouse that does not qualify for the IRC §2523 gift tax marital deduction, with the consequence that the trust is not included in either the settlor's estate or in the spouse's estate at death. Because the trust need not satisfy the requirements for the marital deduction, the trust may provide for only a discretionary income interest or may direct accumulation of income. The spouse's interest in the trust also may terminate in the event of dissolution or on remarriage. The gifts to the trust qualify for the IRC §2503(b) annual exclusion (or the special IRC §2523(i) annual exclusion for noncitizen spouses, who are not eligible for the unlimited marital deduction in any event) by granting the spouse a temporary withdrawal right over the property contributed to the trust. Unlike an inter vivos QTIP trust included in the spouse's estate under IRC §2044 (see §2.39), the nonmarital spousal trust is not limited to situations in which one spouse has substantial property and the other spouse has very little property, because gifts to the trust are specifically excluded from gift tax rather than merely deducted from the settlor's gift tax base. Each spouse may create a trust for the other spouse, although the trust terms should materially differ to avoid any argument that the trusts should be disregarded under the reciprocal trust doctrine discussed in §2.37A. Thus, a wealthy settlor can remove an additional $13,000 per year plus cost-of-living adjustments after 2010 ($134,000 in the case of a noncitizen spouse) from the settlor's estate by making annual exclusion gifts for the benefit of the settlor's spouse after making annual exclusion gifts for the benefit of children and grandchildren, their spouses, and every other natural object of the settlor's bounty. The settlor can remove even more property from the settlor's estate with no gift tax consequences by paying trust income taxes if the trust is structured as a grantor trust. See §3.40.

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§2.37 c. IRC §2503(c) Trusts

Under IRC §2503(c), a transfer to a trust for the benefit of a person under age 21 qualifies for the annual exclusion if certain conditions are met. The most significant condition is that the trust terminate when the person reaches age 21. The other conditions and aspects of §2503(c) trusts are discussed in detail in §§12.111-12.121.

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§2.37A 4. Reciprocal Trust Doctrine

In certain cases, the IRS may disallow annual exclusion gifts made by multiple settlors for related beneficiaries. In *Sather v Commissioner* (8th Cir 2001) 251 F3d 1168, the court held that gifts made by each of three brothers to trusts benefiting children of the other brothers were gifts to the trust benefiting each donor's own children for annual exclusion purposes. Accordingly, each donor was entitled to claim only annual exclusions for his gifts to the trust benefiting his own children. The court relied on the reciprocal trust doctrine in *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730. In *Grace,* a husband and wife each established an identical trust for the benefit of the other. The court concluded that each donor should be treated as establishing the trust for his or her own benefit. In *Sather,* the gifts were all made at the same time, the amounts of the gifts were identical to the extent of the annual exclusion, and the gifts were prearranged. The reciprocal trust doctrine, or reciprocal transaction doctrine, also may be applied to outright annual exclusion gifts. *Estate of Schuler v Commissioner* (8th Cir 2002) 282 F3d 575. For further discussion, see §5.12.

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§2.38 F. Exclusion for Direct Payments of Tuition and Medical Expenses

Internal Revenue Code §2503(e) provides an exclusion from gift tax for all payments of tuition made directly to the educational institution and all payments made for medical expenses, including health insurance premiums, made directly to the provider of goods or services. A payment made to the student or patient as reimbursement for tuition or medical care expenses is not covered by the exclusion.

This exclusion may be particularly attractive to clients who want to assist elderly parents with health care needs or to clients who want to contribute toward the education of their college-age grandchildren or grandchildren attending private school. See §4.14.

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G. Deductions Available to Determine Taxable Amount of Transfer

§2.39 1. Unlimited Marital Deduction

Internal Revenue Code §2523 provides an unlimited deduction for interests, other than terminable interests, in property passing from one spouse to the other, if the recipient spouse is a United States citizen. The marital deduction may apply, however, to assets transferred to an inter vivos QTIP trust. IRC §2523(f). See §§2.39A-2.39D. The marital deduction also may apply to a non-QTIP revocable trust with a testamentary general power of appointment for the recipient spouse if the irrevocability of the QTIP trust is unattractive to the donor spouse. See Levy & Harris, *Planning for Estate Equalization in the Face of Jumbo Exclusions*, 37 Est Plan 16 (Feb. 2010). Less useful is a life estate with power of appointment. IRC §2523(e).

PRACTICE TIP: An inter vivos QTIP may be especially useful for making outright taxable gifts to grandchildren in 2010, when the gift tax rate is only 35 percent and the GST tax does not apply. Outright gifts are necessary because it is uncertain whether GST exemption can be applied to trust transfers in 2010. See chap 4. To hedge against the possibility that the GST tax (and the 45-percent gift tax rate) may be retroactively restored, married settlors can make transfers of property to inter vivos QTIPs that will pass outright to remainder beneficiaries if the beneficiary spouse makes a qualified disclaimer with respect to the trust within 9 months after the transfer. See §§2.20, 9.68. The disclaimer is made when it becomes clear that former tax law will not be restored for gifts in 2010. The disclaimer results in a completed gift to the remainder beneficiaries that is not subject to GST tax. If former law is restored or this does not become clear within 9 months, the property remains in trust for the benefit of the spouse unless distributed to the spouse. Because the resulting gifts are subject to gift tax, the reciprocal trust doctrine should not limit transfers made by spouses to trusts for each other with related beneficiaries. See §2.37A.

If the spouse is not a citizen, the standard marital deduction does not apply; a special annual gift tax exclusion of $100,000 (ten times the unadjusted IRC §2503(b) annual gift tax exclusion of $10,000) plus cost-of-living adjustments ($134,000 in 2010) applies instead. IRC §2523(i). See discussion of nonmarital spousal trust in §2.36A. (Congress may not have intended that annual gift tax exclusion inflation adjustments would indirectly increase the IRC §2523(i) limit, but it is reasonable to construe the statute in this manner.)

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§2.39A a. Inter Vivos QTIP Trust

Contributions to this trust qualify for the gift tax marital deduction under the qualified terminable interest property (QTIP) provisions of IRC §2523(f). The trust is primarily used in situations in which one spouse (the donor) has substantial property and the other spouse (the less wealthy spouse) has very little property. Under these circumstances adverse tax consequences could result if the less wealthy spouse were to die first. Assuming the taxable estate of the less wealthy spouse is worth less than the full IRC §2010(c) applicable exclusion amount ($2 million in 2006-2008, and $3.5 million in 2009), there would be a failure to take maximum advantage of the right of the less wealthy spouse to transfer the full applicable exclusion amount free of tax. Similarly, there would be a failure to take full advantage of the IRC §2631 GST tax exemption of the less wealthy spouse. Further, if the less wealthy spouse dies first, relatively little of the aggregate property interests of both spouses will receive a new income tax basis at the time of that death under IRC §1014 or allocation of aggregate basis increase under IRC §1022 in 2010.

Although these problems can be addressed by an outright gift from the donor to the less wealthy spouse (and a transmutation of separate property into community property often would be the best strategy for maximizing the property receiving a new IRC §1014 basis on the death of the less wealthy spouse), an outright gift, whether or not in the form of a conversion of separate property into community property, is not always acceptable to the donor. A QTIP trust enables the donor to control ultimate disposition of the remainder interest included in the taxable estate of the less wealthy spouse. Further, the remainder will not be subject to the claims of the creditors of the less wealthy spouse, a potentially significant consideration, if only because of the risk of a very expensive final illness.

An inter vivos QTIP trust may affect the eligibility of the estates of either or both spouses for various tax benefits that are dependent on a decedent's estate containing certain percentages of various sorts of business property. These include benefits under IRC §2032A (special use valuation), IRC §303 (redemption of stock to pay death tax), and IRC §6166 (installment payment of estate tax). Whether this will be the case depends on the particular requirements of the various statutes, and the possible application of IRC §2035 concerning transfers made within 3 years of death. The funding of an inter vivos QTIP may increase or decrease the available benefits.

To satisfy QTIP requirements and thereby qualify for the marital deduction, the trust must satisfy the same requirements applicable to testamentary QTIPs. See §2.79. The spouse must be entitled to all trust income for life and no one can have the power to appoint any of the trust property to anyone other than the spouse during the spouse's lifetime. IRC §2523(f)(2)-(3), incorporating portions of IRC §2056(b)(7)(B) by reference. The regulations provide that a state law definition of income that incorporates a trustee power to adjust between principal and income will not disqualify the trust if the statute provides a reasonable apportionment between the income and remainder beneficiaries and satisfies the requirements of Treas Reg §1.643(b)-1. Treas Reg §25.2523(e)-1(f)(1). Treasury Regulation §1.643(b)-1 generally approves exercises of adjustment powers for purposes of fulfilling the trustee's duty of impartiality. See §3.12. However, the California adjustment power statute expressly prohibits an adjustment that would diminish the income that would be paid from a trust qualifying for the marital deduction. Prob C §16336(b)(1). The statute further prohibits an adjustment by a trustee who is a beneficiary of the trust. Prob C §16336(b)(7). Thus, if the spouse is the trustee of the QTIP, the spouse also could not use the adjustment power to increase the income that would be paid from the trust.

The regulations further provide that a trust distribution provision consistent with a state law definition of income as a unitrust amount will not disqualify the trust if the unitrust amount is no less than 3 percent and no more than 5 percent, as provided by Prob C §16328. Treas Reg §1.643(b)-1. The trust can be drafted as a unitrust or the trustee can convert a traditional income trust to a unitrust (even if a beneficiary is the trustee) under Prob C §16336.4. The trustee can convert the trust to a unitrust with a payout percentage of 4 percent without court approval if no beneficiary objects after a 45-day notice period, provided that the trust meets the requirements for exercise of the adjustment power under Prob C §16336(a). Conversion to a unitrust with a greater or lesser percentage requires the written consent of all beneficiaries or court approval under Prob C §16336.5. In *Matter of Heller* (2006) 816 NYS2d 403, 849 NE2d 262, the court upheld the conversion of a net income trust to a unitrust with a payout percentage of 4 percent that reduced the

average income paid to the spouse from $190,000 to $70,000. Trusts converted to unitrusts can be converted back to a traditional income trust under Prob C §16336.6. The statute does not authorize converting a drafted unitrust into a net income trust (Prob C §16336.4(h)(1) prohibits conversions that would change an existing unitrust or annuity amount), but a conversion of a unitrust to a net income trust could be authorized by the trust document.

EXAMPLE: Settlor has $5 million in separate property, including the family home in Hawaii and an apartment in Japan with a fair market value of $1 million. The apartment is used exclusively by noncitizen Spouse. Settlor creates an inter vivos QTIP with a 3-percent unitrust interest for Spouse with the remainder going to Settlor's children. Settlor transfers the apartment and $1 million in other assets to the trust. The trust gives Spouse the exclusive right to possession and control of the apartment, and the trustee will pay Spouse $30,000 per year based on the value of the other assets.

Under Prob C §16336.4(e)(4), the trustee is not required to value residential property or tangible personal property that one or more beneficiaries have the right to occupy, or to possess or control, other than in the capacity of trustee. This avoids the need to have the beneficiaries pay fair market rent to the trustee, who would then pay a unitrust amount to the beneficiaries based on the fair market value of the property. The form provision in §2.39C incorporates this exception.

CAUTION: In a converted unitrust, the spouse presumably retains the income interest provided by the converted trust in the residential property excluded from the unitrust calculation. While the form provision in §2.39C is intended to give the spouse an equivalent interest in the residential property, cautious practitioners may wish to use a separate QTIP trust with a traditional income interest for residential property until there is further guidance from the IRS.

A unique feature of inter vivos QTIPs is that the beneficiary spouse is generally treated as the owner and subsequent transferor of the trust property for transfer tax purposes. As a result, the transferor can retain interests and powers that would otherwise have adverse estate tax consequences. IRC §2523(f)(5). For example, the trust can provide for making distributions to the original donor following the death of the less wealthy spouse without this causing the trust to be included in the estate of the donor under IRC §§2036, 2038. Treas Reg §25.2523(f)-1(f), Example (11). If desired, the trust can provide for distributions of principal to the less wealthy spouse during the spouse's lifetime. If the less wealthy spouse is the trustee or will hold the invasion power personally, it is recommended that the power be limited by an ascertainable standard related to health, education, support, or maintenance so that the less wealthy spouse will not have a general power of appointment under IRC §§2041, 2514. Although the trust property will be included in the estate of the less wealthy spouse in any event, the favorable tax features described in Treas Reg §25.2523(f)-1(f), Example (11) are expressly available for QTIP trusts only and not for general power of appointment trusts. Further, a general power may result in loss of creditor protection. If the donor spouse is the trustee, it is similarly recommended that the principal invasion power to be limited by an ascertainable standard or given to a third party special trustee during the donor's lifetime. Although this should be unnecessary under the general rationale of Treas Reg §25.2523(f)-1(f), Example (11), the regulation does not expressly address the point and there is little reason to risk a dispute on the point.

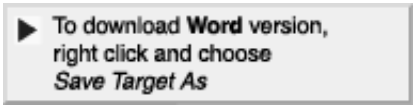
For income tax purposes, an inter vivos QTIP trust is a grantor trust deemed owned by, and taxed to, the donor during the joint lifetimes of the donor and the less wealthy spouse. IRC §§671, 677(a).

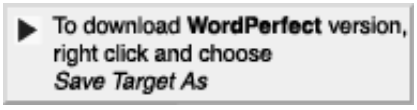
One interesting strategy involving the use of an inter vivos QTIP provides that on the death of the less wealthy spouse all trust income will be paid to the original donor for the life of the donor. This qualifies the trust for a marital deduction on the death of the less wealthy spouse. If the trust corpus has increased in value to the point that the estate of the less wealthy spouse would otherwise be subject to estate tax, the executor can then make a partial QTIP election for whatever amount of the trust property must qualify for the marital deduction so as to eliminate the tax. See IRS Letter Ruling 9731009.

The form provisions in §2.39B are intended for use by a donor spouse wishing to create such an inter vivos QTIP trust. For complete form, see App I. For an alternative form providing for payment of a unitrust amount in satisfaction of the right to income, see §2.39C.

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§2.39B b. Form: Inter Vivos QTIP Trust





2.39B-1 Mandatory distribution of income and discretionary distribution of principal

A. *Mandatory Distribution of Income and Discretionary Distribution of Principal*. During the lifetime of the primary beneficiary, the trustee shall pay to or apply for the benefit of the primary beneficiary all of the net income of this trust in quarter-annual or more frequent installments payable at the end of the period. If the income is insufficient, the trustee shall pay to or apply for the benefit of the primary beneficiary, at quarter-annual or more frequent intervals, as much of the principal of the QTIP trust as the trustee in its discretion determines is appropriate for the primary beneficiary's health, education, and support. In exercising its discretion the trustee may take into account other income and resources available to the primary beneficiary to such extent, if any, as the trustee deems appropriate. Income earned between the last distribution date and the date of the primary beneficiary's death shall be distributed to the persons entitled to distribution of income earned immediately following the primary beneficiary's death. The primary beneficiary, including any attorney-in-fact or Conservator authorized to act on behalf of the primary beneficiary, may compel the trustee to invest the trust estate in income-producing assets.

2.39B-2 Distribution of remainder

B. *Distribution of Remainder*. On the death of the primary beneficiary the remaining trust estate shall be distributed as follows: _ _[*e.g., to the then-living issue of the donor, per stirpes*]_ _

Comment: Form 2.39B-1 is intended to satisfy the IRC §2523(f) requirements for a QTIP trust. For an alternative form providing for payment of a unitrust amount in satisfaction of the right to income, see form 2.39C-1. For further discussion, see Drafting California Revocable Trusts, chap 13 (4th ed Cal CEB 2003).

The provisions of form 2.39B-2 for distribution of the trust following the death of the primary beneficiary can be modified to provide for establishing a second QTIP trust for the benefit of the original donor. See §2.39A. If this is desired, the original donor must be entitled to all trust income from the time of the death of the less wealthy spouse until the donor's death and no person can have a power to appoint the trust assets to anyone other than the donor during that period. IRC §2523(f).

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§2.39C c. Form: Inter Vivos Unitrust QTIP Trust

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

2.39C-1 Mandatory distribution of unitrust amount and discretionary distribution of principal

A. *Mandatory Distribution of Income and Discretionary Distribution of Principal*. During the lifetime of the primary beneficiary, the trustee shall pay to or apply for the benefit of the primary beneficiary in quarter-annual or more frequent installments payable at the end of the period a unitrust amount equal to _ _[*number not less than 3 and not greater than 5*]_ _ percent of the net fair market value of the trust assets, valued annually on the first day of the trust's taxable year for federal income tax purposes. This valuation shall be made in such reasonable manner as the trustee shall, in the trustee's discretion, determine. The primary beneficiary shall have the exclusive and unrestricted right to possession and control of any residential property or tangible personal property of the trust and the trustee shall not pay the unitrust amount with respect to any such property of the trust. If the unitrust amount is insufficient, the trustee shall pay to or apply for the benefit of the primary beneficiary, at annual or more frequent intervals, as much of the principal of the QTIP trust as the trustee in its discretion determines is appropriate for the primary beneficiary's health, education, and support. In exercising its discretion the trustee may take into account other income and resources available to the primary beneficiary to such extent, if any, as the trustee deems appropriate. In a taxable year of the trust that is less than 12 months and in the year of the death of the primary beneficiary, the amount to be paid by the trust shall be a fraction of _ _[*number not less than 3 and not greater than 5*]_ _ percent. The numerator of that fraction shall be the number of days in the trust's first taxable year or the number of days in the trust's year preceding the day on which the primary beneficiary died, and the denominator shall be 365. The unitrust amount for the period between the last distribution date and the date of the primary beneficiary's death shall be distributed to the persons entitled to distribution of income earned immediately following the primary beneficiary's death. This provision is intended to satisfy the right of the primary beneficiary to a qualifying income interest for life under Treasury Regulation §25.2523(f)-1(c)(1).

2.39C-2 Distribution of remainder

B. *Distribution of Remainder*. On the death of the primary beneficiary the remaining trust estate shall be distributed as follows: _ _[*e.g., to the then-living issue of the donor, per stirpes*]_ _

Comment: Form 2.39C-1 is intended to satisfy the IRC §2523(f) requirements for a QTIP trust as modified by Treas Reg §25.2523(f)-1(c)(1), which incorporates the definition of "qualifying income interest for life" in Treas Reg §20.2056(b)-7(d)(1), which further incorporates the definition of "income" in Treas Reg §1.643(b)-1. Under that definition, payment of a unitrust amount of no less than 3 percent and no more than 5 percent in satisfaction of a right to income will be respected if consistent with state law. California law provides an alternative unitrust definition of trust income. Prob C §16328.

Note that the value of residential property in the trust is disregarded in determining the unitrust amount. This provision is intended to track the language of Prob C §16336.4(e)(4). See §2.39A.

On form 2.39C-2, see comment to form 2.39B-2.

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§2.39D d. Estate and Gift Taxation of QTIP Trust

The value of an inter vivos QTIP trust is included in the estate of the donee spouse under IRC §2044 unless the spouse makes a lifetime gift of the income interest in the trust resulting in a taxable gift of the remainder interest under IRC §2519 and the income interest under IRC §2511. Under Treas Reg 25.2519-1(c)(1), the amount treated as a transfer under IRC §2519 on a disposition of all or part of the income interest is equal to the fair market value of the entire trust less the value of the income interest. Under Treas Reg §25.2519-1(c)(4), the amount treated as a transfer under IRC §2519 is further reduced by the amount of gift tax the spouse is entitled to recover under IRC §2207A(b). The gift tax consequences of the disposition of the income interest are determined separately under Treas Reg §25.2511-2. In IRS Letter Ruling 200801009, the IRS ruled that a nonqualified disclaimer of the income interest in a QTIP trust constituted a completed net gift of the remainder interest in the trust. Note that any gift tax paid on an IRC §2519 deemed gift of a QTIP remainder interest will be included in the surviving spouse's estate if death occurs within 3 years of the gift. *Estate of Anne W. Morgens* (2009) 133 TC No. 17.

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2. Charitable Deduction

§2.40 a. In General

The gift tax charitable deduction, unlike the income tax charitable deduction, is unlimited in amount and applies to lifetime transfers to qualifying charitable recipients for public, charitable, religious, educational, or other similar purposes. IRC §§170(b), 2522. The amount qualifying for the deduction equals the fair market value of the transferred asset, as of the date of transfer. Methods for determining the fair market value of an asset are discussed in §§2.20-2.24.

A charitable gift tax deduction usually is unavailable for transfers in which the donor retains an interest. Exceptions exist, however, for charitable lead trusts and charitable remainder trusts. Charitable remainder trusts are discussed in chap 18. Charitable lead trusts are discussed in chap 18A.

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§2.41 b. Combining Unlimited Marital Deduction With Charitable Remainder Trusts

When a donor makes a transfer to a charitable remainder trust (CRT), and the donor's spouse is the only noncharitable beneficiary (other than the donor), the transfer qualifies for both the marital and the charitable deductions (IRC §§2522(c)(2)(A), 2523(g)), and the donor qualifies for an income tax charitable deduction. If, instead, a qualified terminable interest property (QTIP) trust is combined with a remainder interest passing to a qualified charity, the trust still qualifies for the unlimited marital deduction with respect to the spouse's life interest. IRC §2523(f). At the spouse's later death, the property in the QTIP trust will qualify for the estate tax charitable deduction under IRC §2055. Because structuring the gift as a QTIP trust with a charitable remainder does not satisfy the requirements of IRC §170 (which resemble the requirements of IRC §2522), the donor obtains no income tax charitable deduction. The donor may, however, structure the gift in this manner to provide greater benefits and greater flexibility to the spouse (*i.e.*, the ability to receive principal for need). See §2.42. For discussion of QTIP trusts, see §2.79.

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§2.42 c. Charitable Gifts of Remainder Interests Not in Trust

Generally, no gift tax charitable deduction is allowed for gifts of remainder interests that are not provided by a CRT or a charitable pooled-income fund. IRC §2522(c). There are two exceptions to this rule:

- An irrevocable transfer of a remainder interest in a personal residence qualifies for the gift tax charitable deduction in an amount equal to the actuarial value of the remainder interest passing to the charity, determined by using the IRC §7520 valuation tables. Treas Reg §25.2522(c)-3(c)(2)(ii). For this purpose, a personal residence is any property used by the donor as his or her personal residence, even though not used as the principal residence. But see *Ellis First Nat'l Bank v U.S.* (Cl Ct 1977) 550 F2d 9 (exception not applicable if residence held in trust). For gift tax purposes, depreciation of the residence during the life estate or term of years need not be taken into account in valuing the remainder interest passing to charity. Treas Reg §25.2522(c)-3(d)(2). The life estate or term interest may be retained by the donor or given to a third person.
- An irrevocable transfer of a remainder interest in a farm qualifies for a charitable deduction. A farm is any land used by a donor to produce crops, fruits, or other agricultural products or to sustain livestock. Treas Reg §25.2522(c)-3(c)(2)(iii). For gift tax purposes, depreciation of the farm during the life estate or term of years need not be factored in when valuing the remainder interest passing to the charity. Treas Reg §25.2522(c)-3(d)(1). Again, the life estate or term interest may be retained by the donor or given to a third person.

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§2.43 H. Split-Gift Election

If one spouse makes a gift of separate property, the nondonor spouse may elect to split the gift with the donor spouse so that each spouse will be deemed to have made half the gift. IRC §2513. The split-gift election does not make the nondonor spouse a transferor of the property for purposes of possible inclusion in the nondonor spouse's estate under IRC §§2036-2038. IRS Letter Ruling 200130030. Making a split-gift election permits two IRC §2503(b) annual exclusions to apply for each gift. Such an election may offer more effective use of the unified credit of the nondonor consenting spouse if that spouse has relatively little wealth.

When the donor spouse makes a gift to a trust and the nondonor spouse is a beneficiary of the trust, the transfer qualifies for split-gift treatment only if the interest transferred to third parties is ascertainable and severable from the interest transferred to the spouse. If the portion of the transfer allocable to the nondonor spouse cannot be ascertained, none of the transfer qualifies for gift splitting. Treas Reg §25.2513-1(b)(4). See *Stanley L. Wang*, TC Memo 1972-143 (third party interest in trust providing for mandatory distributions of income and discretionary distributions of principal to nondonor spouse was not ascertainable). In IRS Letter Rulings 200616022 and 200422051, the IRS concluded that trust transfers subject to third party *Crummey* withdrawal powers (see §2.36) were eligible for gift splitting to the extent that they exceeded the actuarial value of the nondonor spouse's interest in the trust. However, the IRS did not follow a long line of letter rulings taking the position that the entire transfer is automatically eligible for gift splitting. See Swindle, *Obtaining Split-Gift Treatment for Transfers to Trusts*, 34 Est Plan 25 (Jan. 2008).

For split-gift treatment to be available, both spouses must be citizens or residents of the United States and must consent to the gift-splitting treatment. The nondonor spouse consents to the split gift by signing the appropriate line on the donor's gift tax return (Form 709 or 709A). If both spouses file gift tax returns within the time for signifying consent, one of the following is sufficient (Treas Reg §25.2513-2(a)(1)):

- The consent of the husband is signified on the wife's return, and the consent of the wife is signified on the husband's return;
- The consent of each spouse is signified on his or her own return; or
- The consent of both spouses is signified on one of the returns.

If only one spouse files a gift tax return within the time provided for signifying consent, the consent of both spouses must be signified on that return. Nevertheless, whenever possible, the notice of consent should be shown on both returns, as described in the first option, above.

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§2.44 I. Considerations in Making Gifts

In determining whether to recommend the implementation of a gift-giving program, the attorney must consider a number of factors. These may include:

- The circumstances and objectives of the family;
- The age and state of health of the clients;
- The income and gift estate tax brackets of the clients and the prospective donees;
- The nature of the clients' assets;
- The effect of a gift on the income tax basis of the property;
- The impact of gifts on "percentage of the estate"-sensitive benefits (see §2.45);
- Liquidity problems at the death of each client; and
- The effect on other taxes, such as property or realty transfer taxes.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.45 1. Advantages of Gifts

§2.45 1. Advantages of Gifts

Among the advantages of making lifetime gifts are:

- Reducing assets subject to transfer taxation through a consistent annual exclusion giving program;
- Paying a tax-exclusive gift tax rather than a tax-inclusive estate tax;
- Excluding from the transfer-tax base future appreciation in the transferred asset's value and all income generated by the asset after the date of transfer;
- Making gifts of appreciated property to elderly family members with few assets to obtain a new income tax basis in the donated property on death, subject to restrictions on step-up in basis or allocation of aggregate basis increase for property acquired by gift (IRC §§1014(e), 1022(d)(1)(C));
- Shifting taxable income from higher bracket taxpayers to lower bracket taxpayers, subject to the "kiddie" tax limitations (see §§3.21-3.22); and
- Planning for the use of tax-advantage provisions, such as IRC §303 redemptions, special-use valuation (IRC §2032A), and payment of estate tax in installments (IRC §6166).

CAVEAT: Gifts often are disregarded or treated adversely under IRC §2035(c) in determining whether an estate qualifies for these tax advantage provisions. See §§2.46, 2.72, 2.89, and 2.91 for discussions of the conditions that must be satisfied for the tax-advantage provisions to apply at the donor's death.

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§2.46 2. Disadvantages of Gifts

Disadvantages of making lifetime gifts include:

- *Loss of control and income.* The benefits resulting from lifetime gifts that reduce or eliminate transfer taxes payable may not offer sufficient incentive for a client to relinquish control and use of property and the income from it during his or her lifetime.
- *Loss of basis step-up.* When a client gives property that has appreciated in value, the donee generally must use the same tax basis as the donor to determine gain from a disposition of the property. The donee's basis in the transferred asset, however, will be increased by that portion of any gift tax payable by the donor attributable to the appreciation in the transferred property's value. IRC §1015(d). Alternatively, if the client retains the appreciated property until his or her death, the client's devisees or beneficiaries will have a basis in the property equal to its federal estate tax value in the client's estate. IRC §1014(a); Treas Reg §1.1014-3(a). In addition, at the death of the first spouse to die, community property assets receive a new basis equal to their date-of-death value on the first spouse's death (*i.e.*, a full step-up for the one-half community property interest belonging to the deceased spouse and a full step-up for the one-half community property interest belonging to the surviving spouse). IRC §1014(b)(6). For decedents dying in 2010, the step-up in basis to estate tax value is replaced by the IRC §1022 provision for allocation of $1.3 million in basis increase among the decedent's assets and an additional $3 million in basis increase for assets passing to a surviving spouse, which may be allocated to both halves of community property at the death of the first spouse to die. Under this provision, the loss of basis step-up on gifts continues to be a disadvantage for clients who have insufficient assets to fully utilize the basis increase. The disadvantage does not apply to more wealthy clients who will exhaust the basis increase in any event.
- *Requirement that gift tax be paid immediately.* If the $1-million IRC §2505(a) gift tax applicable exclusion amount has been exhausted, any gift tax due is payable by April 15 of the year after the year in which the gift is made. The estate tax, however, is payable within nine months after the donor's death (or perhaps over a 10-year (or 5-year) period beginning 5 years after the donor's death (or in some cases a 5-year period beginning on the due date of the estate tax return without regard to extensions) if IRC §6166 applies to some or all of the estate tax due). Thus, the estate tax savings to be realized from removing accumulated income and post-gift appreciation from the donor's estate should be discounted to reflect the current value of the savings as compared with the current cost of any gift tax payable.
- *Decrease in liquidity.* Gifts made during the client's lifetime may leave the client without sufficient liquid assets to pay for the client's support and health needs, estate taxes, or other debts, taxes, and expenses.
- *Possible loss of special-use valuation and installment payment of tax.* Gifts of real property used in the operation of a farm or closely held business can prevent qualification for special-use valuation, which is available only at death, and can cause the loss of the deferred payment of estate tax on those business or farm interests. See §§2.72, 2.89, 2.91. Note, however, that the property that is the subject of a gift during the 3 years preceding the decedent's death is considered when determining if the estate qualifies for special-use valuation and installment payment of estate tax. IRC §2035(c).
- *Possible loss of opportunity to redeem closely held stock to pay estate tax.* Transfers of closely held business interests may eliminate the estate's ability to qualify for a stock redemption under IRC §303, but gifts of other assets may assist the estate in qualifying for that benefit. The attorney should exercise caution in advising clients to make gifts of certain assets, because gifts made within 3 years of death are included in the taxable estate for purposes of determining whether the estate is eligible to make such redemptions. IRC §2035(c)(1)(A).

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§2.46A 3. Adequate Disclosure of Gifts

Transfers of property that may involve taxable gifts must be adequately disclosed to the IRS to avoid possible revaluation and assessment of additional tax at a later date. Generally, any gift tax must be assessed within 3 years after the gift tax return was filed. IRC §6501(a). The statute of limitations never begins to run, however, if the gift is not adequately disclosed on a gift tax return or an attachment to a return. IRC §6501(c)(9). Gifts that are adequately disclosed cannot be revalued for estate tax purposes after the expiration of the time for assessing gift tax, even if the value of the gift as shown on the return does not result in any gift tax being owed. IRC §2001(f). Gifts made in a preceding calendar period that were adequately disclosed also cannot be revalued for gift tax purposes in a later period after the expiration of the time for assessing gift tax for the preceding period, regardless of whether gift tax was assessed or paid for the preceding period. IRC §2504(c).

The IRS has issued regulations providing a list of information that taxpayers must report, if applicable, on their gift tax returns. Treas Reg §301.6501(c)-1(f). The regulations make it clear that if there is adequate disclosure, with the result that the assessment period runs and the value of the transferred property can no longer be disputed, the IRS is bound with respect to "adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of gift tax law." Treas Reg §20.2001-1(b). Thus, the IRS loses the ability to challenge annual exclusion claims (*e.g.*, challenge the validity of a trust's *Crummey* clauses) and deduction claims (*e.g.*, marital and charitable deductions). The IRS also loses the ability to raise claims involving later inclusion of the transferred property in the estate (*e.g.*, a claim that a transfer was revocable because the holder of a durable power of attorney did not have the power to make the gift). If the IRS challenges the reported value of the gift, the donor may be able to obtain a declaratory judgment for gift valuation from the Tax Court if the donor has exhausted all administrative remedies within the IRS. This requires that the donor request consideration by Appeals and "participates fully" in the Appeals consideration process, including submitting all information requested by the IRS. IRC §7477; Treas Reg §301.7477-1(d)(4).

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III. TAX CONSEQUENCES OF TRANSFERS OCCURRING AS RESULT OF DEATH

§2.47 A. Determining Decedent's Gross Estate for Federal Estate Tax Purposes

A decedent's gross estate usually includes the value of all property in which the decedent had a beneficial interest at the time of death. See IRC §2033. Thus, the gross estate does not include property to which the decedent holds only bare legal title, such as property held in the capacity of guardian or trustee. Furthermore, if the decedent has an interest in property that terminates at his or her death, the interest is not included in the decedent's gross estate for federal estate tax purposes. This property may be included in the decedent's gross estate, however, if certain special circumstances exist. See IRC §§2035-2042, discussed in §§2.48-2.67.

Less than an entire interest in property may be included in the decedent's gross estate; for example:

- If the estate includes an undivided interest in the entire property, such as an interest in a tenancy in common, only the undivided interest held by the decedent will be included. See *Pacific Nat'l Bank* (1939) 40 BTA 128, acq 1939-2 Cum Bull 28.
- If income accrued through the date of death is required to be paid but has not actually been paid ("stub income"), the decedent's estate may also include an income interest held by the decedent before his or her death.
- If the interest continues beyond the death of the decedent, and the decedent had the power to direct who receives the income after his or her death (*i.e.,* term-of-years income interests and estates per autre vie), the estate may include an income interest.
- In an estate involving a remainder interest in a trust or other transfer in which the decedent was not the transferor, the decedent's estate may include the actuarial value of the remainder interest or other transfer. See §2.82, discussing deferral of estate tax attributable to such a remainder interest.
- In an estate involving income items that, although not actually paid to the decedent before death, had been substantially earned by the decedent (*i.e.,* income in respect of a decedent, or IRD, discussed in §3.9), those income items may be included in the decedent's gross estate.

Federal estate tax treatment of life insurance on the decedent's life is governed by IRC §2042, but any life insurance owned by the decedent insuring the life of someone else is included in the decedent's gross estate under IRC §2033. The value of such insurance for purposes of determining the decedent's gross estate is the interpolated terminal reserve value of the policy (*i.e.,* the cash surrender value plus unearned premiums on whole life that is not paid up, or the unearned premium on term insurance, or, for a paid-up policy, the cost of a comparable policy), determined as of the date of the decedent's death. Form 712, provided by the insurance company, establishes the value of a policy for transfer tax purposes.

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§2.48 B. Transfers in Which Decedent Retains Enjoyment or Control of Property

Even though a decedent may have transferred property during his or her lifetime that is not includable in his or her estate under IRC §2033, this property may still be included in the decedent's estate when the decedent either retained the right to use or enjoy it or the right to alter or control the manner in which someone else used or enjoyed it. IRC §§2036-2038. Thus, estate tax is imposed on property transferred by the decedent when he or she retained the economic benefit of the property, including the right to vote stock. IRC §2036(a)(1), (b).

Estate tax also is imposed on property transferred by the decedent during his or her lifetime when the transfer is essentially a testamentary transfer. A testamentary transfer means that absolute possession or enjoyment of the property by the transferee must await the grantor's death. IRC §§2036(a)(1), 2037-2038. Finally, estate tax is imposed on property transferred by the decedent when he or she has reserved significant powers over the possession or enjoyment of the property until death. IRC §§2036(a)(2), 2038.

Assets transferred to a family limited partnership (FLP) may be included in the donor's estate under IRC §2036(a)(1) (or §2036(a)(2)) if evidence establishes an implied agreement that the donor would continue to enjoy the assets. Such an implied agreement may be established if, for example, the donor receives disproportionate distributions of partnership income. See *Estate of Thompson v Commissioner* (3d Cir 2004) 382 F3d 367; *Estate of Morton B. Harper*, TC Memo 2002-121. These courts held that there was not adequate and full consideration for the transfers (see §2.68) because there was a mere "recycling" of value through the FLPs. See also *Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (no clear error in Tax Court determination that implied agreement existed); *Estate of Dorothy Morganson Schauerhamer*, TC Memo 1997-242. In *Kimbell v U.S.* (5th Cir 2004) 371 F3d 257, however, the court held that the transferred property was protected from inclusion under the "bona fide sale for adequate and full consideration" exception in IRC §2036(a). The *Kimbell* court held that a sale is bona fide if, as an objective matter, it serves a "substantial business [or] other non-tax" purpose. 371 F3d at 267. Applying the *Kimbell* decision, the Fifth Circuit in *Strangi* held that the Tax Court did not clearly err in finding that the transfer of assets in *Strangi* lacked a substantial non-business purpose. In *Estate of Wayne C. Bongard* (2005) 124 TC 95, a majority of the Tax Court held in a reviewed decision that the bona fide sale for adequate and full consideration exception is met only if (1) there is a "legitimate and significant nontax reason" for creating the partnership, and (2) the transferors receive partnership interests proportionate to the value of the property transferred. In *Estate of Anna Mirowski*, TC Memo 2008-74, the court rejected a suggestion that the activities of a limited liability company (LLC) had to rise to the level of a "business" for the bona fide sale exception to apply. The *Mirowski* decision implies that an investment purpose may be a significant nontax purpose. However, the decision may conflict with the Ninth Circuit decision in *Estate of Bigelow v Commissioner* (9th Cir 2007) 503 F3d 955, 972, in which the court rejected the argument that the bona fide sale exception applied to the transfer of real property interests to an FLP because the FLP facilitated management of the property. In *Estate of Lillie Rosen*, TC Memo 2006-115, the court held that there was no legitimate and significant nontax reason for an FLP funded with cash and securities. The opinion declared that creditor protection was only a theoretical justification. The decedent transferred substantially all of her assets to the FLP, which then made "loans" back to the decedent and her estate for payment of living expenses, making gifts, and paying taxes. The court held that there was an implied agreement that the decedent could use the transferred assets when she needed them. For further discussion of these court decisions, see California Estate Planning §18.37 (Cal CEB 2002); *Estate of Anna Mirowski: Estate Wins the Latest Round in the FLP/IRC §2036 Drama*, 29 CEB Est Plan Rep 128 (Apr. 2008); *Strangi II: Fifth Circuit Resists Bright Line Tests of IRC §2036 Challenges to FLPs*, 27 CEB Est Plan Rep 5 (Aug. 2005); *Estate of Bongard: The Tax Court Searches for an IRC §2036 Test for Business Entities*, 26 CEB Est Plan Rep 130 (Apr. 2005); *Estate of Thompson: Third Circuit Hands IRS Major Victory in Passive-Asset FLP Case*, 26 CEB Est Plan Rep 37 (Oct. 2004); *FLPs and IRC §2036 After Kimbell*, 25 CEB Est Plan Rep 148 (June 2004). See also Fox, *FLPs and FLLCs: Are They Still Viable Estate Planning Tools?*, 32 Est Plan 3 (Feb. 2005).

In *Estate of Ida Abraham,* TC Memo 2004-39, aff'd (1st Cir 2005) 408 F3d 26, the court held that transferred FLP interests were included in the decedent's estate under IRC §2036 because the decedent had the right to have all

partnership income used for her support. In *Estate of Lea K. Hillgren,* TC Memo 2004-46, the court held that transferred FLP interests in a partnership formed shortly before death were included in the decedent's estate because decedent did not retain sufficient other assets to support herself. In *Estate of Concetta H. Rector*, TC Memo 2007-367, the court held that FLP assets were included in the decedent's estate because actual use of the transferred assets supported a finding that there was an implied agreement that the assets remained available for her use.

In *Estate of Hilde E. Erickson*, TC Memo 2007-107, the court held that the use of partnership funds to pay estate taxes was evidence of an implied agreement that the decedent retained enjoyment of property transferred to an FLP. In *Estate of Bigelow v Commissioner* (9th Cir 2007) 503 F3d 955, the court held that the transferor's inability to pay her own expenses following the transfer of assets to an FLP 2 years after she suffered a stroke and moved to an assisted-living facility evidenced an implied agreement that she would continue to enjoy the transferred property. See also *Estate of Korby v Commissioner* (8th Cir 2006) 471 F3d 848 (despite fact that wife was already suffering from dementia and living in nursing home when husband and wife transferred assets to FLP, they did not retain enough other assets to cover expected medical expenses); *Estate of Roger D. Malkin*, TC Memo 2009-212 (pledges of FLP assets to secure decedent's debts evidenced an implied agreement that decedent would continue to enjoy benefits of transferred assets); *Estate of Erma V. Jorgensen,* TC Memo 2009-66 (decedent retained sufficient assets to pay regular expenses but lacked sufficient assets to make desired gifts and used partnership assets for those purposes); *Estate of Thelma G. Hurford,* TC Memo 2008-278 (assets transferred to FLP in exchange for private annuity were returned to settlor to pay annuity payments). But see *Estate of Anna Mirowski*, TC Memo 2008-74 (transferred assets not included in decedent's estate even though decedent did not retain sufficient liquid assets to pay gift tax because decedent retained the ability to borrow against her interest in the entity).

In *Estate of Charles Porter Schutt,* TC Memo 2005-126, however, the court held that the decedent's desire to influence the future investment decisions of trusts established by deceased family members provided a sufficient nontax motive for creating business trusts holding single issues of publicly traded stock. See also *Estate of Valeria M. Miller*, TC Memo 2009-119 (marketable securities transferred to FLP shortly before death were included in decedent's estate because assets were needed to pay decedent's estate taxes, but securities transferred to FLP a year before death were not included because purpose of transfer was to obtain active management of securities using specific investment strategy). In *Estate of Samuel P. Black* (2009) 133 TC No. 15, the court held that an objective of preserving the swing vote potential of a block of stock, together with other considerations, provided sufficient nontax reasons for formation of an FLP. See also *Estate of Murphy v U.S.* (WD Ark 2009) 2009-2 USTC ¶60,583, 104 AFTR2d 7703 (significant nontax reasons included preservation of voting power that enabled the family to elect members of the boards of directors of various corporations engaged in oil, banking, and timber businesses); *Estate of Charlene B. Schurtz*, TC Memo 2010-21 (nontax reasons for FLP included protection from risks associated with litigious environment decedent believed to exist and centralization of management for decedent's timber interests).

In *Estate of Eugene E. Stone,* TC Memo 2003-309, the court held that assets transferred to an FLP shortly before death were not includable in the decedent's estate under IRC §2036. On the facts of the particular case, involving the settlement of long-standing disputes within the family, there was no "mere recycling of value." For further discussion of the Tax Court decision in *Stone*, see Bogdanski, *Section 2036 and Family Limited Partnerships: How Much is Etched in* Stone*?*, 31 Est Plan 92 (Feb. 2004).

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§2.49 1. Retained Life Estate

When the decedent has retained or reserved an interest in transferred property for life, for any period not ascertainable without reference to his or her death, or for any period that does not in fact end before his or her death, the property will be included in the decedent's gross estate. IRC §2036(a)(1). Property transferred by a decedent during his or her lifetime (whether in trust or otherwise) that is includable in the decedent's gross estate when he or she retained or reserved the use, possession, right to income, or other enjoyment of the property is valued at its full value on the decedent's date of death.

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§2.50 a. Direct or Implied Right to Use or Occupy Real Property

A transfer of real property, coupled with the reservation of a right to occupy the property, may cause the property to be included in the decedent's estate under IRC §2036(a)(1). The reservation can be either expressed or implied. The mere fact of continued occupancy can show an implied understanding between the grantor and the legal owner of the residence that the grantor had reserved the right to continue to live in the residence for life. See Rev Rul 78-409, 1978-2 Cum Bull 234. The grantor's continued exclusive possession of the residence and withholding of possession from the donee during the remainder of the grantor's lifetime are factors that may result in a finding that such an agreement exists between the donee and the grantor. See *Guynn v U.S.* (4th Cir 1971) 437 F2d 1148; *Estate of Charles E. Reichardt* (2000) 114 TC 144; *Estate of Florence Honigman* (1976) 66 TC 1080. In *Estate of Lorraine C. Disbrow*, TC Memo 2006-34, the court held that the value of a residence transferred to a family limited partnership was included in the decedent's estate. The decedent remained in possession of the residence after it was transferred and paid rent that was less than fair market rent. In *Ina F. Knight* (2000) 115 TC 506, the court respected the existence of a family limited partnership that included two residences and an interest in a ranch despite continued rent-free use of the ranch by the donor of the limited partnership interests and continued rent-free use of the residences by the donor's children, who were beneficiaries of irrevocable trusts that were donees of the limited partnership interests. However, *Knight* did not address the possible application of IRC §2036(a)(1).

The IRS may find that the decedent retained enjoyment of the property when the retained interest was the right to receive rental income from the transferred property for life, even when the decedent had no legally enforceable right to the income. *Estate of McNichol v Commissioner* (3d Cir 1959) 265 F2d 667, cert denied (1959) 361 US 829, 4 L Ed 2d 71, 80 S Ct 78.

In addition, transferred property may be included in the decedent's gross estate when he or she has retained a leasehold interest in the transferred real property incident to the transfer, and the leasehold interest amounts to retention by the decedent of the enjoyment of the transferred property. See *Estate of William du Pont, Jr.* (1975) 63 TC 746. But see *Estate of Roy D. Barlow* (1971) 55 TC 666, acq 1972-2 Cum Bull 1 (when grantor and spouse gave farm to children and simultaneously rented it from children for fair market rate, farm not included in grantor's gross estate). See also *Estate of Timothy J. Tehan,* TC Memo 2005-128 (decedent's estate included residence gifted to children; agreement to pay all assessments, taxes, insurance premiums, and maintenance and repair expenses in exchange for exclusive possession did not require payment of fair market rent); *Estate of Lydia G. Maxwell* (1992) 98 TC 594, aff'd (2d Cir 1993) 3 F3d 591; IRS Letter Ruling 9146002 (*Barlow* distinguished when lease period exceeds grantor's life expectancy).

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b. Indirect Benefits That Constitute Retained Right to Income

§2.51 (1) Assets Available to Creditors

To the extent that the transferred asset remains available to satisfy the claims of the grantor's creditors, it is included in the grantor's gross estate under IRC §2036(a)(1). Thus, if the assets of a trust are available, under state law, to satisfy the grantor's creditors, that statutory right is a retained right of enjoyment. Rev Rul 76-103, 1976-1 Cum Bull 293. See, *e.g.*, Prob C §15304(a) (assets held in spendthrift trust for grantor's benefit fully reachable by grantor's creditors). But see *Estate of German v U.S.* (Cl Ct 1985) 85-1 USTC ¶13,610, 55 AFTR2d 1577 (grantor did not retain interest in transferred property under Maryland law, even though trustees had discretion to pay income and principal to grantor during her lifetime). Because spendthrift provisions do not apply to a settlor's interest in a trust under Prob C §15304(a), a California irrevocable trust providing the settlor with benefits will be included in the settlor's estate at death.

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§2.52 (2) Trustee's Power to Use Income or Corpus for Decedent's Benefit

A power to use trust income or corpus for the grantor's benefit may not cause an estate tax problem if the power is held by a third-party trustee (even if the trustee is the grantor's child), and the power is completely discretionary, so that the grantor may not compel distributions to himself or herself. For example, in *Estate of Gizella Wells*, TC Memo 1981-574, the court held that the property was not includable in the grantor's estate when she transferred property to a trust that gave the trustee (her son) absolute discretion to distribute income or principal to her, and the trustee dutifully distributed all the income to the grantor until her death six years later.

Although a trustee's power to make distributions to a grantor must be discretionary to avoid inclusion of the trust assets in the grantor's gross estate, a grantor-trustee's power to make distributions to other beneficiaries must be controlled by an ascertainable standard to avoid inclusion in the grantor's estate under IRC §2036(a)(2) or §2038. See §§2.58-2.60. For a definition of "ascertainable standard," see §2.12.

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§2.53 (3) Right to Have Income Used for Support of Dependents

The retained right to income includes both the grantor's right to receive the income and the right to have the income used for the grantor's benefit. Thus, a retained right to income also includes the right to have income used to support the grantor's dependents. Treas Reg §20.2036-1(b)(2). Specific circumstances will determine whether estate tax applies when trust income is used to support the grantor's family:

- When the trust instrument requires that income be used to support the grantor's family, the trust corpus is includable in the decedent's gross estate. *Richards v Commissioner* (10th Cir 1967) 375 F2d 997.
- Estate tax also applies when trust income is required to be used for support of the grantor's minor children. *National Bank of Commerce v Henslee* (MD Tenn 1959) 179 F Supp 346.
- Trust corpus probably will not be included in the grantor's gross estate if the income is paid directly to a beneficiary whom the decedent is legally obligated to support, and the beneficiary is free to spend the income as he or she wishes, including applying funds to expenditures that the grantor is legally obligated to make. See *Wishard v U.S.* (7th Cir 1944) 143 F2d 704, 709.
- A trust that gives the trustee discretion to apply trust income for support of the grantor's dependents falls between these two extremes. The trust corpus should not be includable if the grantor is not a trustee and cannot require the trustee to apply the income in discharge of his or her support obligation. *Commissioner v Estate of Douglass* (3d Cir 1944) 143 F2d 961; *Estate of Abner W. Mitchell* (1970) 55 TC 576, acq 1971-2 Cum Bull 3. This is the likely result for estate tax purposes, even if the trustee in fact distributes income for a minor's support, causing the grantor to be taxed on that income for income tax purposes under IRC §677 (discussed in §3.39). See *Commissioner v Estate of Douglass, supra*. Presumably, the grantor also might have to establish that no implied agreement existed for the trustee to make distributions for that purpose. See *Estate of Marguerite M. Green* (1975) 64 TC 1049, acq in result 1976-2 Cum Bull 2; *Estate of Gizella Wells*, TC Memo 1981-574. These principles provide excellent tools for drafting.
- If the trustee has discretion to use the income for the support of the grantor's dependents and the grantor could appoint himself or herself to serve as the trustee, the transfer will cause inclusion under IRC §2036(a)(1). See §2.62.

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§2.54 c. Reciprocal Trusts

Case law has developed the reciprocal-trusts doctrine, which recharacterizes transfers by reciprocal trusts so that they fall within the ambit of IRC §2036(a)(1).

EXAMPLE: *A* creates a trust funded with $100,000 for the benefit of his brother, *B*, for life, with the remainder passing to *B*'s issue at *B*'s death. At the same time, *B* creates a trust funded in an identical amount for the benefit of *A* for life, with the remainder passing to *A*'s issue at *A*'s death. Although this arrangement appears to avoid the mandate of IRC §2036(a)(1) that transferred property in which the decedent retains an interest is included in his or her gross estate (see §2.48), case law recharacterizes the two transactions as a transfer by *A* to *A* for life, with the remainder going to *A*'s issue and a transfer by *B* to *B* for life, remainder to *B*'s issue. Both of these recharacterized transfers are subject to IRC §2036(a)(1). *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730. But see *Estate of Green v U.S*. (6th Cir 1995) 68 F3d 151 (reciprocal-trusts doctrine not applicable when husband and wife each established trust for different grandchild, naming each other as trustee and giving trustee power to accumulate income); *Estate of Herbert Levy,* TC Memo 1983-453 (existence of limited power of appointment over one trust and absence of limited power of appointment over another trust caused both trusts not to be subject to reciprocal-trusts doctrine).

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§2.55 d. Transfer in Exchange for Annuity

In *Simon M. Lazarus* (1972) 58 TC 854, acq 1973-2 Cum Bull 2, aff'd (9th Cir 1975) 513 F2d 824, the taxpayers transferred property to a trust in exchange for a private annuity, the actuarial value of which the taxpayers believed to be equal to the value of the property transferred to the trust. The Tax Court, after considering all the facts of the transaction, rejected the taxpayers' contention that the transaction was a bona fide sale or exchange for full and adequate consideration and instead held that the transaction was a gift in trust with a reserved life estate. Instead of the desired tax advantages of a private annuity, the taxpayers were subject to income tax under IRC §677 on income generated by the trust assets and to gift tax on the gift of the remainder interest.

In *La Fargue v Commissioner* (9th Cir 1982) 689 F2d 845, however, the court treated a similar arrangement as a valid annuity. The Ninth Circuit Court of Appeals distinguished *La Fargue* from *Lazarus* on the basis that the annuity payable to the taxpayer in *La Fargue* was not an attempt to reserve all the trust income for life as it was in *Lazarus.* See also *Stern v Commissioner* (9th Cir 1984) 747 F2d 555 (affirming *La Fargue*).

On remand, the Tax Court in *La Fargue* determined that the taxpayer's investment in the contract under IRC §72 was the annuity's present value. *Esther La Fargue*, TC Memo 1985-90, aff'd (9th Cir 1986) 800 F2d 936. The Ninth Circuit affirmed on appeal, holding that the taxpayer's investment in the annuity contract from which the amount of excludable annuity income was determined was not the transferred property's fair market value but the annuity's actuarial value at the time of the transfer, because the creation of the annuity contract was not an arm's-length transaction. *La Fargue v Commissioner* (9th Cir 1986) 800 F2d 936. The excess of the transferred property's fair market value over the annuity's present value is deemed a gift. See *Marion B. Benson* (1983) 80 TC 789.

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§2.56 2. Retained Voting Rights

The transfer by gift of stock in a controlled corporation when the decedent retained voting rights, either directly or indirectly, is treated as a transfer with a retained life estate, causing the stock to be included in the grantor's estate. IRC §2036(b). Section 2036(b) applies whether the power to vote the stock is exercisable by the grantor acting alone or acting in conjunction with someone else. A controlled corporation is one in which the decedent owned, either directly or through attribution (see IRC §318), 20 percent of the combined voting power of all classes of stock. Relinquishment or cessation of voting rights within 3 years of the decedent's death is treated as a transfer of property for purposes of IRC §2035. IRC §2036(b)(3).

If the decedent has transferred nonvoting stock, the transfer is not covered by IRC §2036(b), even though the decedent also keeps control of voting stock in the same corporation. See Rev Rul 81-15, 1981-1 Cum Bull 457. If the decedent had transferred both voting and nonvoting stock at the same time, IRC §2036(b) would apply only to the value of the voting stock.

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§2.57 3. Retained Reversionary Interest

If the decedent transfers a trust but retains a reversionary interest that exists at his or her death, some or all of the property subject to the reversionary interest may be included in the decedent's gross estate. The result depends on the nature and value of the interest at the time of the decedent's death.

If possession or enjoyment of the transferred interest may be obtained only by surviving the decedent, and the actuarial value of the decedent's reversionary interest exceeds 5 percent of the value of the property subject to the reversionary interest, the entire value of the property received by the contingent remainder beneficiary is included in the decedent's gross estate for federal estate tax purposes. IRC §2037. Otherwise, only the actuarial present value of the reversionary interest at the time of the decedent's death is included in the gross estate. IRC §2033.

Because a reversionary interest may arise either under the express terms of the trust or by operation of law, it is frequently impossible to determine whether the reversionary interest will be governed by IRC §2037 when the transfer is made. The determination must be made at the time of the decedent's death. It is therefore desirable, when drafting a trust, to eliminate any potential reversionary interests (including statutory reversions) in circumstances other than the creation of a qualified personal residence trust. See chap 16.

The IRS contends that the actuarial tables must always be used when valuing a reversionary interest for purposes of IRC §2037. Treas Reg §20.7520-3(b)(3)(ii); Rev Rul 96-3, 1996-1 Cum Bull 348. The Ninth Circuit Court of Appeals accepts the IRS position. *Robinson v U.S.* (9th Cir 1980) 632 F2d 822.

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§2.58 4. Retained Right to Designate Person Who Will Possess or Enjoy Property

Under IRC §2036(a)(2), the full date-of-death value of property transferred by a decedent during his or her lifetime is included in the gross estate, even though the decedent no longer owned any interest in the property, when the decedent retained or reserved the right, either alone or in conjunction with another, to designate the person who will possess or enjoy the property or the income from it. The property is included in the decedent's estate when he or she retained these rights during life, for any period not ascertainable without reference to his or her death, or for any period that did not end before his or her death. IRC §2036(a)(2). Despite the broad reach of IRC §2036(a)(2), it does not apply to a power to distribute income or principal limited by an ascertainable standard. See *Old Colony Trust Co. v U.S.* (1st Cir 1970) 423 F2d 601 (distribution not limited by ascertainable standard).

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§2.59 5. Retained Right, Through Exercise of Power, to Alter, Revoke, or Terminate Transferred Interest

If a decedent transferred property and retained the right, through the exercise of a power held by him or her at the time of death, to alter, amend, revoke, or terminate the interest transferred, the interest is included in the decedent's gross estate. IRC §2038.

The following powers, however, probably will not cause the property to be included in the decedent's gross estate:

- Powers to manage trust assets limited to the allocation of income and principal under the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375);
- Powers to invest funds and determine investment policies under the Uniform Prudent Investor Act (Prob C §§16045-16054); and
- Similar powers that do not affect the rights of beneficiaries to receive distributions from the trust.

An unrestricted discretionary power to distribute income or principal, or both, may be equivalent to the power to terminate the trust. *Lober v U.S.* (1953) 346 US 335, 98 L Ed 15, 74 S Ct 98. When the decedent, as trustee, retained a power to distribute income or principal limited by an ascertainable standard, however, the power generally does not subject the transferred assets to inclusion in the decedent's gross estate. See *Estate of Hurd v Commissioner* (1st Cir 1947) 160 F2d 610 (power not so limited); Rev Rul 73-143, 1973-1 Cum Bull 407. The power to distribute income as necessary to keep the beneficiary in comfort "in accordance with the station of life to which he belongs" was held not to cause inclusion under IRC §2038 in *Jennings v Smith* (2d Cir 1947) 161 F2d 74. See also *Leopold v U.S.* (9th Cir 1975) 510 F2d 617.

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§2.60 6. Right to Designate Person Who Will Possess Property Compared With Right to Alter, Revoke, or Terminate Transferred Interest

For most practical purposes, the Internal Revenue Code sections governing the decedent's retained right to designate the person who will possess or enjoy transferred property (IRC §2036(a)(2)) and the retained right, through exercise of a power, to alter, amend, revoke, or terminate a transferred interest (IRC §2038) are identical. Section 2038 is, however, broader in application. It reaches any power to affect a beneficiary's enjoyment, even if the power affects only the timing of that enjoyment, and applies to both income and remainder interests (see Treas Reg §20.2038-1(a)), while IRC §2036(a)(2) requires that the retained power affect the person's right to receive income during the decedent's lifetime. If income may be accumulated, but the accumulated income eventually must be paid to the income beneficiary or the beneficiary's estate, the power to accumulate income should not be treated as a power to alter or control beneficial enjoyment under IRC §2036(a)(2). Such a power affecting the time of enjoyment, however, causes the income interest to be included in the decedent's gross estate under IRC §2038. Courts have not recognized this distinction, instead holding that §2036(a)(2) is concerned with present enjoyment of income. See *Struthers v Kelm* (8th Cir 1955) 218 F2d 810; *Estate of John A. Alexander* (1983) 81 TC 757.

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§2.61 7. Administrative Powers

A power held in a fiduciary capacity to control the trust's investment program, allocate receipts between income and corpus, or exercise other administrative controls does not affect beneficial enjoyment of the trust. *U.S. v Byrum* (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382; *Old Colony Trust Co. v U.S.* (1st Cir 1970) 423 F2d 601, overruling *State St. Trust Co. v U.S.* (1st Cir 1959) 263 F2d 635; *Estate of Willard V. King* (1962) 37 TC 973, nonacq 1963-1 Cum Bull 5. Note the limited exception to *Byrum* enacted as IRC §2036(b), discussed in §2.56.

In *Estate of Willard V. King, supra,* the court determined that reserved management powers, including a power to substitute assets, did not result in inclusion in the decedent's estate because the reserved powers were subject to court intervention under state law and so were made fiduciary powers. However, the IRS continues to take the position that a retained power such as a power to remove and replace the trustee is not held in trust and generally is not subject to state law fiduciary standards. Therefore, the limitation that prevents retention of administrative powers by the grantor from resulting in inclusion of the subject property in the grantor's estate does not apply. See General Counsel Memorandum 39780 (June 15, 1979), discussed in Janes & Kelly, *When Using a Power of Substitution—Take Nothing for Granted*, 34 Est Plan 3, 6 (Aug. 2007).

On a decedent's power to substitute his or her own assets for trust property, see Rev Rul 2008-22, 2008-16 Int Rev Bull 796 (power to substitute assets exercisable in a nonfiduciary capacity does not cause inclusion of trust assets in the grantor's estate if the trustee has a fiduciary duty to ensure that the assets substituted by the grantor are of equivalent value and the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries); *Estate of Anders Jordahl* (1975) 65 TC 92, acq 1977-1 Cum Bull 1 (power to substitute decedent's own assets was the equivalent of an investment power and did not cause trust assets to be included in decedent's gross estate). See also IRS Letter Ruling 199922007. However, the power should not be used in a life insurance trust. See §3.41. The right to reacquire voting stock of a controlled corporation also could cause inclusion of the stock in the grantor's estate under IRC §2036(b). Prop Treas Reg §20.2036-2(c). See §2.56. On a decedent's power to remove the trustee and appoint a corporate trustee, see §2.62.

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§2.62 8. Trustee's Discretionary Power

If the decedent created a trust giving the trustee power to designate who will enjoy or possess the transferred property and the decedent retained the right to discharge the trustee and name himself or herself as the successor trustee, the IRS takes the position that the decedent indirectly retained the right alter or control the beneficial enjoyment of the transferred property, even though the decedent may never have exercised the right to name himself or herself as trustee. Treas Reg §20.2036-1(b)(3).

The IRS has conceded, however, that if the decedent retains only the right to remove the trustee and appoint a corporate trustee or an individual trustee who is not related or subordinate to the decedent (within the meaning of IRC §672(c), an income tax section), the decedent will not be treated as having retained discretionary control over trust income. Rev Rul 95-58, 1995-2 Cum Bull 191.

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§2.63 C. Life Insurance on Decedent's Life

Death benefits payable under life insurance policies insuring the decedent's life are usually included in his or her gross estate for federal estate tax purposes if the death benefits are receivable (1) by or for the benefit of the decedent's estate, including the use of the death benefits to discharge the decedent's debts, taxes, or expenses of administration (IRC §2042(1)), or (2) by one or more designated beneficiaries other than the decedent's estate, and the decedent retained any incidents of ownership in the policy on the date of his or her death (IRC §2042(2)). The Service has ruled that death benefits are not receivable by the decedent's estate merely because the trustee of a life insurance trust has a discretionary power to pay the insured's estate taxes. IRS Letter Ruling 200147039. Nevertheless, such powers should be avoided because letter rulings cannot be cited as precedent.

For a detailed discussion of the design and implementation of life insurance trusts and how they can be used to remove death benefits payable under a life insurance policy from the gross estate of the insured, see chap 11.

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§2.64 D. Transfers Within Three Years Before Death

In some cases property will be included in the transferor's estate if there is a transfer of the property or an interest in the property within 3 years of death. IRC §2035(a). The primary property subject to this rule is life insurance. If the insured transfers the ownership of a life insurance policy within 3 years before the insured's death, the proceeds of the policy will be included in the insured's estate. This rule also applies if the insured, within 3 years before death, transfers or releases an incident of ownership that would have caused the policy to be included in the decedent's estate under IRC §2042 if the insured had retained the incident of ownership until death. One purpose of these rules is to avoid the difficulties involved in trying to value a life insurance policy shortly before death—particularly when the insured is known to be ill.

Similarly, other property will be included in the estate if the donor: (1) makes a transfer of property but retains an interest or power that would result in inclusion of the transferred property under IRC §§2036-2038 (transfers with retained life estates, transfers effective at death, and revocable transfers.); and (2) subsequently, within 3 years before death, releases the interest or power that would have caused inclusion. For example, assume that Donor transfers Blackacre to Child, reserving a life estate. If there is no subsequent release of the life estate, Blackacre will be included in the donor's estate under IRC §2036. If the Donor releases the life estate before death, Blackacre will no longer be subject to inclusion in the donor's estate under §2036, but Blackacre will be included in the estate under IRC §2035 if the donor fails to survive the release by 3 years.

The decedent's gross estate also includes any gift tax that he or she actually paid for gifts made during the 3 years before death. IRC §2035(b).

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§2.65 E. General Powers of Appointment

The value of the gross estate includes the value of all property that the decedent could have appointed to the decedent, the decedent's creditors, the decedent's estate, or the creditors of the decedent, if the power was exercisable at death. IRC §2041. In addition, property subject to a power of appointment that was released within 3 years before death is included in the gross estate of the powerholder under IRC §2035. Finally, an inter vivos exercise of a general power may result in inclusion in the estate of the appointed property if the decedent retained interests in the appointed property that would have caused inclusion in the estate if the transfer of property had been in the form of a gift by the decedent. IRC §2041(a)(2).

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.66 F. Annuities

§2.66 F. Annuities

An annuity purchased by a decedent is included in his or her gross estate for federal estate tax purposes if all of the following conditions are satisfied (IRC §2039(a)):

- The annuity or other payment is receivable by any beneficiary by reason of surviving the decedent;
- The annuity or other payment is payable under a contract or agreement entered into by the decedent;
- The annuity or other payment was payable to the decedent at the time of his or her death, or he or she possessed the right to receive the annuity or other payment at the time of his or her death, either alone or in conjunction with another; and
- The annuity or other payment is payable for the decedent's life, or for a period not ascertainable without reference to his or her death, or for a period that does not in fact end before his or her death.

An annuity is considered purchased by the decedent to the extent of contributions made by his or her employer by reason of the decedent's employment. IRC §2039(b).

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§2.67 G. Joint Tenancies

When the decedent held title to an asset as a joint tenant with one or more individuals, other than a qualified joint interest discussed below, the following rules apply to determine the portion of the asset included in the decedent's gross estate for federal estate tax purposes (IRC §2040(a)):

- If the decedent and the other joint tenants received interests in the joint tenancy property as a bequest from a third party, a ratable share of the property, determined by the number of joint tenants, is included in the decedent's estate.
- If the joint tenancy property was not inherited, then the portion of the property includable in the decedent's gross estate equals the portion of the total consideration to acquire the property provided by the decedent. Thus, if the decedent provided all the consideration for purchase of the property, the entire value of the property is included in his or her gross estate; conversely, if the decedent provided none of the consideration for the purchase, none of the property's value is included in his or her gross estate.
- If the consideration used to purchase the joint tenancy asset is attributable to gifts made by or to the decedent to or from the other joint tenants, the portion of the property attributable to such gifts is treated as acquired from consideration provided by or to the other joint tenants, but the income earned by the property (and perhaps the gains realized on the sale of that property) during the decedent's lifetime is treated as consideration provided by the decedent.

Creation of the joint tenancy as a taxable gift does not affect estate tax treatment of the joint tenancy. The decedent's estate receives a credit, however, for any gift tax paid as a result of the transfer, and the amount that was reported as a gift for gift tax purposes will be excluded from the decedent's adjusted taxable gifts for estate tax purposes.

A different rule applies to qualified joint interests held only by a husband and wife. If the joint tenancy is a qualified joint interest, each spouse is treated as owning one-half of the property on the death of the first spouse. IRC §2040(b)(1). The statute applies only if the surviving spouse is a citizen. IRC §2056(d)(1)(B).

No fractional-share discount is allowed when valuing a decedent's interest in property valued under IRC §2040. *Estate of Wayne-Chi Young* (1998) 110 TC 297; *Estate of Albert Fratini*, TC Memo 1998-308. As a result, holding title in joint tenancy rather than community property may avoid a reduced date-of-death value for gain or loss purposes. Under Treas Reg §1.1014-3(a), the basis of the decedent's share of property is its estate tax value. The estate tax value is half of the full fair market value of the property for the decedent's share of joint tenancy property held by husband and wife but may be less than half for the decedent's share of community property. See §2.70.

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§2.68 H. Exclusion to Extent of Consideration Furnished

If a transfer described in IRC §§2035-2038 is made for consideration, or if a general power of appointment is created for consideration, the decedent's estate includes only the excess of the value of the trust property at the date of death over the value of the consideration received at the time of transfer. IRC §2043. There is no proration of the appreciation, as occurs when determining the contributions made by a surviving joint tenant to the acquisition of joint tenancy property. See *U.S. v Past* (9th Cir 1965) 347 F2d 7. For discussion of the inclusion rule for joint tenancies, see §2.67.

EXAMPLE: If *A* transfers separate property having a value of $100,000 into a trust for the benefit of son, *S*, retaining a power to distribute the trust to *S* at any time, *S* pays *A* $10,000 (10 percent) as consideration for the transfer of the property, and the property increases in value to $200,000 at the time of *A*'s death, *A*'s gross estate includes $190,000 ($200,000 value minus $10,000 consideration received).

If a transfer is made for full and adequate consideration in money or money's worth, no part of the transferred property is subject to estate tax, because the transfer is not a substitute for a testamentary disposition. IRC §§2035(d), 2036(a), 2037(a), 2038(a).

In *U.S. v Past, supra,* the court assumed that the value of consideration received must equal the value of the entire property interest transferred to the trust in order to avoid inclusion under IRC §2036(a) when the transferor retains a life estate. See also *Gradow v U.S.* (1987) 11 Cl Ct 808, aff'd (Fed Cir 1990) 897 F2d 516. In *Estate of Magnin v Commissioner* (9th Cir 1999) 184 F3d 1074, however, the court held that the transferor only must receive full and adequate consideration for the remainder interest in the property valued under IRC §7520. See also *Estate of D'Ambrosio v Commissioner* (3d Cir 1996) 101 F3d 309; *Wheeler v U.S.* (5th Cir 1997) 116 F3d 749. The underlying theory is that consideration equal to the value of the remainder can be invested in a manner that will cause it to have a value equal to the transferred property if the transferor of the remainder survives for the period of his or her presumed life expectancy. On remand in *Magnin,* the Tax Court determined that the transferor received less than the value of the remainder. *Estate of Cyril I. Magnin,* TC Memo 2001-31.

Relinquishment of a marital right (*i.e.,* dower, curtesy, or a statutory marital right in the decedent's property) is not treated as sufficient consideration for estate tax purposes. See IRC §2043(b). Nevertheless, relinquishment by a spouse of his or her vested one-half interest in California community property is consideration that is deductible for purposes of IRC §2043. *Estate of Christ v Commissioner* (9th Cir 1973) 480 F2d 171. Transfers of property in settlement of marital property rights in compliance with IRC §2516(1) are treated as made for adequate consideration, supporting deductibility of a claim under IRC §2053. IRC §2043(b)(2).

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I. Determining Value of Assets for Federal Estate Tax Purposes

§2.69 1. General Rule

In determining how the assets included in the decedent's gross estate are valued for federal estate tax purposes, the same rules governing valuation of transfers for gift tax purposes, discussed in §§2.20-2.24, generally apply. See IRC §2031(a).

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§2.70 2. Minority Discounts for Community Property Interests

In *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248, the Ninth Circuit Court of Appeals held that unity-of-ownership principles do not apply to valuation of real property for federal estate tax purposes. Instead, the value of an asset included in a decedent's gross estate is measured by the interest that passes, as contrasted with the interest held by the decedent before his or her death or the interest held by the devisee after the decedent's death. The court noted that this factor could affect valuation regardless of whether real or personal property is involved. 680 F2d at 1252 n6. See *Stone v U.S.* (ND Cal 2007) 2007-1 USTC ¶60,540, rejecting the IRS argument that fractional discounts apply only to real property and not to tangible personal property.

Because of this holding, a lack-of-control or minority-interest discount is available for assets when the decedent owns a 50-percent or less interest in an asset. This is true even if, as a result of the decedent's death, the devisee ends up owning the entire interest in an asset. Specifically, the court in *Propstra* held that a discount could be applied when valuing the deceased spouse's undivided one-half interest in community property for federal estate tax purposes. In *Estate of Cervin v Commissioner* (5th Cir 1997) 111 F3d 1252, 1261, the court awarded the estate attorney fees in a case in which the Service failed to concede a reasonable discount for a community property interest. Clearly there is a discount on the second death when an asset is split between the credit trust and the marital trust or survivor's trust. *Estate of Eleanor O. Pillsbury*, TC Memo 1992-425.

PRACTICE TIP: Lack-of-control and fractional interest discounts are generally not desirable at the first spouse's death, because discounts lower the income tax basis of the property of the estate plus the survivor's one-half share of any community property. The editors are aware that the IRS may attempt to limit the basis step-up in community property by insisting on the use of these discounts when examining the estate tax return of the first spouse to die.

In *Estate of Bright v U.S.* (5th Cir 1981) 658 F2d 999, the decedent and spouse owned 55 percent of the outstanding stock of a corporation as their community property. The IRS tried to impose a control premium on the decedent's interest in the stock because, under its family-attribution approach, stock held by the decedent's spouse individually, and stock passing to the decedent's spouse as trustee for the decedent's children under provisions in the decedent's will, should be viewed as a single block of stock. The Fifth Circuit Court of Appeals held that a control premium was not appropriate under the circumstances, and the estate's 27.5-percent interest in the corporation was a minority interest.

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§2.71 3. Problems in Applying Premiums or Discounts to Charitable Gifts or Marital Gifts

In *Ahmanson Found. v U.S.* (9th Cir 1981) 674 F2d 761, the corporation being valued had one share of voting common stock and 99 shares of nonvoting common stock, all of which was included in the decedent's estate. The one share of voting common stock went to a trust for the benefit of the decedent's son, and the 99 shares of nonvoting common stock went to charity. The decedent's estate applied a discount in valuing the 99 nonvoting shares that passed to the charity, both in determining the value of the gross estate and the charitable deduction allowable. The court held that the decedent's estate was not entitled to any discount in valuing the decedent's gross estate. Rather, the full 100-share block owned by the decedent should be valued in his gross estate without considering the fact that the block was split between two beneficiaries at the decedent's direction. The court did apply a 3-percent reduction for purposes of the charitable deduction under IRC §2055 because the 99 shares were nonvoting. In IRS Letter Ruling 200648028, the IRS ruled that the value of an irrevocable trust's stock that was included in the settlor's estate under IRC §2036 must be aggregated with the settlor's other stock for valuation purposes, but the charitable deduction is limited to the value of the minority interest passing to charity. See also *Estate of Marvin M. Schwan,* TC Memo 2001-174 (redemption agreement for voting stock did not reduce estate tax value of majority block of stock but might reduce value of nonvoting stock for charitable deduction purposes). But see IRS Letter Ruling 200418002 (restrictions on devise of art collection to museum and foundation will not cause charitable deduction to be lower than value at which collection will be included in decedent's estate). In *Estate of Frank M. DiSanto*, TC Memo 1999-421, the decedent owned a controlling interest in a corporation, but only a minority interest passed to the spouse. The court held that the marital deduction allowing for stock passing to the spouse was based on its minority interest value. Fortunately, the issue is less likely to occur in a community property context, where it is less likely that the first spouse to die will have a majority interest.

In *Dean A. Chenoweth* (1987) 88 TC 1577, the decedent owned 100 percent of an entity's stock. Although the decedent's estate and the IRS agreed on the value of the stock as a whole, the estate sought to value a 51-percent interest in the entity, which passed to the decedent's spouse, at a premium for purposes of computing the amount of the marital deduction (IRC §2056), because of the control feature inherent in a 51-percent block of stock. The IRS argued that the value of that interest for purposes of determining the marital deduction should be 51 percent of the entire value of the entity, as reported in the decedent's gross estate. The court held that the decedent, in dividing his 100-percent ownership of the company into two unequal shares and giving the majority interest to his surviving spouse, created a new and different asset that carried with it the control premium for valuation purposes.

PRACTICE TIP: The hypothetical nightmare scenario involves a client whose estate consists entirely of a majority interest in corporation common stock that is devised one-half to spouse and one-half to charity. The stock is included in the client's estate with a control premium value, but the marital and charitable gifts are valued using minority interest discounts for deduction purposes—resulting in a large estate tax that further reduces the marital and charitable deductions. At least in theory, a similar result can occur when an estate is divided among multiple charities. A potential solution to these problems is to give the transferees rights to compel the distributing fiduciary to sell the control block before making distributions.

Based on these cases, counsel should be aware that minority-interest discounts or control premiums with respect to distributions have no effect on the value of the decedent's interest includable in the decedent's gross estate. Inattention to the impact of the control premium in this situation could result in the personal representative's understating the estate tax deduction or overfunding a gift. Conversely, failure to recognize the minority-interest discount could result in losing the full deduction, underfunding the gift, or both.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.72 4. Special-Valuation Provisions for Certain Assets Included in Gross Estate

§2.72 4. Special-Valuation Provisions for Certain Assets Included in Gross Estate

The following statutory provisions may apply to certain assets in the decedent's estate:

- *IRC §2032*. The estate may value assets on the alternate valuation date rather than on the date of the decedent's death, if the use of the alternate valuation date reduces both the aggregate value of assets included in the gross estate and the federal estate tax payable by the estate. IRC §2032(c). The valuation date is the date 6 months after the decedent's death, or, if an asset has been sold, distributed, or otherwise disposed of before that date, the date of the sale, distribution, or other disposition. For purposes of determining the aggregate value of assets included in the gross estate, postdeath earnings on corporate stock may be deemed "included" property owned by the decedent at death if the earnings are not "severed" from the stock as a result of a declaration of dividends. Treas Reg §20.2032-1(d)(4). See IRS Letter Ruling 200343002. To preserve the option of making the election, sale or distribution in the first 6 months should generally be avoided. However, if asset values drop to the point that the estate tax is zero, quick distributions or sales can provide a strategy for ensuring that the estate tax will remain zero even if the market rebounds during the 6-month period. Note that the election cannot be made if no estate tax is payable. In essence, alternate valuation may not be used to increase the value of assets in estates when no federal estate tax is due solely to increase the basis of assets owned by the decedent for income tax purposes. Accordingly, it will usually be necessary for the surviving spouse to disclaim a small amount of property so that an estate tax will be payable to make the election in the context of formula marital deduction estate plans that are designed to produce a zero estate tax on the first death. The election can be made on a late return as long as the return is filed not later than 1 year after the original due date. IRC §2032(d). See *Estate of Loree v U.S.* (D NJ 2008) 2008-1 USTC ¶60,555, 101 AFTR2d 698 (election must be made on return filed by extended due date for the return). If a return is filed within that period that does not make the election, the estate may apply for an extension of time to make the election even after that period has expired. Treas Reg §20.2032-1(b)(3). It is also possible to make a protective election, although the election is irrevocable if it is later determined that the estate is eligible. Treas Reg §20.2032-1(b)(2). In *Estate of Kenneth R. Mapes* (1992) 99 TC 511, for example, the court approved a protective election that would be valid only in the event the estate failed to qualify for a special use valuation under IRC §2032A.
- *IRC §2032A*. An estate may value real property used in connection with the operation of a farm or closely held business based on its current use by the farm or business rather than its highest and best use. The amount by which the value of the real property may be reduced through the use of IRC §2032A, however, may not exceed $750,000 plus cost of living adjustments ($1,000,000 for decedents dying in 2009). IRC §2032A(a)(2)-(3). For example, real property used to grow oranges and avocados that is located near Disneyland may be valued based on its use as farming property rather than its highest and best use (presumably parking, rides, or guest facilities for Disneyland). This special-use valuation provision will be available only if (a) the adjusted value of the farm or business (*i.e.,* the gross value reduced by expenses that are allowable under IRC §2053(a)(4)) is at least 50 percent of the value of the decedent's adjusted gross estate (see §2.73) and (b) the adjusted value of the real property used in the operation of the farm or business is at least 25 percent of the value of the decedent's adjusted gross estate. IRC §2032A(b)(1). Property transferred by the decedent during the 3-year period preceding death is included in the estate when determining whether IRC §2032A is available. IRC §2035(c)(1). See §2.64.

PRACTICE TIP: When designing an estate plan for clients, the practitioner should give special attention to the impact of the plan on the availability of IRC §2032A. Inattention to detail, especially when dealing with couples whose estate plan defers estate tax until the surviving spouse's death, could result in the unnecessary loss of the availability of IRC §2032A. When analyzing the availability and desirability of applying IRC §2032A in a particular case, the attorney should consider the adverse tax impact of the recapture provisions of IRC §2032A(c) if the real property used in connection with the business or farm may possibly cease to be used for business or farming

purposes by a qualified heir within the 10-year period after the later of the decedent's death or the date when the qualified use begins. See IRC §2032A(c)(7) (ability to delay beginning of qualified use of property for up to 2 years after decedent's death). Note that a qualified conservation contribution during the recapture period under IRC §170(h) (see below) is not considered a disposition of special use property. IRC §2032A(c)(8). However, the IRS has ruled that this exception does not apply to a sale of a conservation easement. IRS Letter Ruling 200840018.

- *IRC §2057*. This section provides a deduction from the value of the gross estate for qualified family-owned business interests. The maximum amount of the deduction is $300,000, the difference between $1.3 million and the $1 million IRC §2010(c) applicable exclusion amount that applies in 2002-2003 and after 2010. The deduction does not apply in 2004-2009, when the applicable exclusion amount is $1.5 million or more. IRC §2057(f). For the estate to qualify, the adjusted value of the estate's qualified family-owned business interests must exceed 50 percent of the "adjusted gross estate." IRC §2057(b)(1).
- In *Estate of Duane B. Farnam* (2008) 130 TC 34, the court held that debt owed by the family business corporation to the deceased shareholders did not constitute qualified family-owned business interests for these purposes. The definition of adjusted gross estate is intended to neutralize the effects of certain types of gifts and to prevent attempts to claim that passive investments are qualifying business interests. A business does not qualify unless the decedent's family owns at least 50 percent of the value of a business. IRC §2057(e)(1). A business does not qualify if its securities or debt are tradable in an established market. IRC §2057(e)(2)(B). A member of the family must materially participate in the business both before the death and afterwards. IRC §§2057(b)(1)(D), (f). Due to these stringent requirements, few estates qualify for the deduction; those most likely to qualify are those that include farms or ranches. Those estates may qualify for the benefits of both IRC §2032A and IRC §2057.
- *IRC §2031(c)*. This subsection provides an exclusion from the value of the gross estate for the lesser of a specified percentage of the value of land subject to a qualified conservation easement as of the date of the contribution or a specified exclusion limitation. The maximum percentage is 40 percent. The dollar limitation is $500,000. The easement can be created after death and the exclusion can be claimed repeatedly as long as the property stays in the family. In IRS Letter Ruling 200418005, the IRS ruled that a postdeath contribution of a scenic easement qualified for the exclusion provided that no persons claimed an income tax deduction. Generally, it is preferable to create a conservation easement before death. This entitles the donor to an income tax deduction under IRC §170(h), reduces the fair market value of the property, and qualifies the estate for the IRC §2031(c) exclusion. The deduction is allowed to the extent that the donor's total qualified conservation contributions do not exceed 30 percent of adjusted gross income for the taxable year, with excess deductions carried over to later years. IRC §170(b)(1)(E); Notice 2007-50, 2007-25 Int Rev Bull 1430. In Rev Rul 2003-123, 2003-2 Cum Bull 1200, however, the IRS ruled that a trust was not allowed an income tax deduction under IRC §642(c) for a contribution of a conservation easement, because the contribution was not made from income. In *Thomas B. Goldsby, Jr.,* TC Memo 2006-274, the court held that the income beneficiary of a trust also could not claim the deduction, even though he was the owner of the income portion of the trust under IRC §678, because he failed to show that the easement was contributed from the income portion of the trust.
- The contribution must have a qualifying conservation purpose under IRC §170(h)(4)(A). In *James D. Turner* (2006) 126 TC 299, the court held that a deed that limited the number of housing units that could be built on a tract did not create a qualified conservation easement because of failure to prove that the limitation would preserve a nearby historic site. In *Glass v Commissioner* (6th Cir 2006) 471 F3d 698, however, the court held that easements limiting development of portions of lakefront property were qualified conservation easements because they protected a relatively natural habitat. In *Kiva Dunes Conserv., LLC*, TC Memo 2009-145, the court allowed a $28.7 million deduction for the donation of a charitable easement that effectively preserved the current use of a golf course. The court found that the contribution reduced the value of the golf course land from $32 million to $3 million and enhanced the value of adjacent property by $300,000.
- Special rules apply with respect to certified historic structures under IRC §170(h)(4)(B), (f)(13). In *Whitehouse Hotel Ltd. Partnership* (2008) 131 TC 112, the court held that a partnership grossly overstated the value of its donation of a façade easement in a downtown New Orleans historic building under these rules. In *Gordon Kaufman* (2010) 134 TC No. 9, the court held that a grant of a façade easement in a building that was

subject to a mortgage did not meet the requirements for a charitable contribution because the easement was not protected in perpetuity. In *Dorothy Jean Simmons*, TC Memo 2009-208, the court held that façade easements for residences in historic areas of Washington, D.C., reduced the value of the residences by only 5 percent. In *J. Maurice Herman*, TC Memo 2009-25, the court disallowed a claimed deduction for a conservation easement that reduced possible future enlargement of a New York City historic building because the easement did not prevent the taxpayer from totally altering the appearance of the building, or even from demolishing it. In *Bruzewicz v U.S.* (ND Ill 2009) 604 F Supp 2d 1197, the court disallowed a charitable deduction for donation of a preservation façade easement in the donor's residence in a historic district because the donors failed to obtain a contemporaneous written acknowledgment from the donee organization and attach a certified appraisal as required by IRC §170(f)(8).

- *IRC §§2703 and 2704*. Besides the provisions discussed above, the special valuation provisions of these sections may apply to certain business interests included in the decedent's gross estate. See §§2.29-2.30.

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J. Deductions From Gross Estate to Arrive at Taxable Estate

§2.73 1. Deductions to Arrive at Adjusted Gross Estate

Generally, the estate may deduct the estate's administration expenses and the decedent's debts and taxes. IRC §2053. Administration expenses that are deducted for estate tax purposes may not also be deducted for income tax purposes (IRC §642(g)), except deductions for "expenses in respect of a decedent" (IRC §691(b)).

The estate may also deduct losses from fires, storms, shipwrecks, other casualties, and thefts when the estate has not been compensated for these losses by insurance or otherwise. IRC §2054. The estate may not claim deducted losses for income tax purposes. IRC §642(g). Usually, if estate tax must be paid, expenses generally should be deducted from the estate, because the effective estate tax rate (45 percent in 2007-2009) is higher than the maximum combined federal and state income tax rate of approximately 41 percent in California (35 percent plus 9.3 percent minus federal income tax deduction for state income tax (35 percent of 9.3 percent)). See §§2.5-2.6.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.74 2. Charitable Deduction

§2.74 2. Charitable Deduction

A decedent's estate may claim a charitable deduction for qualifying interests passing to qualifying charities. The percentage of the decedent's estate that may qualify for a charitable deduction is unlimited. IRC §2055. Qualifying interests include:

- An outright, fee-simple interest in all or part of an asset (vertical slice),
- A remainder interest in a charitable remainder trust or pooled income funds (horizontal slice),
- A lead interest in a charitable lead trust (horizontal slice), or
- A remainder interest in a residence or a farm (horizontal slice) (IRC §2055(e)(2)).

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3. Marital Deduction

§2.75 a. In General

A decedent's estate may claim a marital deduction for interests passing to the decedent's spouse, other than certain nonqualifying terminable interests. IRC §2056. If the recipient spouse is not a United States citizen, however, the transfer *must* be in the form of a qualified domestic trust (QDOT) or must be transferred by the spouse to a QDOT. IRC §§2056(d), 2056A. See §§2.80-2.81.

Under IRC §2056(b)(1)(A)-(B), an interest is a terminable interest if:

- The interest passing to the surviving spouse will terminate because of the lapse of time or occurrence of an event or contingency;
- At the time of the lapse or occurrence, the interest will pass to any person other than the surviving spouse or the estate of surviving spouse; and
- By reason of the interest passing, a person other than the surviving spouse may possess or enjoy the interest after termination of surviving spouse's interest.

These restrictions are generally intended to assure that a transfer cannot qualify for a marital deduction without the surviving spouse acquiring an interest in the property that assures the property will later be subject to estate tax when the spouse dies (or an earlier gift tax) except to the extent the survivor consumes the property.

A terminable interest also is created if the decedent's will directs the trustee or representative to use the decedent's assets to acquire a terminable interest for the benefit of his or her surviving spouse. IRC §2056(b)(1)(C). In Rev Rul 85-100, 1985-2 Cum Bull 200, the IRS found that when an interest was a prohibited terminable interest as of the date of the decedent's death, but became a nonterminable interest during the alternate valuation period, use of the alternate valuation date did not permit the otherwise terminable interest that passed to the surviving spouse to qualify for the marital deduction.

Generally, the devise of an interest contingent on the surviving spouse surviving the deceased spouse is a terminable interest, as is an interest passing to the surviving spouse in trust. Some terminable interests, however, qualify for the marital deduction, as discussed in §§2.76-2.79.

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b. Exceptions to Terminable Interest Rule

§2.76 (1) Estate Trust

An estate trust, consisting of a trust that pays or accumulates income for the benefit of the surviving spouse during his or her lifetime, but the remainder of which must be paid to the surviving spouse's estate at his or her death, is not a terminable interest. Treas Reg §20.2056(c)-2(b)(1). An estate trust can be an attractive alternative when a client is worried about the surviving spouse's ability to manage and conserve income, or if the surviving spouse is or might become incompetent.

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§2.77 (2) Six-Month Survivorship

There is an exception to the terminable interest rule for devises to a surviving spouse subject to a survivorship requirement, provided the period during which the spouse must survive does not exceed 6 months. IRC §2056(b)(3). Although careful drafting of the survivorship requirement is desirable, a defective survivorship provision probably can be cured under California law. See Prob C §21525(a) (when marital deduction intended, survivorship automatically limited to 6 months); IRS Letter Ruling 8810002 (when state statute limits survivorship to 6 months, requirements of IRC §2056(b)(3) met even though documents provided for 1-year survivorship).

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§2.78 (3) General Power of Appointment Trust

An exception to the terminable interest rule exists for general power of appointment (GPA) trusts. IRC §2056(b)(5). For a trust to qualify as a GPA trust, the surviving spouse must be entitled to receive all income from the entire interest or a specific portion of the interest, for life, and must have the power to appoint the entire trust, or a specific portion of it, to himself or herself or to his or her estate. IRC §2056(b)(5). The specific portion must be a fractional or percentage portion. IRC §2056(b)(10). This deduction is rarely used for irrevocable trusts.

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§2.79 (4) Qualified Terminable Interest Property (QTIP) Trust

An exception to the terminable interest rule is created by means of a qualified terminable interest property (QTIP) trust. IRC §2056(b)(7). In general, any trust in which the surviving spouse has the right to receive all the income from the entire interest or a specific portion of the interest, for life, qualifies for the marital deduction as a QTIP trust. No person other than the surviving spouse, however, may receive distributions from the trust during the surviving spouse's lifetime. Thus, a QTIP trust can prevent the surviving spouse from giving away principal to the new spouse, new stepchildren, or charities.

As in a general power of appointment trust, the surviving spouse must have the right to receive all the income from the QTIP trust, at least annually, for life. Therefore, the right to receive the income from the QTIP trust cannot terminate on the surviving spouse's remarriage. Treas Reg §20.2056(b)-7(h), Example (5). The regulations provide that a state law definition of income that incorporates a trustee power to adjust between principal and income will not disqualify the trust if the statute provides a reasonable apportionment between the income and remainder beneficiaries and satisfies the requirements of Treas Reg §1.643(b)-1. Treas Reg §20.2056(b)-5(f)(1). Treasury Regulation §1.643(b)-1 generally approves exercises of adjustment powers for purposes of fulfilling the trustee's duty of impartiality. See §3.12. However, the California adjustment power statute expressly prohibits an adjustment that would diminish the income that would be paid from a trust qualifying for the marital deduction. Prob C §16336(b)(1).

The marital deduction is available only if a proper QTIP election is made. If the election is made, the remaining trust estate is includable in the surviving spouse's gross estate at his or her later death. IRC §2044. Unless the surviving spouse's will or revocable trust directs otherwise, the estate tax attributable to inclusion of the QTIP trust in the surviving spouse's gross estate under §2044 is paid from the QTIP trust. IRC §2207A. Under §2207A(a)(2), the right of recovery is waived only to the extent that the language in the will or trust specifically so indicates by specific reference to QTIP, the QTIP trust, §2044, or §2207A. In IRS Letter Ruling 200452010, the IRS ruled that a boilerplate tax apportionment clause did not waive the right to recover additional estate taxes attributable to inclusion of QTIP property in the decedent's estate under §2044. The estate tax charged to the QTIP trust is determined by subtracting the estate tax that would have been due if the QTIP trust were excluded from the surviving spouse's gross estate from the total estate tax actually payable.

Although the QTIP property is included in the surviving spouse's estate, the surviving spouse's property will not be aggregated with the QTIP property for purposes of applying minority-interest discounts in valuing the property to be taxed on the survivor's death. *Estate of Harriet R. Mellinger* (1999) 112 TC 26, acq 1999-2 Cum Bull xvi. Thus, each half of a community asset divided between the surviving spouse and a QTIP trust may be entitled to a minority-interest discount, but the reduced valuation also would apply to the step-up in basis on both halves of community property for income tax purposes. See §2.70.

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§2.80 4. Marital Deduction for Noncitizens

The standard estate tax marital deduction is not available for estate tax purposes for transfers to or for the benefit of a spouse who is not a United States citizen. IRC §2056(d)(1). A temporary deduction, however, can be obtained if property passes to a qualified domestic trust (QDOT) or the surviving spouse retransfers property to a QDOT. IRC §2056(d)(2). If the transfer is made by the spouse, the property must be transferred before the due date of the estate tax return. IRC §2056(d)(2)(B). Under Treas Reg §20.2056A-4(b)(1), that deadline is the date of the deadline for making the QDOT election under IRC §2056A(a)(3). Under IRC §2056A(d), the election must be made on the estate tax return, and no election can be made more than 1 year after the due date (including extensions) of the return. Under Treas Reg §20.2056A-3(a), the election must be made on the last federal estate tax return filed before the due date or, if a timely return is not filed, on the first federal estate tax return filed after that date. In IRS Letter Rulings 200821030, 200712010, the IRS granted extensions of time for assigning property to the QDOT and making the QDOT election on a supplemental return.

The benefit of a QDOT is tax deferral. The QDOT can pay income to the surviving spouse and also make hardship distributions of principal to the spouse, but each year other distributions of principal are made and in the year of the survivor's death, the marital deduction for the distributed principal (or the balance of principal at death) is effectively added back into the estate of the deceased spouse and the tax on the estate of the deceased spouse is recalculated. In determining whether a trustee has made a distribution of principal from a QDOT, the IRS will generally honor the exercise of the trustee power to adjust between principal and income under Prob C §16336 for purposes of fulfilling the trustee's duty of impartiality under Prob C §16003. Treas Reg §§20.2056(b)-7(d)(1), 20.2056A-5(c)(2). The primary function of the QDOT is to provide a mechanism for assuring that the government will eventually receive its tax even if the surviving noncitizen spouse is never subject to United States estate tax. IRC §2056A. The IRS also should honor a trust provision giving the surviving spouse a unitrust interest with a payout percentage between 3 and 5 percent, instead of an income interest. Under Treas Reg §§20.2056A-5(c)(2), the term "income" has the same meaning as provided in IRC §643(b). The definition of "income" in Treas Reg §1.643(b)-1 includes a unitrust amount of no less than 3 percent and no more than 5 percent of the fair market value of trust assets if provided by local law, and Prob C §16328 provides that "net income" means a unitrust amount between 3 and 5 percent during any period in which the trust is being administered as a unitrust under the trustee conversion powers in Prob C §§16336.4-16336.7 or the terms of the trust. Thus, the trustee can pay the spouse as much as 5 percent per year of trust assets (an amount likely to be larger than traditional trust income) under the terms of the trust without making a distribution of trust principal.

EXAMPLE: Noncitizen Spouse receives one-half of Decedent's $4 million estate. Decedent's applicable exclusion amount is used to shelter $2 million in assets passing to Decedent's children. Spouse receives the remaining $2 million in assets, including a residence with a fair market value of $1 million and $1 million in marketable securities. Spouse creates a QDOT with a 5-percent unitrust interest to hold the assets. Spouse will pay the trustee $3000 per month to live in the residence and the trustee will pay Spouse $100,000 per year, based on the value of trust assets.

In a unitrust QDOT, in contrast to an inter vivos unitrust QTIP (see §2.39C), the drafter presumably would want to maximize the amount paid to the spouse. Accordingly, the drafter normally would choose the highest possible payout percentage, and the drafter would not wish to provide that residential property used by the spouse is not included in determining the unitrust amount, as permitted by Treas Reg §§20.2056(b)-7(d)(1) and as provided by Prob C §16336.4(e)(4)(A). Instead, the spouse will pay the trustee fair market rent for the use of the residence (to avoid a deemed distribution of principal) and the trustee in turn will pay the spouse 5 percent of the fair market value of the residence each year (likely to be a larger sum for residential property in California). For alternative unitrust and traditional income clauses, see §2.81F.

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§2.81 a. Requirements of Qualified Domestic Trust (QDOT)

To qualify as a qualified domestic trust (QDOT), a trust must otherwise qualify for the marital deduction (*i.e.,* as a qualified terminable interest property trust, a general power of appointment trust, or an estate trust) *or* the trust must be established by a surviving spouse who received the property in a transfer that qualified for the marital deduction. Generally, at least one trustee must be a United States citizen or bank, although the Service may waive this requirement. IRC §2056A(a)(1). Certain requirements (including bonding, depending on the value of assets held in the QDOT) ensure collection of the §2056A tax.

- If the QDOT assets are worth more than $2 million, the trust instrument must require that either (1) at least one United States trustee is a bank or (2) the United States trustee furnish a bond, letter of credit, or other acceptable security equal to 65 percent of the fair market value of the trust corpus, based on the date-of-death value of assets transferred to the QDOT. Treas Reg §20.2056A-2(d)(1)(i).
- If assets held in the QDOT are worth $2 million or less, the trust instrument must require one of the following: (1) At least one United States trustee is a bank; (2) the United States trustee furnish a bond or security equal to 65 percent of the fair market value of trust corpus, based on the date-of-death value of assets transferred to the QDOT; or (3) no more than 35 percent of the fair market value of trust assets, determined annually on the last day of the trust's taxable year, consist of real property located outside the United States. Treas Reg §20.2056A-2(d)(1)(ii).
- For purposes of determining whether the $2 million threshold has been exceeded, the executor of the estate may elect to exclude up to $600,000 in value attributable to real property and related furnishings used by the surviving spouse as a personal residence. Treas Reg §20.2056A-2(d)(1)(iii).
- If the trustee uses any device having as its principal purpose the avoidance of federal estate tax, the trust immediately ceases to qualify as a QDOT. Treas Reg §20.2056A-2(d)(1)(v).
- No distributions of principal may be made from a QDOT unless the United States trustee has the right to withhold from the distribution the additional tax caused by the distribution. IRC §2056A(a).

Unlike other areas of federal estate tax, the reformation of trusts to qualify as QDOTs is anticipated and encouraged. See IRC §2056(d)(5); Treas Reg §20.2056A-4. Sample language for complying with the security requirements is contained in Rev Proc 96-54, 1996-2 Cum Bull 386. Some practitioners prefer to use surviving-spouse established QDOTs, which are grantor trusts under IRC §671, because it simplifies income tax reporting. If the spouse creates such a trust, the spouse must retain a power of appointment over the remainder interest to avoid making a completed gift when property is transferred to the trust.

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§2.81A (1) Inter Vivos Qualified Domestic Trust

If the decedent leaves property to a standard marital deduction trust, the trust can be reformed to satisfy the requirements of IRC §2056A. If, however, property passes outright to the spouse, the temporary marital deduction is available only if the surviving spouse establishes an irrevocable inter vivos trust meeting qualified domestic trust (QDOT) requirements. The form provisions in §§2.81B-2.81G are intended for use by a noncitizen surviving spouse wishing to establish such a trust. The trust must be funded with property included in the decedent's gross estate (or acquired by sale or exchange of such assets). Treas Reg §20.2056A-4(b)(3). To satisfy the requirements for a QDOT, the trust generally must have a "United States trustee" who has the power to withhold the QDOT tax in connection with any distribution of principal from the trust. Because the outright transfer from the decedent to the surviving spouse is sufficient to satisfy regular marital deduction requirements, it is not necessary for the trust to satisfy those requirements.

The trust should require that the trustee must make all distributions to the spouse that will not be subject to the QDOT tax. Accumulation of income in the trust, or some other failure to make an exempt distribution, could lead to a later dispute concerning the amount of property subject to tax on the surviving spouse's death. The statute appears to impose the tax on all property of the trust on the date of death. IRC §2056A(b)(1)(B). The tax does not apply in 2010. IRC §2210(b)(2). Even if the statute is not applied literally, it is easier to currently distribute income than to try to distinguish between income and principal at a later date.

An inter vivos QDOT should have some mechanism for terminating the trust in the event the spouse becomes a citizen and the trust is no longer subject to tax. The form effectively permits termination by giving the settlor a withdrawal power.

The drafter should take care to avoid making a completed gift of the remainder when establishing the trust. The form accomplishes this by causing the settlor to retain a general power of appointment with respect to the remainder. Generally, a disposition of the remainder in favor of the settlor's estate or revocable trust will be desirable to avoid complex problems of tax apportionment and tax collection on the settlor's death.

Because of the spouse's right to income and power to dispose of the remainder, the trust will be a grantor trust under IRC §671 for income tax purposes. IRC §677.

The code and regulations contain detailed provisions concerning the timing requirements for establishing and funding the QDOT and making the required QDOT election. Further, QDOTs are subject to a variety of special tax return requirements. A QDOT will not accomplish its purposes unless there is compliance with these requirements. See §2.81.

Because the QDOT in the form is a "grantor trust" under IRC §671, no gain or loss will be recognized if the settlor exchanges assets with the trust after the trust is funded. For complete form, see App J.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.81B (2) Form: Construction of Trust

§2.81B (2) Form: Construction of Trust

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2.81B-1 Construction of trust

ARTICLE TWO
Qualified Domestic Trust

A. *Purpose of Trust*. This trust is intended to be a qualified domestic trust ("QDOT") satisfying the requirements of Internal Revenue Code §2056A, and applicable Treasury Regulations, including Treasury Regulation §§20.2056A-0 through 20.2056A-13. All provisions of this trust shall be construed in a manner that will result in the trust satisfying those requirements and the trustee shall administer the trust accordingly. The trustee shall have continuing authority to modify this trust to the extent necessary to satisfy those requirements.

Comment: The foregoing language is not required, but is highly recommended.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.81C (3) Form: Compliance With Security Requirements

§2.81C (3) Form: Compliance With Security Requirements

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2.81C-1 Compliance with security requirements

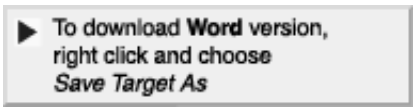
B. *Security Requirements*. This trust must be administered in compliance with Treasury Regulation §20.2056A-2(d)(1)(i)(A), (B), or (C).

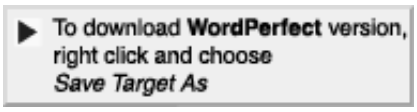
Comment: The governing instrument must contain the language of this subparagraph or far more extensive language concerning compliance with requirements for security arrangements. Treas Reg §20.2056A-2(d)(1)(i); Rev Proc 96-54, 1996-2 Cum Bull 386.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.81D (4) Form: United States Trustee

§2.81D (4) Form: United States Trustee





2.81D-1 United States trustee

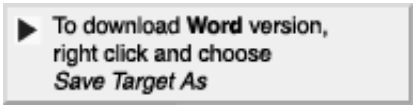
C. *United States Trustee*. In accordance with the requirements of Internal Revenue Code §2056A, this trust shall at all times have at least one trustee who is a citizen of the United States with a tax home (as defined in Internal Revenue Code §911(d)(3)) in the United States or a domestic corporation. The trustee satisfying this requirement is hereafter referred to as "the United States trustee." No distribution (other than a distribution of income) may be made from this trust unless the United States trustee has the right to withhold from such distribution the tax imposed by Internal Revenue Code §2056A.

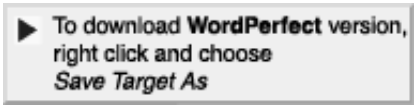
Comment: The provisions of this subparagraph are required by IRC §2056A(a)(1)(A)-(B) and Treas Reg §20.2056A-2(d)(2).

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.81E (5) Form: Designated Filer

§2.81E (5) Form: Designated Filer





2.81E-1 Optional addition: Designated filer

D. *Designated Filer*. Property of the settlor's predeceased spouse has been transferred to more than one qualified domestic trust for the benefit of the settlor. The Internal Revenue Code §2056A(b)(2)(C) designated filer for all of such trusts is _ _[*e.g., the United States trustee of this trust*]**_ _.**

Comment: This paragraph is not needed unless there is more than one QDOT. If there are multiple QDOTs, QDOT tax will be imposed at the maximum estate tax rate unless there is a designated filer. IRC §2056A(b)(2)(C). A designated filer is named on the estate tax return and a majority of the trustees can elect a replacement if necessary. Treas Reg §20.2056A-9. Multiple QDOTs with different beneficiaries create difficult coordination problems because the QDOTs that distribute principal first will often be subject to lower estate tax rates than the QDOTs distributing principal later.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.81F (6) Form: Distributions of Principal and Income

§2.81F (6) Form: Distributions of Principal and Income

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2.81F-1 Distributions of principal and income

ARTICLE THREE
Distributions

A. *Trustee's Right to Withhold Tax*. The provisions of this Article Three are subject to the right of the United States trustee to withhold from distribution the tax imposed by Internal Revenue Code §2056A, as set forth in Article Two.

B. *Mandatory Distribution of Income*. During the lifetime of the settlor, the trustee shall pay to or apply for the benefit of the settlor, at quarter-annual or more frequent intervals, _ _[*all income of the trust/a unitrust amount equal to 5 percent of the net fair market value of the trust assets, valued annually on the first day of the trust's taxable year for federal income tax purposes in such reasonable manner as the trustee shall, in the trustee's discretion, determine*]**_ _ and such amounts of principal as may be so paid or applied without making a distribution that will be subject to tax (regardless of whether any tax would be due) under Internal Revenue Code §2056A(b).**

C. *Discretionary Distributions of Principal*. If the foregoing amounts are insufficient, the trustee shall pay to or apply for the benefit of the settlor, at quarter-annual or more frequent intervals, such additional sums as the trustee determines are appropriate for the settlor's health, education, maintenance, and support. In exercising its discretion, the trustee is not required to take into account other income and resources available for these purposes.

D. *Settlor's Withdrawal Power*. The trustee shall further pay to or apply for the benefit of the settlor such additional sums as the settlor may from time to time request in writing. This power of withdrawal may be exercised on behalf of the settlor by an attorney-in-fact if so authorized in the appointing instrument.

E. *Distribution to Settlor on Termination*. If this trust is terminated during the life of the settlor, the balance of the trust estate shall be distributed to the settlor.

F. *Settlor's Power of Appointment*. On the death of the settlor, the remaining trust estate shall be distributed as the settlor directs in a written instrument delivered to the trustee during the settlor's lifetime. This is a general power of appointment, which may be exercised in favor of any desired appointee including the settlor's estate. In the event this power of appointment is not effectively exercised with respect to any assets of the trust estate, those assets shall be distributed on the death of the settlor as follows: _ _[*specify*]**_ _.**

Comment: The alternative unitrust language in Paragraph B is also intended to satisfy the right of the spouse to all income of the trust and may allow the spouse to receive a larger amount. See §2.80.

If the settlor has a revocable trust estate plan, it may be desirable for the QDOT trust to pour over to the revocable trust. The tax on distributions from the QDOT during the lifetime of the settlor under IRC §2056A(b)(1)(A) applies until December 31, 2020, even if estate tax repeal becomes permanent in 2010. IRC §2210(b)(1). The tax on the value of the property remaining in the QDOT on the death of the settlor under IRC §2056A(b)(1)(B) does not apply to decedents dying after December 31, 2009. IRC §2210(b)(2).

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§2.81G (7) Form: Designation of Successor Trustees

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2.81G-1 Restrictions on trustee

ARTICLE FOUR
Trustees

A. *Restrictions on Trustee*. The provisions of this Article Four are subject to the restrictions contained in Article Two.

2.81G-2 Designation of successor trustees

B. *Nomination of Successor Trustees*. If at any time a trustee ceases to act as trustee, the settlor may name a new trustee. If the settlor fails to do so, the _ _[*person(s)/institution(s)*]_ _ listed below shall serve as successor trustee(s) in the order named:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

_ _[*If the nominated successor also fails to qualify or ceases to act, _ _[name]_ _ may name a successor trustee.*]_ _

Comment: In the context of a QDOT, it is permissible to give the settlor the power to name successor trustees.

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§2.81H (8) Alternative Spousal Access Trust

An alternative to a qualified domestic trust (QDOT) for a noncitizen spouse is a form of irrevocable life insurance trust (ILIT) known as a spousal access trust. See Balakrishna, *Using a Spousal Access Trust as a QDOT Alternative for a Noncitizen Spouse,* 35 Est Plan 15 (June 2008). The trust is generally funded with a single-life insurance policy on the grantor's life to provide for the surviving spouse during the grantor's life and after the grantor's death. The trust is funded with annual exclusion gifts and may provide for distributions to the grantor's spouse and children during the grantor's lifetime subject to an ascertainable standard, allowing access to the policy cash value. If necessary, additional gifts can be made using the grantor's $1 million lifetime gift exemption. Because a spousal access trust for a noncitizen spouse need not qualify for the marital deduction, it can be more flexible than a QDOT. The beneficiary spouse can be named as the trustee, as long as distributions are subject to an ascertainable standard, or an independent trustee can be given greater discretion to make distributions to the grantor's spouse and children. As long as the trust is drafted and administered correctly, the trust assets will not be included in the grantor's estate. Proceeds payable on the grantor's death are excluded from taxable income. IRC §101(a). For further discussion of life insurance trusts, see chap 11.

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§2.82 b. Credit for Prior Transfer Property (PTP)

If the noncitizen surviving spouse's estate is eventually subject to United States estate tax, the survivor's estate may claim a prior transfer property (PTP) credit for the full amount of the federal estate tax paid by the deceased spouse for property included in the gross estate of the surviving spouse. See IRC §2056(d)(3). In a departure from the normal IRC §2013 rules (see §2.86), the credit is not reduced or eliminated due to the length of time between the deceased spouse's death and the surviving spouse's death. Treasury Regulation §20.2056A-7(a) provides that when property is transferred from a qualified domestic trust (QDOT) to the surviving spouse during his or her lifetime for other than hardship and, as a result, deferred estate tax is paid, the surviving spouse's estate is entitled to a full PTP credit.

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§2.83 c. Applicability of Customary Marital Deduction Rules When Spouse Becomes United States Citizen

If the surviving spouse was a resident of the United States at all times after the death of the deceased spouse and becomes a citizen before the date on which Form 706 is filed, the customary rules applicable to United States citizens for determining the marital deduction (see §§2.75-2.79) govern. A qualified domestic trust (QDOT) is also no longer subject to deferred estate tax as part of the deceased spouse's estate when the surviving spouse, who was a United States *resident* at all times after the deceased spouse's death and before becoming a citizen, becomes a citizen after the QDOT is established or when no taxable distributions were made from the QDOT before the surviving spouse became a citizen (regardless of the residency of the spouse). Treas Reg §20.2056A-10(a)(1). The United States trustee, however, must notify the IRS of the surviving spouse's citizenship (by filing final Form 706-QDT on or before April 15, plus extensions, of the year following the year in which the spouse became a citizen) and must certify in writing that the spouse is a citizen. Treas Reg §20.2056A-10(a)(2). Note that IRC §2056A(b)(12) does not impose any such notice requirement, and the instructions for Form 706-QDT do not indicate that the filing is mandatory when the surviving spouse becomes a citizen. In IRS Letter Rulings 200719002 and 200451024, the IRS granted an extension of time to satisfy the notice requirement when the spouse's attorney or the trustee inadvertently failed to file the required notice. Finally, when a surviving spouse, who was not a resident of the United States at all times after the deceased spouse's death and before becoming a citizen has received distributions from the QDOT on which deferred estate tax was imposed, and the spouse then becomes a citizen, the QDOT no longer is subject to deferred estate tax as part of the deceased spouse's estate if the surviving spouse makes a special election to treat the previously made taxable distributions from the QDOT as taxable gifts by the spouse. Treas Reg §20.2056A-10(b). Assuming the spouse was always a resident or there were never distributions subject to QDOT tax, there is no need to make the election on Form 706-QDT.

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K. Credits Applicable to Estate Tax

§2.84 1. Credit for State Death Taxes

When determining the credits available to a decedent's estate, a particularly troublesome area is determination of the credit for state death taxes. See IRC §2011. The following restrictions limit availability of the credit:

- The credit is available only to the extent that tax has actually been paid to one or more states within four years after filing of the Form 706, subject to three limited exceptions set out in IRC §2011(c)(1)-(3).
- The credit is limited to an amount determined under IRC §2011(b). Under that section, the credit is based on the decedent's taxable estate (*i.e.*, the gross estate minus deductions, and not the decedent's estate tax base, which includes adjusted taxable gifts), reduced by $60,000, under a table using marginal rates ranging up to 16 percent. The credit is repealed for estates of decedents dying in 2004-2009. IRC §2011(f). The credit is replaced in these years by the IRC §2058 deduction for state death taxes paid. Under the deduction, however, total taxes are increased if any state death tax is paid, and the California estate tax is a pick-up tax that results in no payment of tax if the federal estate tax is not reduced by 100 percent of state death tax paid. Rev & T C §13302. See §20.80.
- If the decedent has assets located in a state that imposes death taxes exceeding the amount determined under IRC §2011, no credit is allowed to the extent that the state death tax actually paid exceeds the amount of the credit determined under IRC §2011. States that impose a pick-up tax (*i.e.,* a tax equal to the credit under IRC §2011) typically provide that if estate assets are located in more than one state, the credit determined under IRC §2011 will be apportioned among the states on the basis of the fair market value of the assets located in each state. For decedents dying in 2004-2009, however, these states will not be entitled to any tax, and the decedent will only pay tax to states that impose an additional death tax on property subject to that state's jurisdiction, as discussed in chap 20.

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§2.85 2. Credit for Gift Taxes Paid

The credit for gift taxes paid (see IRC §2012) applies only to gift taxes paid for gifts made before January 1, 1977, on gifts included in the decedent's gross estate (for example, under IRC §§2035-2038). For gifts made on and after January 1, 1977, the actual gift taxes paid are irrelevant. Instead, gift taxes payable are specifically covered under rules that subtract gift taxes payable on the adjusted taxable gifts from the tentative tax. Both of these calculations use the rates applicable on the decedent's date of death.

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§2.86 3. Credit for Prior Transfer Property (PTP)

A credit is available for estate taxes paid on a prior transfer. See IRC §2013. It is generally available in two situations.

EXAMPLE 1: *A* dies and leaves property to *D*, who dies within 10 years of *A's* death. *D*'s estate is entitled to a prior transfer property (PTP) credit for the amount of estate tax paid by *A*'s estate on property included in *D*'s taxable estate. IRC §2013.

EXAMPLE 2: *A* gives property to *D* that will be included in *A*'s gross estate. *D* dies, and *D*'s gross estate includes the property received from *A*. If *A* dies within 2 years after *D*'s death, *D*'s estate can claim a PTP credit for the full amount of federal estate tax paid by *A*'s estate attributable to property included in *D*'s gross estate. If *A* dies more than 10 years before or 2 years after *D*, no credit is allowed. IRC §2013.

The credit is sometimes also available under a QTIP trust estate plan if the surviving spouse dies soon after the deceased spouse, but was not so sick on the date of the first death that Treas Reg §20.7520-3(b)(3)(i) will apply. Under that regulation, the valuation tables cannot be used to determine life expectancy if, as of the deceased spouse's death, the survivor's health is such that there is a least a 50-percent probability that the survivor will die within one year. In this situation, the personal representative of the deceased spouse may then decline to make the QTIP election. This results in the deceased spouse having a taxable estate. For PTP credit purposes, the survivor is treated as receiving a transfer of the income interest. If a partial election is made, the survivor is treated as receiving the full value of the property for which the election was made plus the value of the life income interest for the portion of the property for which the election was not made. See digest and comment for IRS Legal Memorandum 200218003 in 23 CEB Est Plan Rep 163 (June 2002). Because the PTP rules do not provide for tracing the transferred property, it will be irrelevant that the survivor's early death results in the survivor receiving little if any income from the trust. No credit is allowed, however, if both spouses die in a common accident. Treas Reg §20.7520-3(b)(3)(iii). For further discussion, see digest and comment for *Estate of Judith U. Harrison* (2000) 115 TC 161 in 22 CEB Est Plan Rep 47 (Oct. 2000).

The amount of the credit available is determined under IRC §2013(b). It is a fraction of the estate tax paid by the prior decedent, *A*. The numerator of the fraction is the value for estate tax purposes of the property *D* receives from *A,* and the denominator is the value of *A*'s taxable estate. As indicated above, the PTP credit cannot exceed the federal estate tax attributable to property included in *D*'s gross estate. IRC §2013(c).

The amount of credit also varies depending on the number of years between *A*'s death and *D*'s death. If *D* dies within two years of *A* (either before or after), *D*'s estate may claim a credit equal to the full amount determined under IRC §2013(b). The credit is reduced if *D*'s death occurs more than 2 years after *A*'s death, as follows:

- If *D*'s death occurs in the third or fourth year after *A*'s death, *D*'s estate may claim 80 percent of the full credit;
- If *D*'s death occurs in the fifth or sixth year after *A*'s death, *D*'s estate may claim 60 percent of the full credit;
- If *D*'s death occurs in the seventh or eighth year after *A*'s death, *D*'s estate may claim 40 percent of the full credit;
- If *D*'s death occurs in the ninth or tenth year after *A*'s death, *D*'s estate may claim 20 percent of the full credit; and
- If *D*'s death occurs more than 10 years after *A*'s death, no credit will be available.

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L. Payment of Estate Tax

§2.87 1. General Rule

The full amount of federal estate tax due must usually be paid nine months after the decedent's death. IRC §6151. Limited exceptions and special rules, however, govern the payment of estate tax in some circumstances, as discussed in §§2.88-2.91.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.88 2. Extension of Time for Reasonable Cause

§2.88 2. Extension of Time for Reasonable Cause

The IRS can extend the time for the payment of the estate tax for a period of 1 to 10 years on a showing of reasonable cause. IRC §6161. Reasonable cause can be demonstrated if the estate is highly illiquid (*e.g.,* extensive real estate holdings) and does not qualify for installment payment of estate tax under IRC §6166. See *Estate of Donny D. Doster,* TC Memo 2002-2 (IRS did not abuse discretion by denying extension to pay estate tax on nonassignable rights to lottery payments). If an extension is granted for reasonable cause, interest accrues on the deferred estate tax at normal deficiency rates.

PRACTICE TIP: An estate usually can obtain only a 1-year deferral, and it must reapply annually for an additional deferral.

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Source: Estate Planning/Drafting California Irrevocable Trusts/2 Estate and Gift Tax: A Drafter's Guide/§2.89 3. Extension of Time for Tax Attributable to Interest in Closely Held Business

§2.89 3. Extension of Time for Tax Attributable to Interest in Closely Held Business

Under IRC §6166, estate taxes attributable to interests in closely held businesses can be paid in 14 annual installments (9 in the case of certain holding company stock), with the first installment due one year and nine months after death. The first four installments are interest only; the last ten (or five) are principal plus interest. (Under a special rule for stock in qualifying lending and finance businesses, the estate tax can be paid in five equal annual installments, including principal, beginning on the due date of the estate tax return without regard to extensions.) The outstanding balance of tax is divided into a 2-percent portion and a remaining portion. Interest accrues on the 2-percent portion at that rate and on the remaining portion at the rate of 45 percent of the rate charged on underpayments of tax. IRC §6601(j). The interest cannot be deducted for estate or income tax purposes. IRC §163(k).

To qualify for the extension of time under IRC §6166 to pay estate tax attributable to a closely held business or farm, the following requirements must be met:

- The value of the business or farm must exceed 35 percent of the value of the decedent's adjusted gross estate. The adjusted gross estate is the gross estate reduced by the deductions available under IRC §§2053-2054 for administration expenses, debts, and losses (see §2.73). Additional requirements apply to qualifying lending and finance businesses. IRC §6166(b)(10).
- The business must not have more than 45 partners or shareholders; alternatively, 20 percent or more of the total capital interest in the partnership or 20 percent of the stock of the corporation must be included in the decedent's estate. (These tests also apply to limited liability companies taxed as partnerships.) IRC §6166(b)(1). Community property interests are treated as owned by one partner or shareholder and interests owned by members of decedent's family are treated as owned by the decedent for purposes of the 45-owner limit but not the 20-percent ownership rule, unless the estate makes an election under IRC §6166(b)(7) to treat non-readily-tradable partnership interests or stock of family members as owned by the decedent, in which case the estate must pay the estate tax in 10 installments beginning on the regular due date for payment of the tax. The election also results in a loss of the right to pay interest at the 2-percent rate for a portion of the unpaid tax. IRS Letter Ruling 200529006.
- The decedent must have actively participated in the business or farm until his or her death (*i.e.,* passive ownership of rental properties does not qualify for IRC §6166 deferral). IRC §6166(b)(9). In Rev Rul 2006-34, 2006-26 Int Rev Bull 1171, the IRS issued guidance concerning the factors that might be relevant in determining whether real property is used in a trade or business. In general, the ruling compares the level and type of services performed by the decedent with the services performed by independent contractors. In IRS Letter Ruling 200340012, the IRS concluded that the decedent's activities in connection with rentals of real property, including activities of his sons and employees, were sufficient to qualify his assets as assets held by a trade or business, even though some activities were performed by independent contractors.
- If more than 50 percent of the interest in the business or farm is distributed, sold, exchanged, or otherwise disposed of, or more than 50 percent of the funds are withdrawn from the business or farm, the balance of federal estate tax that remains to be paid immediately becomes due and payable. An exception to this rule applies, however, if the interest is redeemed in an IRC §303 redemption. IRC §6166(g)(1). A transfer of a business to a limited liability company, however, is not a disposition. IRS Letter Ruling 200129018.
- If any installment payment is late, the 2-percent interest rate will be lost for that payment, and a penalty will be assessed. If more than 6 months have passed since the due date of the installment payment, the balance of the deferred estate tax will become immediately due and payable. IRC §6166(g)(3). Under IRC §7422(j), an estate may not sue for a refund of estate tax that is being paid in installments if the IRS has accelerated any portion of the tax. *Hansen v U.S.* (8th Cir 2001) 248 F3d 761.

To the extent that the estate tax is paid in installments under these provisions, IRC §6324 imposes a lien for federal estate tax on the assets of the decedent's estate, except for those used to pay debts and administration expenses, for

10 years after the date of the decedent's death or until sooner paid in full. The executor can also make an election to provide a special lien on the closely held business interests for the entire deferral period under IRC §6324A in lieu of bond that may be required by the IRS under IRC §6165. However, the Tax Court has held that the IRS cannot require a bond or lien for every estate election. *Estate of Edward P. Roski, Sr.* (2007) 128 TC 113.

In Notice 2007-90, 2007-46 Int Rev Bull 1003, the IRS issued interim guidance in advance of regulations that would set standards to be applied on a case-by-case basis in determining whether a bond or lien will be required to qualify for the election. The IRS has since issued additional guidance in the form of a program manager technical advice (PMTA) memorandum. PMTA 2009-046, 2009 TNT 129-21, Tax Analysts Doc No. 2009-15307. The memorandum states that the amount of bond required by the IRS in its discretion may include interest that will be payable in the future in an amount not exceeding the amount of the deferred tax. Consistent with the *Roski* decision, the memorandum also states that the IRS can require a bond or lien in an amount less than the maximum amount.

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§2.90 4. Extension of Time for Tax Attributable to Vested Remainder Interest

A decedent's estate may extend the time for the payment of tax attributable to a vested remainder interest, which must be included in the gross estate even though the life-estate beneficiary is still living, until six months following the delivery of assets as a result of the death of the life tenant. IRC §6163(a). This period may be extended for up to 3 years for reasonable cause. IRC §6163(b). Interest accrues on the deferred estate tax at normal deficiency rates.

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§2.91 5. Stock Redemptions to Pay Estate Tax

In general, any distribution by a corporation to its shareholders is a dividend distribution that is treated as ordinary income to the shareholders to the extent that it is considered paid from current or accumulated earnings and profits of the corporation. IRC §301. A distribution is treated as a liquidating distribution, however, if it is made (a) by a corporation to a deceased shareholder's successors in redemption of some or all of the decedent's of the corporation, and (b) in an amount that does not exceed the sum of the estate tax and all other death taxes due as a result of the shareholder's death and the funeral and administration expenses allowable as a deduction to the shareholder's estate. IRC §303(a). See IRC §2053 (deductible expenses). Under legislation enacted in 2001, no federal or California estate tax will be paid as a result of the death of shareholders dying in 2010, but some states may continue to apply death taxes. See chap 20. To the extent that the distribution is a liquidating distribution, the difference between the amount distributed to the shareholder's estate and the basis of the shareholder's estate for the stock is taxed as a capital gain. Because the basis will equal the stock's fair market value as of the date of the shareholder's death under IRC §1014 if the shareholder dies after 2010, and the stock may receive an allocation of aggregate basis increase sufficient to increase the carryover basis to the stock's fair market value as of the date of the shareholder's death under IRC §1022 if the shareholder dies in 2010, the amount of capital gain that must be reported by the deceased shareholder's successor will be frequently nominal, if not zero, for redemptions shortly after the date of death.

For the deceased shareholder's successor to be eligible to make an IRC §303 redemption, the redeemed stock must be included in the decedent's gross estate (IRC §303(a)), and the stock's value must exceed 35 percent of the decedent's adjusted gross estate (IRC §303(b)(2)). The shareholder's interest in the corporation must be directly reduced by the redemption. IRC §303(b)(3). Thus, when the corporation is owned by two or more unrelated shareholders, the attorney should give careful consideration to whether a §303 redemption is a viable alternative when the redemption will result in loss of control or loss of the ability to block undesirable shareholder actions.

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3

Income Tax: A Drafter's Guide

Ann C. Harris

I. INTRODUCTION TO TRUST TAXATION

A. Nongrantor and Grantor Trusts §3.1

B. Relationship Between Federal and California Income Tax Rules §3.2

II. TAXATION OF NONGRANTOR TRUSTS

A. Characterization of Nongrantor Trust

1. Trust Is Treated as Separate Taxpayer, Pass-Through Entity, or Both §3.3

2. Trust May Be Treated as Association §3.4

B. General Rules

1. Determining Taxable Income §3.5

2. Selecting Tax Year §3.6

3. Income Tax Rates Applicable to Trusts §3.7

4. Disallowance of Certain Capital Losses §3.8

5. Alternative Minimum Tax §3.9

C. Determining Distributable Net Income (DNI) §3.10

D. Simple Trusts

1. Definition of Simple Trust §3.11

2. Taxation of Simple Trust and Its Beneficiaries §3.12

3. Estimated Tax Payments for Simple Trusts §3.13

E. Complex Trusts

1. Definition of Complex Trust §3.14

2. Taxation of Complex Trusts §3.15

3. Estimated Tax Payments for Complex Trusts

a. Determining Liability for and Amount of Estimated Tax Payments §3.16

b. Problems in Determining Estimated Tax Using Annualized Income Method §3.17

(1) Trustee Problems §3.17A

(2) Beneficiary Problems §3.17B

4. Taxation of Beneficiaries of Complex Trusts §3.18

a. First-Tier Distributions §3.18A

b. Second-Tier Distributions §3.18B

c. The Intermediate Tier §3.18C

d. The Variable Tier §3.18D

5. Separate Share Rule §3.18E

F. Impact of "Kiddie" Tax

1. Operation of "Kiddie" Tax §3.19

2. Avoidance of "Kiddie" Tax §3.20

G. Tax Consequences of Termination of Nongrantor Trusts §3.21

III. TAXATION OF GRANTOR TRUSTS

A. Definition of Grantor Trust §3.22

B. Grantor Trusts Subject to Different Rules §3.23

C. Use of Grantor Trusts as Planning Device §3.24

D. Grantor as Owner of Trust

1. Retained Powers That Cause Grantor to Be Treated as Owner

a. Right to Reversionary Interest §3.25

b. Right to Control Enjoyment of Trust §3.26

c. Administrative Powers §3.27

d. Power to Revest Title to Trust Property §3.28

e. Power to Use Income for Grantor's Benefit §3.29

2. Retained Powers That Do Not Cause Grantor to Be Treated as Owner §3.30

a. Power to Apply Income and Principal to Support of Dependents §3.31

b. Power to Distribute Corpus Under Certain Circumstances §3.32

c. Power to Accumulate Income Under Certain Circumstances §3.33

d. Power to Distribute or Accumulate Income for Minor Beneficiary §3.34

e. Trustee's Power to Distribute Income and Principal That Is Limited by Ascertainable Standard §3.35

f. Independent Trustee's Powers §3.36

g. Power to Use Income to Discharge Grantor's Support Obligations §3.37

E. Person Other Than Grantor Treated as Owner §3.38

F. Tax Treatment of and Reporting for Grantor Trusts §3.39

1. Trust Owned Entirely by One Person Who Is a Trustee §3.39A

2. Trust Owned Entirely by One Person Who Is Not a Trustee §3.39B

3. Trust Owned Entirely by Two or More Persons §3.39C

4. Grantor Trust Reporting in All Other Cases §3.39D

G. Creating "Defective" Grantor Trusts

1. IRC §674(c) Provisions §3.40

2. IRC §675(4)(C) Provisions §3.41

3. Other IRC §675 Provisions §3.41A

4. IRC §677(a)(3) Provisions §3.42

5. IRC §678 Provisions §3.43

6. Special Concerns and Considerations §3.44

H. Former Grantor Trust Taxed as Estate §3.44A

I. Installment Sale to "Defective" Grantor Trust §3.44B

J. Sale to Grantor Trust Versus GRAT §3.44C

K. Beneficiary Defective Trust §3.44D

L. Grantor Irrevocable Life Insurance Trust (GILIT) §3.44E

IV. CHARITABLE REMAINDER TRUSTS AND CHARITABLE LEAD TRUSTS

A. Charitable Remainder Trusts (CRTs) §3.45

1. Taxation of CRTs §3.46

2. Taxation of Noncharitable Beneficiaries §3.47

3. Taxation of Charitable Beneficiaries §3.48

B. Charitable Lead Trusts (CLTs) §3.49

1. Grantor CLTs §3.50

2. Nongrantor CLTs §3.51

V. TRUSTS HOLDING S CORPORATION STOCK

A. General S Corporation Trust Rules §3.52

B. Grantor Trusts Holding S Corporation Stock

1. Eligible Trusts §3.53

2. *Crummey* Trusts §3.54

3. Tax Treatment After Deemed Owner's Death §3.55

4. Areas of Particular Concern §3.56

C. Qualified Subchapter S Trusts (QSSTs)

1. General Rule §3.57

2. Basic Requirements for QSST §3.58

3. Requirement to Distribute All Income §3.59

4. One-Beneficiary Requirement §3.60

5. QSST Election §3.61

6. Tax Consequences of QSST §3.62

7. Creative Use of S Corporations and Trusts §3.63

D. Electing Small Business Trusts (ESBTs)

1. General Rule §3.64

2. Basic Requirements for ESBTs §3.65

3. Determining Number of S Corporation Shareholders §3.66

4. Taxation of ESBTs §3.67

VI. FOREIGN TRUSTS

A. Definition of Foreign Situs Trust §3.68

1. Court Test §3.68A

a. Safe Harbor for Court Test §3.68B

b. Automatic Migration Rule for Court Test §3.68C

2. Control Test §3.68D

a. Twelve-Month Grace Period After Inadvertent Change in Trust Residence §3.68E

b. Automatic Migration Rule for Control Test §3.68F

B. Taxation of Foreign Trusts; Reporting Requirements §3.69

1. Annual Reporting Required for Foreign Trust With United States Grantor §3.69A

a. Appointment of United States Agent §3.69B

b. Owner-Reporting Requirements §3.69C

2. Reporting Establishment of and Transfers to Foreign Trusts §3.69D

a. Reportable Event §3.69E

b. Gratuitous Transfer §3.69F

c. Responsible Party §3.69G

3. Penalties for Failure to Comply With Foreign Trust Reporting Obligations §3.69H

C. Special Grantor-Trust Rules Applicable to Foreign Trusts §3.70

D. Other Issues Connected With Creation and Funding of Foreign Trusts §3.71

E. When Foreign Trust Is Not Taxed as Grantor Trust §3.72

F. Taxation of Beneficiaries of Foreign Trust §3.73

G. Consequences of Using Foreign Trusts to Defer or Avoid Tax §3.74

H. Transfers of Appreciated Property to Foreign Trusts §3.75

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I. INTRODUCTION TO TRUST TAXATION

§3.1 A. Nongrantor and Grantor Trusts

This chapter distinguishes taxation of nongrantor and grantor trusts. Income of an irrevocable trust may be taxed to the trust, its beneficiaries, or its settlors.

- The income of a nongrantor trust is taxed to either the trust itself or the beneficiaries. Generally, most irrevocable trusts are nongrantor trusts. See §§3.3-3.21.
- The income of a grantor trust is taxed to the settlors, with the existence of the trust being ignored for most income tax purposes. See §§3.22-3.44.

Other exceptions to the usual rules include trusts treated as associations (see §3.4) charitable trusts (see §§3.45-3.51), qualified subchapter S trusts or electing small business trusts (see §§3.52-3.67), and foreign trusts (see §§3.68-3.74). In addition, some grantor trusts may be treated as part of the estate of the grantor for a period of time following death of the grantor, in which case the separate existence of the trust is essentially ignored. IRC §645. This option is typically available in the case of a revocable trust that becomes irrevocable as a result of the grantor's death. An advantage of making the election is that estates are permitted to use fiscal year tax years.

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§3.2 B. Relationship Between Federal and California Income Tax Rules

Taxation of estates, trusts, and beneficiaries in California is determined according to Subchapter J of the Internal Revenue Code (IRC §§641-692), except as provided otherwise in the Revenue and Taxation Code. Rev & T C §17731. For taxable years beginning on or after January 1, 2010, California law conforms to IRC provisions as enacted through January 1, 2009. Rev & T C §17024.5(a)(1). California has not conformed to IRC §679, pertaining to foreign trusts. Rev & T C §17024.5(b)(6). See §3.70.

Although federal and California fiduciary income taxation of trusts is parallel, the rules are not entirely the same for out-of-state trusts. California treats the California residency of any beneficiary or trustee as sufficient nexus to impose a tax. See chap 20.

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II. TAXATION OF NONGRANTOR TRUSTS

A. Characterization of Nongrantor Trust

§3.3 1. Trust Is Treated as Separate Taxpayer, Pass-Through Entity, or Both

Nongrantor trusts, governed by Subchapter J of the Internal Revenue Code (IRC §§641-692), are irrevocable trusts that are treated as separate taxpayers. These trusts are allowed a deduction for the amount of distributable net income (DNI) distributed to the beneficiaries. See §§3.5-3.21 for discussion of the taxation of nongrantor trusts and beneficiaries.

CAVEAT: Two or more nongrantor trusts with substantially the same grantor and the same primary beneficiaries may be treated as a single trust for income tax purposes if the principal purpose of the trusts is the avoidance of tax. IRC §643(f).

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§3.4 2. Trust May Be Treated as Association

In rare instances, a trust may be treated as an association that is taxable as a corporation if the trust has "associates" and "an objective to carry on business and divide the gains therefrom." Treas Reg §301.7701-2. In determining whether a trust is actually an association taxable as a corporation, the key factors are the extent to which the trust (a) is authorized to and actually does carry on active business operations and (b) affords opportunities for investors to voluntarily associate themselves to pursue a joint profit. See *Laurel Hill Cemetery Ass'n v U.S.* (ED Mo 1977) 427 F Supp 679, aff'd (8th Cir 1977) 566 F2d 630.

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B. General Rules

§3.5 1. Determining Taxable Income

The taxable income of a nongrantor trust is computed in much the same manner as taxable income for individuals. IRC §641(b). There are specific differences, however, with respect to computing the taxable income of trusts:

- Certain deductions may be claimed as estate tax deductions or income tax deductions, but not both (IRC §§213(c), 642(g));
- Special rules apply to the allocation of the depreciation deduction (IRC §167(d));
- The deduction for the personal exemption is lower and varies depending on whether the trust is a simple trust (see §§3.11-3.13) or a complex trust (see §§3.14-3.18D);
- The personal exemption is $300 for a simple trust and $100 for a complex trust (the regular personal exemption applies if the trust is a "qualified disability trust") (IRC §642(b)); and
- Expenses that would be miscellaneous itemized deductions for an individual taxpayer but that would not have been incurred absent the trust (*i.e.,* trustee fees and attorney fees related to trust tax matters) are not subject to the 2-percent adjusted gross income floor (IRC §67(e)). In contrast, trust investment advisor fees are generally considered miscellaneous itemized deductions subject to the 2-percent floor because investment advisor fees are commonly incurred in the absence of a trust. See *Knight v Commissioner* (2008) 552 US 181, 169 L Ed 2d 652, 128 S Ct 782. The IRS also issued proposed regulations shortly before the U.S. Supreme Court decision and has issued further temporary guidance in response to the decision. Prop Treas Reg §1.67-4; Notice 2010-32, 2010-16 Int Rev Bull 594.

A trust may take a deduction for distributions and amounts required to be distributed to beneficiaries. IRC §§651, 661. In general, the distribution deduction is equal to the lesser of the amount distributed or required to be distributed or the trust's distributable net income (DNI). See §3.10 for a discussion of DNI.

A trust is also entitled to a charitable deduction for trust accounting income (other than tax-exempt income) paid to a qualified charity under the terms of the trust. IRC §642(c). However, the requirements for obtaining the deduction can be fairly restrictive. See *Brownstone v U.S.* (2d Cir 2006) 465 F3d 525; *United States Trust Co. v IRS* (5th Cir 1986) 803 F2d 1363; *Mott v U.S.* (Ct Cl 1972) 462 F2d 512, cert denied (1973) 409 US 1108 (trust instrument must both mandate or authorize distributions to charity and provide that distributions are to be made from gross income). See also IRS Letter Ruling 200906008 (deduction allowed for distributions made pursuant to trust instrument provision giving primary beneficiary discretionary power to make distributions to charity). A trust can also claim a charitable deduction for the trust's distributive share of charitable contributions by a partnership in which the trust has an interest (or an S corporation in the case of an electing small business trust (ESBT)), even though the trust instrument has not authorized the charitable contributions. Treas Reg §1.641(c)-1(d)(2)(ii); IRS Letter Ruling 200140080. The trust may take the deduction:

- For income it pays to a charity during the taxable year in which the trust receives the income (IRC §642(c)(1)); or
- For income it pays to a charity before the close of the taxable year after the year in which the trust receives the income, if it makes an appropriate election not later than the time, including extensions, for filing a return for the succeeding year (Treas Reg §1.642(c)-1(b); IRS Letter Ruling 200905027).

In IRS Letter Ruling 200344021, the IRS granted an extension of time to make the election for an amount set aside for a charity pending qualification as a tax-exempt entity. The trust had erroneously claimed a distribution deduction in the year the income was received. In IRS Letter Ruling 200702016, the IRS granted an extension of time to make the election for amounts paid to two charities when payment was delayed by litigation regarding the proper amount of the payments.

In Rev Rul 2004-5, 2004-1 Cum Bull 295, the IRS ruled that a trust could take a charitable deduction for the trust's distributive share of a charitable contribution made by a partnership from gross income, even though the trust's governing instrument did not authorize the trustee to make charitable contributions.

Unlike the charitable deduction for individuals, the charitable deduction for trusts is not limited to a fraction of the trust's adjusted gross income. Special rules applicable to the creation and taxation of charitable remainder trusts (CRTs) and charitable

lead trusts (CLTs) are discussed in §§3.45-3.51.

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§3.6 2. Selecting Tax Year

All nongrantor trusts except charitable trusts must use a calendar year as their taxable year. IRC §644. For tax purposes, a nongrantor trust begins on the date on which property is first transferred to the trustee. This is true whether the nongrantor trust is testamentary or inter vivos. The trust usually terminates on the date of the final distribution of the corpus. If the distribution of trust corpus is unreasonably delayed, however, the trust is considered terminated after the expiration of a reasonable period of time required for the trustee to complete administration of the trust. Treas Reg §1.641(b)-3(b). In cases in which the beneficiaries also use a calendar year as their taxable year, the shortened 5-month automatic extension period (until September 15) for filing an income tax return of the trust in Temp Treas Reg §1.6081-6T, as compared with the 6-month automatic extension period (until October 15) for individual taxpayers in Treas Reg §1.6081-4, increases the likelihood that the beneficiaries will receive K-1 forms from the trust before the extended due dates for filing the beneficiaries' own income tax returns.

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§3.7 3. Income Tax Rates Applicable to Trusts

The federal income tax rates for nongrantor trusts are substantially higher than those for individuals at the same income levels. The rates are adjusted annually for inflation; the 2010 rates are (IRC §1(e)):

Taxable Income	**Federal Rate of Tax**
0-$2,300	15%
$2,301-$5,350	$345 plus 25% of excess over $2,300
$5,351-$8,200	$1,107.50 plus 28% of excess over $5,350
$8,201-$11,200	$1,905.50 plus 33% of excess over $8,200
Over $11,200	$2,895.50 plus 35% of excess over $11,200

The California income tax rates for trusts are the same as those of a single taxpayer at the same income levels. The rates are adjusted annually for inflation; the 2009 rates as temporarily increased by 0.25 percent in each bracket are (Rev & T C §17041(e)):

Taxable Income	**California Rate of Tax**
0-$7,060	1.25%
$7,061-$16,739	$88.25 plus 2.25% of excess over $7,060
$16,740-$26,419	$306.03 plus 4.25% of excess over $16,739
$26,420-$36,675	$717.43 plus 6.25% of excess over $26,419
$36,676-$46,349	$1,358.43 plus 8.25% of excess over $36,675
Over $46,349	$2,156.54 plus 9.55% of excess over $46,349

The maximum federal tax rate for adjusted net capital gains or qualified dividends is 15 percent, regardless of whether the taxpayer is a trust or an individual. The California tax rates are the same for ordinary income and capital gains. Thus, there is little difference between retaining capital gains or qualified dividends in the trust and distributing them to the beneficiaries, except in very unusual circumstances (*e.g.,* when the marginal tax rate applicable to the beneficiary is less than 25 percent; then the tax rate on the gain or dividends is 0 percent). IRC §1(h). However, trusts in the highest federal tax bracket in taxable years beginning after December 31, 2012, are subject to an additional Medicare tax of 3.8 percent on retained "net investment income" that would otherwise apply only to trust income distributed to individual beneficiaries with adjusted gross income in excess of $200,000 per year ($250,000 for married taxpayers filing a joint return). IRC §1411.

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§3.8 4. Disallowance of Certain Capital Losses

Capital losses that occur as a result of transactions between related parties are disallowed. IRC §267(a)(1). Under IRC §267(b)(4)-(8), (13), related parties include:

- An estate and its beneficiaries;
- The settlor of a trust and the trustee of that trust;
- The trustee of one trust and the trustee of another trust if both trusts have the same settlor;
- The trustee of the trust and any of its beneficiaries;
- The trustee of one trust and the beneficiaries of another trust if both trusts have the same settlor; and
- The trustee of a trust and a corporation, more than 50 percent of which is owned by the settlor.

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§3.9 5. Alternative Minimum Tax

The alternative minimum tax (AMT) applies to trusts. IRC §55. The rate of tax is 26 percent of the first $175,000 of alternative minimum taxable income (AMTI) and 28 percent on the excess. Lower rates apply to capital gains. The exemption amount for trusts is $22,500. If the trust has AMTI over $75,000, however, the amount of AMTI subject to the AMT is increased by the lesser of (a) 25 percent of the excess AMTI over $75,000 or (b) $22,500.

PRACTICE TIP: Although the planner should be aware that AMT applies to trusts, in most cases trusts are unlikely to be subject to the tax. This is particularly true for simple trusts and for complex trusts that distribute all or most of their income in the current taxable year. However, trusts with substantial miscellaneous itemized deductions may be subject to the AMT because deductions subject to the 2-percent floor of IRC §67(e) are disallowed in calculating AMTI of the trust. See §3.5.

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§3.10 C. Determining Distributable Net Income (DNI)

Distributable net income (DNI) is the amount of the trust's taxable income that is taxable to a beneficiary, if distributed, or to the trust, if retained. Determination of a trust's DNI begins with finding the trust's taxable income, to which special adjustments are made as set forth in IRC §643(a). The most common adjustments include:

- Adding back the distribution deduction and the personal exemption applied in determining the trust's taxable income. IRC §643(a)(1)-(2).

- Including net tax-exempt income in DNI. Net tax-exempt income is the total tax-exempt income earned by the trust, reduced by expenses allocable to the tax-exempt income (including a prorata share of general expenses like trustee fees and attorney fees) and by the amount of tax-exempt income paid to a charity. IRC §643(a)(5). Because DNI consists of a prorata portion of each class of income included in DNI, the net tax-exempt income retains its tax-exempt character when distributed to the beneficiaries.

- Subtracting net long-term capital gain unless the gain has been (1) allocated to income, either under the terms of the trust or under local law or under a reasonable and impartial exercise of discretion by the trustee in accordance with a power granted by local law, such as the trustee power to adjust between principal and income under Prob C §16336 or the trustee power to convert the trust to a unitrust under Prob C §§16336.4-16336.7, as provided in Prob C §16328; (2) allocated to corpus and actually paid to the beneficiary during the taxable year; (3) used to determine the amount that must be distributed to the beneficiary; or (4) paid to a charity. IRC §643(a)(3); Treas Reg §§1.643(a)-3(a), 1.643(b)-1. The DNI of a simple trust that is not being administered as a total return trust as provided in Prob C §16336 or as a unitrust under the trustee conversion power or the terms of the trust usually will not include net long-term capital gain.

- For simple trusts only, subtracting extraordinary dividends and taxable stock dividends that the trustee, in good faith, allocates to corpus. IRC §643(a)(4).

As mentioned above, distributions of DNI are deemed to consist of a prorata portion of each class of income included in the DNI of the trust unless the trust agreement provides otherwise. See IRC §652(b). A trust provision calling for the allocation, however, of a specific class of income to a specific beneficiary (*e.g.,* taxable income to a beneficiary in a lower income tax bracket and tax-exempt income to a beneficiary in a higher tax bracket) is recognized for tax purposes only if the allocation has an economic effect independent of its income tax consequences. Treas Reg §1.652(b)-2(b). Thus, the amount of the distribution that the beneficiary subject to the special allocation is entitled to receive must be directly related to and directly affected by the amount of income actually earned by the class of income to which the special allocation relates. In IRS Letter Ruling 200648025, the IRS ruled that an income ordering rule in a proposed charitable lead annuity trust (CLAT) would not be given effect because it had no economic effect on the distributions independent of tax consequences. Proposed amendments to Treas Reg §§1.642(c)-3(b)(2) and 1.643(a)-5(b) would confirm this treatment. REG-101258-03, 2008-28 Int Rev Bull 111. The ordering rule would have provided that annuity payments would be made in the opposite order from the rule prescribed by the IRS. See §3.48.

EXAMPLE: The following trust provision would not have an economic effect: a provision directing that one half of all trust accounting income be paid to *B,* to be paid first from tax-exempt income and to be paid from taxable income only if tax-exempt income is insufficient to fully satisfy the amount to be distributed. Because there is no economic effect to the allocation, it would not be recognized, and the amount distributed to *B* would be considered a prorata share of the tax-exempt and taxable income included in DNI.

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D. Simple Trusts

§3.11 1. Definition of Simple Trust

Under IRC §651, a simple trust is one that:

- Requires all trust accounting income to be distributed at least annually;
- Makes no distributions of principal during the taxable year; and
- Makes no distributions to charity.

A trust can be a simple trust in some taxable years and a complex trust in others. For example, a qualified terminable interest property (QTIP) trust (see §2.79) is a complex trust in taxable years when corpus is distributed to the spouse (such as a distribution of corpus for the spouse's support), and a simple trust in all other years. A trust will be considered a simple trust even if the required income distribution is not made. Treas Reg §1.651(a)-1. Furthermore, the amount of income to be distributed to a particular beneficiary does not need to be specified. Treas Reg §1.651(a)-2(b).

All net trust accounting income earned by a simple trust during the taxable year is deemed distributed to the beneficiaries, on or before the last day of that taxable year, whether the net income is actually distributed.

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§3.12 2. Taxation of Simple Trust and Its Beneficiaries

The term "income" as used in IRC §651(a)(1) means trust accounting income as determined under the terms of the trust and governing law. See IRC §643(b); Treas Reg §1.643(b)-1.

PRACTICE TIP: Trust accounting income frequently is not the same as taxable income. When determining what constitutes trust accounting income, the practitioner should pay close attention to the default rules provided by the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375).

California law provides for three alternative definitions of trust accounting income ("net income"): (1) the traditional definition of net income (total receipts minus total disbursements) determined under Prob C §16335; net income as determined under Prob C §16336 (the "power to adjust"); and (3) a unitrust amount that is not less than 3 percent and not more than 5 percent of the fair market value of trust assets. Prob C §16328.

The trust receives a distribution deduction equal to the lesser of the trust accounting income distributed or the DNI, reduced in each case by the amount of net tax-exempt income. IRC §651. The DNI of a simple trust usually does not include net long-term capital gain, extraordinary dividends, or taxable stock dividends, even though those items may be included in the trust's taxable income. See Treas Reg §§1.643(a)-3(a), 1.643(a)-4. Under the regulations, however, capital gains are included in DNI if the trust document allocates the gains to the distribution or if they are allocated to income under a reasonable and consistent exercise of discretion by the trustee in accordance with a power granted by local law, *e.g.,* through exercise of the adjustment power under Prob C §16336 or through administration of the trust as a unitrust under the conversion power in Prob C §16336.4 or the terms of the trust. Treas Reg §1.643(a)-3(b).

If a distribution in kind is made in satisfaction of a right to income, as defined in IRC §643(b), the trust will be treated as having sold the property for its fair market value on the date of distribution. Treas Reg §1.651(a)-2(d). This rule incorporates the Treas Reg §1.643(b)-1 definition of income, with the consequence that the rule also applies to any portion of principal allocated to income under the Prob C §16336 trustee power to adjust, including the principal portion of unitrust payments made in satisfaction of a right to income under the Prob C §16336.4 trustee conversion power or the terms of the trust.

Each beneficiary must report the lesser of: (1) the trust accounting income he or she is entitled to receive, whether or not it is actually received; or (2) a share of DNI, consisting of a prorata portion of each class of income included in the DNI. IRC §652. To the extent that a portion of the distribution made to the beneficiary includes net tax-exempt income, the portion retains its tax-exempt character in determining the tax payable by the beneficiary. If there is more than one beneficiary, DNI is shared by all the beneficiaries on a prorata basis.

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§3.13 3. Estimated Tax Payments for Simple Trusts

In general, nongrantor trusts must make estimated tax payments. As a practical matter, however, a simple trust will typically not have significant income each year (unless the trust has capital gain) because most of the income will be taxed to the beneficiaries. Each beneficiary of a simple trust must report any DNI deemed distributed to him or her as of each reporting period for purposes of determining the beneficiary's estimated tax payments.

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E. Complex Trusts

§3.14 1. Definition of Complex Trust

A complex trust is any trust that is not a simple trust. IRC §661. Thus, a complex trust is:

- Any trust in which all of the income is not required to be distributed;
- Any trust with current charitable beneficiaries; and
- Any trust in which principal distributions are actually made during the taxable year.

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§3.15 2. Taxation of Complex Trusts

The distribution deduction for a complex trust equals the lesser of DNI (excluding any net tax exempt income included in DNI) or the amount actually distributed by the trust, determined as follows (IRC §661(a)):

- For any net trust accounting income required by the terms of the trust to be distributed currently, the amount required to be distributed, whether it is actually distributed on or before December 31 of the current taxable year; and
- For all other distributions from the trust, income and corpus actually distributed on or before December 31 of the current taxable year or, if the trustee elects under IRC §663(b), within the next 65 days thereafter.

NOTE: If the trustee elects under IRC §663(b) to treat distributions made during the first 65 days of a year as having been made in the previous year, those distributions will not be considered distributions in the current taxable year. IRC §663(b).

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3. Estimated Tax Payments for Complex Trusts

§3.16 a. Determining Liability for and Amount of Estimated Tax Payments

Complex nongrantor trusts must make estimated tax payments. Trusts that become irrevocable as a result of the grantor's death are subject to special rules beyond the scope of this book. See IRC §6654(*l*)(2). When the tax liability of a complex trust for the current taxable year is less than $1000, the trust is not required to make any estimated payments. IRC §6654(e)(1). When the tax liability exceeds that amount, there are two methods for determining estimated taxes (for procedures, see IRS Notice 87-32, 1987-1 Cum Bull 477):

- The first method uses the taxable income earned by the trust in the preceding taxable year. A nongrantor trust cannot use this method in its first taxable year, because there is no preceding taxable year. Nor can a nongrantor trust with a short first taxable year use this method in its second taxable year, because the preceding taxable year must be a full 12 months.

- The second method uses annualized income. To determine the income on which estimated taxes must be paid net of the distribution deduction, the trustee may consider only distributions that are actually made through the end of the taxable period preceding the date that the estimated payment is due or, if greater, distributions that are required under the trust instrument. This limitation may create problems. See §3.17.

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§3.17 b. Problems in Determining Estimated Tax Using Annualized Income Method

Use of the annualized income method to determine estimated tax payments may be difficult for both the trustee (see §3.17A) and the beneficiary (see §3.17B) in certain situations, especially when the trust is a discretionary pot trust.

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§3.17A (1) Trustee Problems

Before deciding what amount to distribute from such a trust to each beneficiary for the year, the trustee must first analyze each beneficiary's tax situation as compared with the trust's tax liability and future cash needs. The methods prescribed in IRS Notice 87-32, 1987-1 Cum Bull *477*, require a quarterly review of trust income and expenses, a quarterly determination of amounts to be distributed, and an actual distribution on or before the last day of each taxable period. To avoid estimated tax payments, trustees of complex trusts, and their advisors, must closely and carefully monitor taxable income and DNI of these trusts so that they can, as much as possible, distribute a rough estimate of the taxable income earned by the trust (other than long-term capital gain) to the beneficiaries on or before the last day of each quarterly period.

PRACTICE TIP: Although annual payments are permissible for some trusts (*e.g.*, qualified terminable interest property trusts), to facilitate estimated payments, the practitioner should consider including a provision for quarterly distributions in the trust instrument.

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§3.17B (2) Beneficiary Problems

To determine income for each applicable period, a beneficiary who uses the annualized income method to determine estimated tax payments must consider distributions actually made through the end of the appropriate period and distributions required under the terms of the trust instrument.

EXAMPLE: The trust requires that one half of all net income be distributed to *B* currently and that the rest be paid or accumulated in the trustee's discretion. The trustee makes no distributions before March 31. When *B* makes the estimated payment due April 15, *B* must report one half of all the net trust accounting income earned by the trust through March 31, for purposes of determining annual income, even though no payment has actually been made.

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§3.18 4. Taxation of Beneficiaries of Complex Trusts

Beneficiaries of complex trusts are taxed on the basis of tiers. See IRC §662. The first tier usually consists of beneficiaries entitled to receive trust accounting income that must be distributed currently. Thus, if the trust directs the distribution of a fixed amount each year, payable from income or principal, or both, and if trust accounting income is sufficient to make the payment, the beneficiaries entitled to the distribution are assigned to the first tier. The second tier includes all other beneficiaries of the trust. Beneficiaries in the first tier receive no benefit from any charitable deduction available to the trust. See IRC §662(a)(1) (DNI of first-tier beneficiaries "computed without the deduction allowed by section 642(c)").

The DNI of a complex trust is allocated among the separate tiers and among the beneficiaries within each tier as follows:

- Each beneficiary in the first tier must report the lesser of the DNI or net trust accounting income he or she is entitled to receive, whether it is actually received by December 31 of the current taxable year. If the amount distributed to the first-tier beneficiaries exceeds DNI, the amount taxed to those beneficiaries is the greater of the amount distributed or DNI increased by the amount of the charitable deduction claimed by the trust (modified DNI). IRC §662(a)(1). If more than one beneficiary is in the first tier, DNI or modified DNI, as the case may be, is shared by all such beneficiaries on a prorata basis.

- If, after allocating DNI among members of the first tier, any DNI remains (residual DNI), the residual DNI is allocated among members of the second tier on a prorata basis. IRC §662(a)(2). Each beneficiary in the second tier must report the lesser of residual DNI or distributions actually made to him or her on or before December 31 of the current taxable year, or within the next 65 days thereafter if the trustee elects to deduct those distributions in the prior taxable year under IRC §663(b). Note that to the extent that the beneficiaries in the first tier must report modified DNI, there will be no residual DNI to be reported by the beneficiaries in the second tier.

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§3.18A a. First-Tier Distributions

Fiduciary accounting income that is required to be distributed currently constitutes the first tier of distributions. IRC §662(a)(1); Treas Reg §§1.661(a)-2(a)(1), 1.662(a)-2(a). It is included in a beneficiary's gross income, to the extent of DNI, whether or not it is actually distributed. IRC §662(a)(1); Treas Reg §1.662(a)-2(a). If the amount required to be distributed exceeds DNI (without taking into account any charitable deduction), each beneficiary includes a ratable amount of DNI in his or her gross income. IRC §662(a)(1); Treas Reg §1.662(a)-2(b). Income required to be distributed currently includes income *or principal* (such as an annuity) to the extent that it is actually paid out of current trust accounting income. IRC §662(a)(1); Treas Reg §1.661(a)-2(b). First-tier distributions also include amounts required to be paid by court order, such as a family allowance, to the extent such amounts are paid from trust accounting income. IRC §662(a)(1); Treas Reg §1.661(a)-2(c).

If an estate or trust distributes appreciated (or depreciated) assets in satisfaction of a mandatory right to income, the distribution is treated as a sale or exchange and the estate or trust recognizes gain on the distribution. See Treas Reg §1.661(a)-2(f). This rule incorporates the Treas Reg §1.643(b)-1 definition of income (see §3.12), with the consequence that the rule also applies to any portion of principal allocated to income under the Prob C §16336 trustee power to adjust, or the principal portion of unitrust payments made in satisfaction of a right to income under the trustee conversion power in Prob C §§16336.4-16336.7 or the terms of the trust.

A first-tier distribution that qualifies for the charitable deduction does not qualify for the distribution deduction. IRC §663(a)(2); Treas Reg §1.663(a)-2. A charitable distribution may, however, have an effect on noncharitable first-tier distributions. If the amount required to be distributed, including any charitable distribution, is less than the DNI (computed without taking the charitable deduction into account), the noncharitable first-tier distributees simply take into account the amounts distributed to them. See Treas Reg §1.662(a)-2(e), Example (1). If, however, the amounts required to be distributed *exceed* the amount of DNI (once again, computed without taking the charitable deduction into account), first-tier beneficiaries must include in gross income a ratable portion of DNI, the end result being that the charitable deduction is of no benefit to those beneficiaries. IRC §662(a)(1). See Treas Reg §1.662(a)-2(e), Example (2).

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§3.18B b. Second-Tier Distributions

All distributions properly paid, credited, or otherwise required to be distributed, other than amounts "required to be distributed currently," fall into the second tier. Second-tier beneficiaries are taxable only to the extent that DNI is not used up by first-tier beneficiaries, and then only as to their proportionate share (based on amounts received) of the remaining DNI. IRC §662(a)(2); Treas Reg §1.662(a)-3(a). "Other amounts distributed" do not, however, include specific gifts payable in not more than three installments or distributions that qualify for the charitable deduction provided in IRC §642(c). IRC §663(a); Treas Reg §§1.663(a)-1, 1.663(a)-2.

A complex trust or estate receives a deduction for, and a second-tier beneficiary takes into account, only amounts "properly paid or credited." Thus, beneficiaries do not take into account the amount overpaid by mistake of fact or law, but the amount properly payable. See *Freuler v Helvering* (1934) 291 US 35, 78 L Ed 634, 54 S Ct 308. Similarly, payments by an executor to the beneficiary of a testamentary trust not yet established by court order are not properly paid or credited. *Hopper v Government of V.I.* (3d Cir 1977) 550 F2d 844. But see *Buckmaster v U.S.* (10th Cir 1993) 984 F2d 379 (distributions made without court order at executor's peril were properly paid by subsequent court approval).

The statute requires actual payment or crediting. IRC §§661(a), 662(a). Nothing in the statute implies that distributions may be accrued. The payment of a debt to a creditor who is also a beneficiary of an estate or trust is not a distribution that is properly paid or credited. See *DuPont Testamentary Trust* (1976) 66 TC 761, aff'd (5th Cir 1978) 574 F2d 1332. A distribution to a beneficiary who immediately lends the distributed funds back to the trust or estate, however, qualifies as paid, if not part of a prearranged plan. See, *e.g., Tobin Trust,* TC Memo 1951-35. Payment is, of course, a factual question. If the executor is a beneficiary and commingles personal and estate funds, the result depends on the facts of administration. See *McCauley v U.S.* (ED Ark 1961) 193 F Supp 938 (doctrine of constructive receipt not applicable unless administration unduly prolonged). In contrast, payments to a third party for a beneficiary's benefit, such as taxes, qualify as payment. See Treas Reg §1.662(a)-4; *Grant v Nicholas* (D Colo 1955) 127 F Supp 236 (beneficiary's income taxes).

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§3.18C c. The Intermediate Tier

As discussed in §3.18A, first-tier beneficiaries get no benefit from a trust's or estate's charitable deduction, but because DNI takes the charitable deduction into account, it limits the amounts taxable to tier two beneficiaries. Thus, the charitable deduction is sometimes referred to as the "intermediate tier." If tier two distributions are equal to or less than DNI (computed without taking the charitable deduction into account) minus tier one distributions, the trust or estate gets the benefit of the charitable deduction. IRC §662(a)(1). See Treas Reg §1.662(a)-2(e), Example (1). If tier two distributions exceed DNI (once again, computed without taking the charitable deduction into account) minus tier one distributions, tier two beneficiaries get some or all of the benefit of the charitable deduction. IRC §662(a)(1). See Treas Reg §1.662(a)-2(e), Example (2). The end result is that the charitable deduction is of no benefit to first-tier beneficiaries.

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§3.18D d. The Variable Tier

Annuities may be first-tier or second-tier distributions. If the annuity amount may be paid only from trust accounting income, it is first-tier. Treas Reg §1.662(a)-2(c). If the annuity amount may only be paid from principal, it is second-tier. Treas Reg §1.662(a)-3(b). If the annuity amount may be paid from either income or principal, it is variable-tier and its treatment will depend on the actions of the fiduciary and the existence of trust income. An annuity that may be paid from income or principal is deemed to come from income to the extent that there is fiduciary accounting income that has not been paid, credited, or required to be distributed to other beneficiaries during the taxable year. Treas Reg §1.662(a)-2(c). See Treas Reg §1.662(a)-2(e), Example (1). As with first-tier or second-tier distributions, annuity recipients are taxable to the extent of the allocable DNI, but the tier rules determine, as between the various beneficiaries, the taxable priorities. Moreover, charitable distributions may affect an annuity recipient's tier status, because the annuity recipient's status depends on the amount of FAI available for distribution. See Treas Reg §1.662(a)-2(e), Examples (1)-(2).

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§3.18E 5. Separate Share Rule

For purposes of computing distributable net income for complex trusts under IRC §§661-662, if a single trust has more than one beneficiary with shares substantially separate and independent from those of other beneficiaries, the shares are treated as separate trusts. IRC §663(c). This treatment avoids the taxation of one beneficiary on income accumulated for another beneficiary. See Treas Reg §1.663(c)-1. Those shares are not treated as separate for any purpose other than determining distributable net income in calculating the distribution deduction, and it is not necessary or appropriate to file separate tax returns, maintain separate accounts, or segregate assets for each separate share. See Treas Reg §§1.663(c)-1(b)—1.663(c)-1(c). See also §11.12 on the effect of failing to distinguish between a trust with separate shares treated as separate trusts and true separate trusts.

The separate share rule does not apply to a single trust instrument that creates several trusts—which does require the filing of separate tax returns for each of these separate trusts (Treas Reg §1.663(c)-1(a))—or to trusts that provide for successive interests (see Treas Reg §1.663(c)-3(e)).

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F. Impact of "Kiddie" Tax

§3.19 1. Operation of "Kiddie" Tax

Internal Revenue Code §1(g) provides that, in general, the net unearned income of a dependent qualifying child (as defined in IRC §152(c)) under age 19 (age 24 in the case of a student) is taxed at his or her parent's highest marginal federal income tax rate.

The kiddie tax does not apply:

- To *earned* income of a child under age 19 (*i.e.,* payments received for services like baby-sitting, paper routes, or a menial job in the parent's business for which that child is clearly qualified, such as a file clerk). Distributions from a "qualified disability trust" (as defined in IRC §642(b)(2)(C)(ii)) included in the child's income are considered earned income under IRC §1(g)(4)(C).

- To *unearned* income of a child under age 19, to the extent that it does not exceed the amount of the dependent standard deduction provided in IRC §63(c)(5)(A) ($950 in 2010) *plus* the greater of (a) the standard deduction or (b) the amount of itemized deductions allowed to the child that is directly connected with the production of the child's unearned income ($950 in 2010). Thus, the limit on unearned income in 2010 is $1900. These amounts are adjusted for inflation.

EXAMPLE: A child who was age 18 has $2500 of unearned income and no earned income in 2010. The $2500 of unearned income is reduced by the child's standard deduction of $950, the next $950 is taxed at the child's marginal rate for federal income tax purposes, and the remaining $600 is taxed at the parents' highest marginal rate for federal income tax purposes.

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§3.20 2. Avoidance of "Kiddie" Tax

The kiddie tax may be reduced or avoided by acquiring temporarily low-income-producing assets. For example, the custodian of a California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) account or the trustee of a simple trust for the benefit of the child could purchase and retain, until the child attains age 19 (age 24 in the case of a student):

- *United States Series EE Government Savings Bonds.* The custodian or trustee could elect not to report the accrued interest on the bonds each year. (This opportunity would not be available if Series EE bonds were purchased by a donor and then given to the CUTMA account or the trust.)
- *"Growth stocks" that forgo dividends to produce capital growth and appreciation.* However, the application of the kiddie tax to students under age 24 reduces or eliminates the tax benefits of strategies for paying college education expenses that involve making gifts of appreciated securities to students who then sell the securities to pay the expenses.
- *Municipal bonds that produce tax-free income*.
- *Unimproved real estate likely to appreciate over time.*
- *Life insurance on the lives of either or both parents*. The internal growth in the value of such a policy is tax free for income tax purposes until there is a taxable sale or exchange of the policy. An exchange of the policy for another life insurance, endowment, or annuity contract is not a taxable exchange. See IRC §1035.

PRACTICE TIP: Aside from planning for the trust to acquire low-income-producing assets, the attorney could draft the trust to permit accumulations of income for the benefit of the child, at least until he or she attains age 21. The trustee could refrain from making distributions to the child in excess of the amount not subject to the kiddie tax ($1900 in 2010) until the child is age 19 or older. Note, however, that under the compressed income tax rates applicable to trusts, less income tax may be payable by the child under age 19 who is subject to the kiddie tax rules than would be paid on ordinary income accumulated in the trust for the benefit of that child.

In addition to the above considerations, note that the distributive share of income, gain, loss, deduction, and credit in an S corporation or a family limited partnership allocable to a child under age 24 also may be subject to the kiddie tax rules.

Alternatively, the donor should consider making contributions to a tax-deferred account for the benefit of the child such as a Coverdell Education Savings Account (ESA) under IRC §530 or an IRC §529 college savings account. See §§12.37A-12.37B.

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§3.21 G. Tax Consequences of Termination of Nongrantor Trusts

For income tax purposes, a trust does not necessarily terminate when the event measuring the duration of the trust occurs. Rather, it terminates after a reasonable period during which the trustee performs the duties necessary to complete the administration of the trust. Treas Reg §1.641(b)-3(b). The trust will be considered terminated after a reasonable period if the administration of the trust is unduly prolonged. Treas Reg §1.641(b)-3(d). After the trust is terminated for income tax purposes, all items of income, gain, loss, deduction, and credit are taxed to the beneficiaries entitled to receive the trust assets, in proportion to their undivided shares of the trust, as if the trust did not exist. Treas Reg §1.641(b)-3(d).

In the year in which the trust terminates, the trustee can pass through the trust's unused deductions and losses to the beneficiaries. See IRC §642(h). Only three items of deduction and loss may be passed through. These are:

- Net operating loss (NOL) carryovers (Treas Reg §1.642(h)-1(a));
- Capital loss carryovers (Treas Reg §1.642(h)-1(b)); and
- Deductions, other than the personal exemption and charitable deduction, incurred in the last taxable year of the trust that exceed taxable income (excess deductions) (Treas Reg §1.642(h)-2).

The beneficiary may not carry back any unused NOL passed through to him or her from the trust and may carry over any unused NOL only for the balance of the 20-year carryover period. California does not allow NOL carrybacks by the trustee or the beneficiary for taxable years beginning before January 1, 2011. Rev & T C §17276(c). If the NOL was not incurred in the year of termination, 2 carryover years are used up in the year the trust terminates, 1 for the last year of the trust and 1 for the first year of the beneficiary. If the trust incurs a NOL in the year of termination, however, the full 20-year carryover period is available to the beneficiary receiving the passed-through NOL. IRC §172(b). Finally, if a NOL is in its 20th carryover year, it passes through to the beneficiary as an excess deduction rather than as a NOL. See Treas Reg §1.642(h)-1(b).

Only deductible expenses incurred in the year of termination pass through to the beneficiaries. To the extent that the trust's deductible expenses exceeded taxable income in taxable years before the year of termination, the excess deductions are unavailable as a pass-through deduction to the beneficiaries. In addition, an excess deduction is passed through to the beneficiaries as a miscellaneous itemized deduction with respect to each beneficiary. Thus, it is deductible only to the extent that it exceeds 2 percent of a beneficiary's adjusted gross income. IRC §67.

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III. TAXATION OF GRANTOR TRUSTS

§3.22 A. Definition of Grantor Trust

A grantor trust is a trust in which the grantor has retained either economic benefits or a sufficient degree of control of the beneficial enjoyment to cause him or her to be considered the owner of assets held in the trust for income tax purposes. See IRC §§671-677. Someone other than the grantor may also be treated as the owner of assets held in the trust for income tax purposes. If more than one person transfers assets to a trust without receiving full consideration, the trust will have more than one grantor. If one person funds a trust but is then reimbursed by a second person, the second person is the grantor. If the holder of a general power of appointment appoints property to a trust, the holder of the power is the grantor. If one person establishes a trust but a second person funds it, the second person is the grantor for purposes of the grantor trust rules but both persons are grantors for purposes of the IRC §6048 foreign trust reporting requirements. See IRC §678; Treas Reg §1.671-2(e). See also §3.38.

If the trust is a grantor trust with respect to the income interest, all items of income, deduction, and credit attributable to income earned by trust assets are taxed to the owner as if the trust did not exist. Similarly, if the trust is a grantor trust with respect to corpus of the trust, all items of gain, loss, and credit attributable to trust assets are taxed to the owner as if the trust did not exist.

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§3.23 B. Grantor Trusts Subject to Different Rules

To the extent that the grantor retains certain benefits in or control over the beneficial enjoyment of the trust, the normal rules governing nongrantor trusts in Subchapter J (*e.g.,* rules of simple and complex trusts, DNI) do not apply. Grantor trusts are governed by their own rules within Subchapter J, set forth in IRC §§671-679.

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§3.24 C. Use of Grantor Trusts as Planning Device

In some estate planning situations, grantor trust status may produce tax advantages, particularly if the rights and powers that will produce grantor trust status will not also result in the trust estate's being included in the grantor's estate for federal estate tax purposes. For example, it is generally important that a grantor retained annuity trust (GRAT) be a grantor trust during the period of the retained annuity. Because transactions between a grantor and a trust taxed to the grantor are generally ignored for income tax purposes, grantor trust status makes it possible for the GRAT to satisfy annuity payment obligations by distributions of appreciated property in kind without the recognition of capital gain that would normally result if the trust and the grantor were treated as different taxpayers. For similar reasons, grantor trust status is important if the grantor wants to sell property to the trust. See §3.44B for further discussion of installment sales to grantor trusts.

Grantor trusts are also useful if the grantor owns stock in an S corporation. A trust cannot own S corporation stock unless the trust is a grantor trust, a qualified subchapter S trust (QSST), or an electing small business trust (ESBT) See §§3.57-3.63 for discussion of QSSTs, and see §§3.64-3.67 for discussion of ESBTs. In light of these considerations, planners may intentionally want to create "defective" (*i.e.,* grantor) trusts. Also, planners may want to create irrevocable grantor trusts to purchase assets from the grantor as an alternative to grantor retained annuity trusts (GRATs). See §3.44B.

When a trust is treated as a grantor trust, all the trust's taxable income is taxed to the grantor even though it is actually paid to another beneficiary or accumulated in the trust. In Rev Rul 2004-64, 2004-2 Cum Bull 7, the IRS ruled that the payment of taxes by the grantor generally does not result in a taxable gift by the grantor to the trust beneficiaries. The IRS further ruled that if the trust's governing instrument or applicable local law gives the trustee discretion to reimburse the grantor for the grantor's income tax liability attributable to trust income, the existence of the discretion itself, whether or not exercised, will not cause the value of the trust's assets to be includible in the grantor's trust estate under IRC §2036(a)(1). However, the IRS ruled that, for trusts created on or after October 4, 2004, the trust assets are includable in the grantor's estate if, under the trust's governing instrument or applicable local law, the trustee is required to reimburse the grantor for the income tax on trust income. The IRS had previously ruled that a grantor trust provision requiring payment of the grantor's additional taxes resulting from grantor trust status was not a retained interest for estate tax purposes. See, *e.g.,* IRS Letter Rulings 200030018, 9710006, 9413045. Note that California law generally does not require reimbursement of the grantor by the trustee.

The most commonly used provisions to cause a trust to be treated as a grantor trust are summarized in §§3.40-3.44. See also §§5.9-5.10.

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D. Grantor as Owner of Trust

1. Retained Powers That Cause Grantor to Be Treated as Owner

§3.25 a. Right to Reversionary Interest

If the grantor or the grantor's spouse retains a reversionary interest in the income or principal, or both, of a trust, the actuarial value of which exceeds 5 percent of the amount transferred to the trust, the grantor is treated, for income tax purposes, as the owner of the portion of the trust to which the reversionary interest relates. IRC §673. In valuing the retained reversionary interest, it is assumed that all discretionary powers granted under the trust instrument are exercised to maximize the value of the reversionary interest. Depending on the exact interest rate in effect under IRC §7520, a reversionary interest typically will exceed 5 percent if it is for less than 30 years or follows a life estate of an individual over age 30.

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§3.26 b. Right to Control Enjoyment of Trust

If the grantor, the grantor's spouse, a nonadverse party, or both, can alter or control the beneficiary's beneficial enjoyment of principal or income without an adverse party's approval or consent, the grantor is treated, for income tax purposes, as the owner of the portion of the trust to which the retained right applies. IRC §674(a). Because a grantor is treated as holding any power held by the spouse under IRC §672(e), the grantor is treated as the owner of the trust if his or her spouse can alter or control the beneficiary's beneficial enjoyment of the trust.

An adverse party is any person with a substantial beneficial interest in the trust that will be adversely affected by the exercise or non-exercise of a power possessed by him or her. IRC §672(a). A nonadverse party is any person who is not an adverse party. IRC §672(b).

EXAMPLE 1: Assume that *G* transfers property to a trust for the benefit of *X* and *Y* during *Y*'s lifetime, with the assets remaining in the trust passing to *Y* on *X*'s death. *G* names spouse, *S,* to serve as the trustee and gives the trustee the power to distribute principal, not limited by an ascertainable standard, to *X* or *Y,* or both, during *X*'s lifetime (*i.e.,* a power to alter or control the beneficial enjoyment of both the income and the principal of the trust). Even though *S* cannot exercise the power to benefit *G,* all powers held by *S* are treated as if held by *G* (IRC §672(e)) and, as a result, *G* is treated as having the power to alter or control the beneficial enjoyment of the trust, with respect to both the income and principal interests. Thus, the trust is treated as a grantor trust for income tax purposes, as to both income and corpus, even though *G* has not personally retained any direct interest in the trust and does not have the right to alter or control the beneficial enjoyment of the trust.

EXAMPLE 2: Assume, instead of the facts in Example 1, that the trust provides that *S* and *X* serve as cotrustees, and that the trustees, acting jointly, have power to distribute principal to *X* or *Y*, or both, but may not exercise this power in favor of *G*. The trust is not treated as a grantor trust with respect to the trust accounting income because the power to alter or control the beneficial enjoyment of the income interest is exercisable only with the consent of an adverse party (*X*). The trust is still treated as a grantor trust with respect to principal (*i.e.*, capital gain) realized on the principal, however, assuming that capital gain is allocated to principal under the trust instrument, because the power to alter or control the beneficial enjoyment of the principal is not subject to the consent or approval of an adverse party (*Y*).

Adverse parties under IRC §672(a) may include individuals who are "related or subordinate" to the grantor under IRC §672(c). In IRS Letter Ruling 200502014, the IRS ruled that an irrevocable trust that permitted distributions of principal to be made to members of a class who could be appointed by the unanimous agreement of the grantor and either the grantor's parent or sibling (or by the unanimous agreement of the parent and sibling) was not a grantor trust for income tax purposes, while the assets in the trust would be included in the grantor's estate under IRC §2036. See also IRS Letter Rulings 200647001, 200247013, 200148028. Such a trust may be useful if the grantor has low-basis assets and will not have an estate tax problem, because the income tax liability can be shifted to family members in lower income tax brackets without relinquishing the ability to get a new income tax basis at death. See Scroggins, *The Estate Defective Trust*, 83 Taxes 69 (Jan. 2005). However, the IRS has announced in a news release that it is reconsidering the logic of these rulings for possible inconsistency with Rev Rul 77-158, 1977-1 Cum Bull 285 (each of three trustees, also beneficiaries, had general power of appointment, resulting in inclusion of one-third of trust corpus in estate of each trustee); Rev Rul 76-503, 1976-2 Cum Bull 275 (permissible appointees did not have adverse interest). IR-2007-127. At issue is whether the parent and sibling in the above example would have an incentive not to consent to appoint the property to themselves immediately in equal shares if they did not stand to gain an increased share of the property by surviving the other.

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§3.27 c. Administrative Powers

Some administrative powers or actions, if retained by the grantor, the grantor's spouse, or a nonadverse party, will cause a trust to be treated as a grantor trust for federal income tax purposes. These include:

- The power to purchase, exchange, or otherwise deal with or dispose of income or corpus for less than full consideration and without an adverse party's approval or consent. IRC §675(1).

- The power to borrow income or corpus, without adequate interest or security, unless the trustee (other than the grantor or grantor's spouse) may, under a general lending power in the trust instrument, loan to any person without regard to interest or security. IRC §675(2).

- The borrowing of income or principal by the grantor or grantor's spouse, who do not completely repay the loan before the beginning of the taxable year. IRC §675(3). Section 675(3) applies for any year during any part of which the loan is outstanding, so the grantor may be treated as the owner of the trust even when he or she repays the loan in the same year the funds were borrowed. Rev Rul 86-82, 1986-1 Cum Bull 253. Section 675(3) does not apply if a loan provides for adequate interest and security and is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor.

- Any of the following powers exercisable by any person without the consent of the trustee: (1) to vote stock when the holdings of the grantor (or the grantor's spouse) and the trust are significant in terms of voting control, (2) to control the investment of trust funds when they consist of stock or securities of corporations in which the holdings of the grantor (or the grantor's spouse) and the trust are significant in terms of voting control, or (3) to reacquire trust corpus by substituting other property of equivalent value. IRC §675(4).

See the discussion in §3.41 regarding the intentional use of administrative powers to create a grantor trust for federal income tax purposes. It is also possible to use the trustee's power to resign and appoint a successor trustee or to change the trust's situs as a means to turn grantor status on and off by changing the trust to a foreign trust and back again, because a foreign trust is treated as a grantor trust under IRC §679. See §3.70. For further discussion of this strategy, see Razook & Ramsey, *Offshore Trusts are More Than Just Asset Protection Vehicles*, 32 Est Plan 36 (Aug. 2005).

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§3.28 d. Power to Revest Title to Trust Property

If the grantor, the grantor's spouse, or a nonadverse party has the power to revest title to trust property in the grantor, or to alter or amend the trust (*i.e.,* a standard revocable living trust), the trust is treated as a grantor trust for federal income tax purposes. IRC §676. Note that such a power is unlikely to apply in the context of an irrevocable trust.

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§3.29 e. Power to Use Income for Grantor's Benefit

The grantor is treated as the owner of any portion of a trust when, in the discretion of the grantor, the grantor's spouse, or a nonadverse party, trust income is or may be:

- Distributed to the grantor or his or her spouse (IRC §677(a)(1));
- Accumulated for future distribution to the grantor or his or her spouse (IRC §677(a)(2)); or
- Applied to pay premiums on life insurance policies on the life of the grantor or his or her spouse (IRC §677(a)(3)).

Case law generally provides that income of a trust is taxable to the grantor under IRC §677(a)(3) only if the trust actually owns policies of life insurance on the grantor, the trust has income, and premiums are actually paid (whether or not the premiums are paid by the trust). *Joseph Weil* (1944) 3 TC 579, acq 1944 Cum Bull 29; *Genevieve F. Moore* (1939) 39 BTA 808, acq 1939-2 Cum Bull 25.

In Field Attorney Advice 20062701F, the IRS took the language of the statute at face value and contended that the trust in question was a grantor trust even though there was no indication that the trust owned any life insurance. However, it appears that the position taken there does not reflect an intentional change of policy by the IRS but rather an abusive fact pattern.

The trust should be a grantor trust if there is any possibility that income could be distributed for any of these proscribed purposes. But see the discussion in §3.42 regarding the intentional use of these provisions to create a grantor trust for federal income tax purposes.

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§3.30 2. Retained Powers That Do Not Cause Grantor to Be Treated as Owner

Internal Revenue Code §674(b) specifies powers that do not cause the grantor to be treated as the owner of the trust for income tax purposes regardless of who holds the power. (These powers are exceptions to the general rule of IRC §674(a) that any discretionary power held by anyone over the trust causes the grantor to be treated as owner. See §3.26.) Sections 674(c) and (d) specify additional powers that, if retained by nonadverse parties other than the grantor or the grantor's spouse, do not cause the trust to be treated as a grantor trust for income tax purposes. All these provisions are discussed in §§3.31-3.37. In those sections, any reference to the grantor refers both to the grantor and to the grantor's spouse.

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§3.31 a. Power to Apply Income and Principal to Support of Dependents

Any power exercisable by anyone in a fiduciary capacity, including the grantor, to apply income or principal, or both, to the support and maintenance of dependents does not cause the trust to be taxed to the grantor unless the power is actually exercised and then only to the extent of the amount actually distributed. IRC §§674(b)(1), 677(b). A trust that contains a power of this nature is subject to the grantor-trust rules, however, whether the power is actually exercised, if the grantor or a nonadverse party cannot exercise the power in a fiduciary capacity (*i.e.,* a power that may be exercised by the grantor or a nonadverse party acting in a capacity other than as a trustee).

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§3.32 b. Power to Distribute Corpus Under Certain Circumstances

A power exercisable by anyone, including the grantor, under either of the following circumstances does not cause the trust to be treated as a grantor trust with respect to corpus:

- To distribute corpus to income beneficiaries or remainder beneficiaries when the power is limited by a reasonably definite standard (IRC §674(b)(5)(A); Treas Reg §1.674(b)-1(b)(5)(i)); or
- To distribute corpus to current income beneficiaries when the trust calls for the creation of separate and distinct shares for each current income beneficiary, but only to the extent that a distribution made to a beneficiary is charged against the separate share held in trust for the payment of income to that beneficiary (IRC §674(b)(5)(B)).

Note that a power to add beneficiaries other than after-born or after-adopted children causes the trust to be treated as a grantor trust. See §5.10.

EXAMPLE 1: To illustrate IRC §674(b)(5)(A), assume that *G* creates a trust providing that income will be paid to *G*'s son, *S*, for life. In addition, *G*, as the trustee, has the power to distribute corpus for medical expenses incurred by *S* and the children of *S*, and at the death of *S*, the remainder of the trust passes to *S*'s children. The trust is not a grantor trust for income tax purposes because *G*'s power to invade corpus is limited by an ascertainable standard and is exercisable only in favor of income or remainder beneficiaries.

EXAMPLE 2: Assume, instead of the facts in Example 1, that *G*'s invasion power permits *G* to distribute corpus for medical expenses of *S* and *D*. The trust is considered a grantor trust because *D* is neither an income nor a remainder beneficiary of the trust. See IRC §674(b)(5)(A). Alternatively, if *G*'s invasion power permitted *G* to distribute corpus to *S* and *S*'s children for their happiness, the trust is considered a grantor trust because happiness is not a reasonably definite standard.

EXAMPLE 3: To illustrate IRC §674(b)(5)(B), assume that *G* creates a trust that provides for income of specific portions of the trust to be paid to both *S* and *D* during their lifetimes, with any distributions of principal to *S* or *D* from their respective portions of the trust reducing the future income that *S* or *D* receives from their respective portions. The trust is not treated as a grantor trust because any distributions of principal to *S* or *D* reduces the portion held for their benefit.

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§3.33 c. Power to Accumulate Income Under Certain Circumstances

A power exercisable by the grantor to accumulate income does not cause the trust to be treated as a grantor trust, when the accumulated income is ultimately payable to either of the following (IRC §674(b)(6); Treas Reg §1.674(b)-1(b)(6)):

- The beneficiary to whom the accumulated income would otherwise be payable, to his or her estate, or subject to his or her broad general or special power of appointment (IRC §674(b)(6)(A)); or
- The current income beneficiaries of the trust, in shares that are irrevocably set by the trust instrument, on termination of the trust or other distribution of the corpus, when the distribution would include the accumulated income (IRC §674(b)(6)(B)).

If the beneficiary for whom income is accumulated does not survive to the date of distribution, and if that date could reasonably be expected to occur during the beneficiary's lifetime, either of these exceptions still applies when the trust instrument provides that the beneficiary's share will pass, at his or her death, to the beneficiary's appointees or persons selected by the grantor other than the grantor or the grantor's estate. The power to add beneficiaries other than after-born or after-adopted children causes the trust to be subject to the grantor-trust rules.

EXAMPLE 1: Assume that *G* creates a trust, and serves as trustee. The trust provides that one half of the income *must be* distributed to *S*, and the remaining one half of the income *may be* distributed to *D*, or accumulated until *D*, who is *G*'s youngest child, turns age 30. In addition, when *D* turns age 30, the trust, including any accumulated income, will be distributed one half to *S* and one half to *D*. Under these circumstances, the grantor's powers as trustee are protected by IRC §674(b)(6)(B), even though the grantor may shift income from *D* to *S*, because the shares passing to *S* and *D* at the termination of the trust are irrevocably stated in the trust agreement.

EXAMPLE 2: Assume, instead of the facts in Example 1, that the trust provides that when *D* turns age 30, the balance of assets remaining in the trust will be distributed to *S* and *D* in such shares as *G* selects. The trust will then be treated as a grantor trust because the accumulated income is not payable to *D* or to her estate (IRC §674(b)(6)(A)), nor has *D* been given the requisite power of appointment over the accumulated income (IRC §674(b)(6)(A)), and the shares distributable to *S* and *D* at the termination of the trust are not irrevocably specified in the trust instrument (IRC §674(b)(6)(B)).

EXAMPLE 3: Finally, assume that the trust provides that all income earned by the trust will be accumulated until *G*'s death, and at *G*'s death one half of all the accumulated income will be distributed to *S* and one half will be distributed to *D*. If either child is not then living, that child's share passes to the child's then-living issue, or if none, to the other child, if living, or to that child's living issue. In that situation, the trust is covered by IRC §674(b)(6)(A) because *S* and *D* both would normally be expected to survive *G* (*i.e.,* the date of distribution is reasonably expected to occur in each child's lifetime). Therefore, the trust is not a grantor trust even if it provides for the distribution of each such share to the issue of the child who is not living on the date of *G*'s death, even though the issue are not current income beneficiaries of the trust because the issue are irrevocably designated in the trust instrument as the beneficiaries in the event a child predeceases the grantor.

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§3.34 d. Power to Distribute or Accumulate Income for Minor Beneficiary

A discretionary power to distribute or accumulate income that is held by anyone, even the grantor, for the benefit of a beneficiary who is under age 21 or is under any legal disability does not cause the grantor to be treated as owner of the trust. IRC §674(b)(7). Note that this exception does not require that the accumulated income ultimately be paid to the income beneficiary. Rather, it may be distributed to a remainder beneficiary who is not an income beneficiary.

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§3.35 e. Trustee's Power to Distribute Income and Principal That is Limited by Ascertainable Standard

A trust is not a grantor trust if it contains a power to distribute income and principal that is exercisable by any trustee, other than the grantor or the grantor's spouse (even a trustee who is a related or subordinate party), provided the power is limited by a reasonably definite external standard. IRC §674(d). If the grantor reserves the power, however, to remove the trustee and appoint himself or herself (or his or her spouse) as a trustee, the trust does not qualify for this exception. Treas Reg §1.674(d)-2(a). See §2.65 for a discussion of case law and IRS changes in position concerning a power to remove the trustee and appoint someone other than himself or herself (or his or her spouse).

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§3.36 f. Independent Trustee's Powers

The grantor-trust rules do not apply when the following powers are exercisable by an independent trustee, defined as one or more trustees, none of whom is the grantor, and no more than half of whom are related or subordinate to the grantor (IRC §674(c)):

- The power to distribute, accumulate, or apportion income to or for the benefit of a specified class of beneficiaries (*i.e.,* the power to sprinkle income); or
- The power to distribute or apportion principal to or for the benefit of a specified class of beneficiaries (*i.e.,* the power to sprinkle principal).

In each of these cases, the power to sprinkle need not be limited by an ascertainable or reasonably definite standard. See IRC §674(c). If the grantor reserves the power, however, to remove the trustee and appoint himself or herself (or his or her spouse) as a trustee, the trust does not qualify for this exception. Treas Reg §1.674(d)-2(a).

For purposes of IRC §674(c), a "related or subordinate party" is defined as (IRC §672(c)):

- The grantor's spouse, if living with the grantor (but note that, under IRC §672(e), the grantor's spouse is treated as if he or she is the grantor for purposes of applying the grantor-trust rules);
- The grantor's father, mother, brother, sister, or issue; or
- An employee of (1) the grantor, (2) a corporation in which the stock holdings of the grantor and trust are significant for purposes of control, or (3) a corporation in which the grantor is an executive.

Note that the grantor's attorney and accountant are not considered subordinate parties.

EXAMPLE 1: To illustrate the operation of IRC §674(c), assume that *G* creates a trust that allows income to be sprinkled among *G*'s children for the care, comfort, welfare, and happiness of each (*i.e.,* the sprinkle power is not subject to an ascertainable standard) and the corpus to be sprinkled among *G*'s children and grandchildren in equal or unequal amounts, in the trustee's discretion. Assume, further, that *ABC Bank* is appointed to serve as the sole trustee of the trust. This trust is not treated as a grantor trust because the trustee is an independent trustee. If *ABC Bank* and *G*'s wife, *W,* are appointed cotrustees, however, the trust is treated as a grantor trust because any power held by *W* is treated as held by *G* (IRC 672(e)), and *G* may not be one of the trustees for IRC §674(c) to apply.

EXAMPLE 2: Assume the same facts as in Example 1, but that *G*'s sibling, *B*, is appointed to serve as the sole trustee of the trust. Because *B* is a related party and, as the sole trustee, constitutes more than half of the trustees, IRC §674(c) does not apply to the trust, and the trust is a grantor trust.

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§3.37 g. Power to Use Income to Discharge Grantor's Support Obligations

Even if the trust permits income to be distributed in the discretion of (1) anyone other than the grantor, (2) an independent trustee, or (3) the grantor, acting as a trustee or a cotrustee of the trust, for the support and maintenance of any beneficiary whom the grantor is legally obligated to support (other than his or her spouse), the trust is not treated as a grantor trust unless the income is actually used to discharge the grantor's support obligations. IRC §677(b). If a distribution that satisfies the grantor's obligation of support is made from other than income, however, the tax consequences of that distribution are attributable to the grantor and are governed by IRC §§661(a)(2) and 662.

The IRS has found that state law governs the extent of the grantor's support obligations. Rev Rul 56-484, 1956-2 Cum Bull 23. For example, under New Jersey law, parents have a legal obligation to provide private secondary, collegiate, and postgraduate education for their children if the parents are financially able to do so. *Frederick C. Braun, Jr.*, TC Memo 1984-285. Although the *Braun* holding was based on New Jersey case law governing the obligation of support in a divorce context, it nevertheless should serve as a warning to planners when the grantor does not want to create a grantor trust but intends to use trust income to pay for the education of his or her children. See §§5.16-5.20 for a discussion of the grantor's support obligations.

EXAMPLE 1: Assume that *G* creates a trust providing that income will be paid to *G* or *G*'s children in the trustee's discretion. Also assume that the trustee is *ABC Bank*. Even if all income was paid to *G*'s children in the tax year in question, the trust is treated as a grantor trust because trust income could have been distributed to *G*. See IRC §677(a)(1). If, instead, the trust provides that all income may be distributed as needed for the health, support, and maintenance of *G*'s children only, for each year in which a payment discharging *G*'s support obligation is made to *G*'s children, the trust is treated as a grantor trust to the extent of these payments. See IRC §677(b). The trust is not treated as a grantor trust to the extent that income is not actually used to discharge *G*'s support obligations. See IRC §677(b).

EXAMPLE 2: Assume that *G*, who is not a trustee or cotrustee of the trust, has the right to require the trustee to distribute income for the health, education, support, and maintenance of *G*'s children, even though no income may be distributed to *G* and even though no distributions are actually made to *G*'s children during the year. In that situation, the trust is treated as a grantor trust. The special exception afforded by IRC §677(b) does not apply, because the power to distribute income can be exercised by *G* in a nonfiduciary capacity. See Treas Reg §1.677(b)-1(e).

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§3.38 E. Person Other Than Grantor Treated as Owner

Any person who has the power, acting alone, to distribute income and principal to himself or herself is treated as the owner of the trust for income tax purposes. IRC §678(a)(1).

EXAMPLE 1: Assume that *G* creates a trust permitting income and principal to be sprinkled among *G*'s adult children, *S* and *D,* as needed for their care, support, comfort, and welfare. Assume also that when *D* attains age 40, the trust will be distributed equally to *S* and *D*. *G* names *S* to serve as the sole trustee. Because *S* has the power, acting alone, to distribute income and principal to himself, *S* is treated as the owner of the entire trust, even in years when distributions are made to *D*.

Additionally, after a power to withdraw is released or modified, the powerholder will continue to be treated as the owner of the trust if his or her interests in the trust would cause the trust to be treated as a grantor trust under IRC §§671-677 if the powerholder had actually contributed the property to the trust. IRC §678(a)(2). The "5 or 5" exception (see §§2.11-2.65) to the lapse of a withdrawal right is unavailable in the income tax arena. Thus, a *Crummey* withdrawal power (see chap 11) makes the powerholder the owner of the trust for income tax purposes, even if the power is limited by the "5 or 5" exception. The IRS has ruled that a *Crummey* powerholder is taxed as the owner of a *Crummey* trust for federal income tax purposes under IRC §678 as to a portion of the trust. Rev Rul 81-6, 1981-1 Cum Bull 385. The IRS has taken the position that an "ever expanding portion" of a *Crummey* trust would become subject to IRC §678 as the demand powers lapsed, adding to the portion treated as owned by the grantor the portion of the amount with respect to which the power lapsed that was not already owned by the grantor. IRS Letter Ruling 200022035.

In IRS Letter Ruling 9226037, the IRS has also ruled that, when a *Crummey* powerholder released the power but retained the right to have all the income of the trust either paid to him or her or accumulated for later distribution to him or her, the powerholder would be treated as the owner of the entire trust when:

- The transfers to any one trust do not exceed the amount that the beneficiary may withdraw;
- The donor does not restrict the beneficiary's *Crummey* power with respect to any contribution; and
- The grantor of the trust does not have, acquire, or exercise a power that would result in the grantor's being treated as the owner of the trust under IRC §§671-677.

If the rights in or power over a trust would make the trust a grantor trust with respect to the actual grantor under IRC §§671-677 and a beneficiary would also be treated as the owner of the trust under IRC §678, the grantor, rather than the beneficiary, is treated as the owner of the trust. IRC §678(b). Although IRC §678(b) refers to income, the IRS acknowledges that this can be both ordinary income and capital gain.

EXAMPLE 2: To illustrate IRC §678(b), assume the same facts as in Example 1. Because *S* is an adverse party, *G* is not treated as the owner of the trust under IRC §674(a). If, however, *G* retains a reversionary interest in the income and principal of the trust, the actuarial value of which exceeded 5 percent of the value of the trust (see IRC §673), *G* rather than *S* is treated as the owner of the trust for income tax purposes.

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§3.39 F. Tax Treatment of and Reporting for Grantor Trusts

The Treasury Regulations, in Treas Reg §1.671-4(a), give several options in reporting the tax items of a grantor trust. That section provides one set of rules when a trust is treated as owned entirely by one person (either a grantor or an IRC §678 beneficiary) who is a trustee of the trust, owned entirely by one person who is not a trustee, or owned entirely by two or more persons, and a second set of rules when a trust is only partially owned by such persons (see §3.39D).

The first set of rules applicable to trusts that are owned entirely by one or more persons (see §§3.39A-3.39C) may not be used in the following cases (Treas Reg §§1.671-4(b)(6)-(7)):

- Trust is a common trust fund under IRC §584.
- Trust has its situs or any of its assets outside the United States.
- Trust is a qualified subchapter S trust (QSST).
- Owner of trust uses fiscal year.
- Owner of trust is not a United States person.
- Certain circumstances in which there are exempt recipients for information-reporting purposes.

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§3.39A 1. Trust Owned Entirely by One Person Who Is a Trustee

Two reporting options are available (in addition to the method described in §3.39D) when the trust is owned by one person under the grantor trust rules and that person is serving as trustee (Treas Reg §1.671-4(b)(2)(i)(A), (b)(2)(ii)-(iii)):

Option 1

- Receive from the owner a completed Form W-9 (Request for Taxpayer Identification Number and Certification).
- Furnish to all payors to the trust the name and taxpayer identification number (TIN) of the person who owns the trust, together with the address of the trust.
- No income tax return of any kind is required by the trust.

Option 2

- Furnish to all payors to the trust the name, address, and taxpayer identification number (TIN) of the trust.
- File Form 1099 with the IRS reporting the income and gross proceeds received by the trust, showing the trust as the payor and the owner of the trust as the payee.

When the owner of the trust is serving as a trustee, using the trust owner's TIN (*i.e.,* social security number) is generally the more convenient method, although using the trust's name and TIN may have a privacy advantage.

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§3.39B 2. Trust Owned Entirely by One Person Who Is Not a Trustee

Two reporting options are available (in addition to the method described in §3.39D) when the trust is owned by one person under the grantor trust rules and that person is not serving as trustee (Treas Reg §1.671-4(b)(2)(i)(A), (b)(2)(ii)-(iii)):

Option 1

- Receive from the owner a completed Form W-9 (Request for Taxpayer Identification Number and Certification).
- Furnish to all payors to the trust the name and taxpayer identification number (TIN) of the person who owns the trust, together with the address of the trust.
- Furnish to the owner of the trust a statement that contains the following information:
- Shows all items of income, deduction, and credit of the trust for the taxable year;
- Provides the owner with the information needed to compute his or her taxable income; and
- Informs the owner that the items of income, deduction, and credit and other information on the statement must be reported by the owner on his or her income tax return.
- No income tax return of any kind is required by the trust.

Option 2

- Furnish to all payors to the trust the name, address, and taxpayer identification number (TIN) of the trust.
- File Form 1099s with the IRS reporting the income and gross proceeds received by the trust, showing the trust as the payor and the owner of the trust as the payee.
- Furnish to the owner of the trust a statement containing the same information as the statement described above in Option 1.
- Furnishing the statement satisfies the trustee's obligation to furnish Form 1099 information to the trust owner.

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§3.39C 3. Trust Owned Entirely by Two or More Persons

When the trust is owned by two or more persons, the trustee may report under the method described in §3.39D or as follows (Treas Reg §1.671-4(b)(3)):

- Furnish to all payors to the trust the name, address, and taxpayer identification number (TIN) of the trust.
- File Form 1099 with the IRS reporting the income and gross proceeds received by the trust, showing the trust as the payor and the owner of the trust as the payee.
- Furnish to each owner of the trust a statement that contains the following information:
- Shows all items of income, deduction, and credit of the trust for the taxable year;
- Provides the owner with the information needed to compute his or her taxable income; and
- Informs the owner that the items of income, deduction, and credit and other information on the statement must be reported by the owner on his or her income tax return.
- Except as to IRC §3406 (backup withholding), furnishing the state satisfies the trustee's obligation to furnish Form 1099 information to the trust owners.

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§3.39D 4. Grantor Trust Reporting in All Other Cases

When the trust does not qualify for any of the methods described in §§3.39A-3.39C, or the trustee elects not to use them, the trustee is required to report under Treas Reg §1.671-4(a). Under that section, the trustee is required to file a Form 1041 with a statement attached. The items of income, deduction, and credit attributable to the portion of the trust owned by the owner or the trust under the grantor trust rules are shown on a separate statement attached to Form 1041 and provided to the owner of the trust.

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G. Creating "Defective" Grantor Trusts

§3.40 1. IRC §674(c) Provisions

Provisions may be included in the trust instrument that will cause what would otherwise be a nongrantor trust to be "defective" and thus be treated as a grantor trust. One provision is designed to fail the exception to the grantor-trust rules offered by IRC §674(c), discussed in §3.36. If the grantor's spouse serves as sole trustee or as cotrustee of a trust that permits the discretionary distribution of trust income and principal, the grantor is considered the owner of the trust for federal income tax purposes. IRC §672(e). Provisions relying on the grantor's spouse, however, should be combined with other provisions to avoid the loss of grantor trust status on the death of the spouse.

Even if neither the grantor nor his or her spouse serves as a trustee, the trust is treated as a grantor trust because it will not satisfy the exception provided by §674(c) under any of the following circumstances:

- More than half of the trustees of the trust are related or subordinate to the grantor or the grantor's spouse (see §3.36);
- Exercise of the discretionary distribution powers by the trustee is subject to the approval or consent of any other person (Treas Reg §1.674(c)-1);
- The grantor's spouse has the power to remove and replace trustees (Treas Reg §1.674(d)-2(a)); or
- Any person other than the beneficiary of the trust (*e.g.,* the trustee) has the power to add beneficiaries other than the grantor's after-born or after-adopted issue (*e.g.,* a power to add in-laws), unless the power is exercisable solely by the person's will under IRC §674(b)(3) (Treas Reg §1.674(d)-2(b)). For example, in IRS Letter Ruling 200030018, the grantor included a power to add charitable beneficiaries exercisable by an independent trustee to qualify a charitable remainder trust as an S corporation shareholder.

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§3.41 2. IRC §675(4)(C) Provisions

A provision that triggers the application of IRC §675(4)(C) will cause the grantor to be treated as owner of the trust. Under that section, if the trust agreement gives the grantor the power, exercisable in a nonfiduciary capacity (*i.e.*, not as trustee), to reacquire trust assets by substituting other property of equivalent value, the trust is taxed as a grantor trust for income tax purposes. The power should not be used in a life insurance trust because the right to buy a life insurance policy is an incident of ownership that can cause inclusion of the policy in the insured's estate. See Rev Rul 79-46, 1979-1 Cum Bull 303.

The determination of whether the power is exercisable in a fiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration. Treas Reg §1.675-1(b)(4). It seems unlikely, however, that these circumstances will provide strong evidence in most cases. See Janes & Kelly, *When Using a Power of Substitution—Take Nothing for Granted*, 34 Est Plan 3, 7 (Aug. 2007).

The IRS has previously ruled that the mere existence of this power in a trust agreement was enough to make the trust in question a grantor trust for income tax purposes. See IRS Letter Rulings 9352017, 9345035, 9247024. By contrast, in IRS Letter Rulings 200709011, 200434012, 200022018, and 200010036, the IRS declined to rule that the trust in question was a grantor trust, stating:

The circumstances surrounding the administration of the trust will determine whether the power of administration is exercisable in a fiduciary or nonfiduciary capacity. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined.

In Rev Rul 2008-22, 2008-16 Int Rev Bull 796, the IRS ruled that a nonfiduciary power does not cause inclusion of trust property in the grantor's estate under IRC §2036 if certain conditions are met, citing *Estate of Anders Jordahl* (1975) 65 TC 92, acq 1977-1 Cum Bull 1. However, it appears that the power to substitute assets in *Jordahl* was held in a fiduciary capacity. See discussion in §2.61.

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§3.41A 3. Other IRC §675 Provisions

Given the government's hostility toward IRC §675(4)(C) powers (see §3.41), other approaches should also be considered. For example, a provision giving the grantor's spouse the power to create an IRC §675 power will cause the grantor to be treated as the owner of the trust (Treas Reg §1.675-1(a)), actually giving the spouse the particular IRC §675 power is not necessary (see §3.27). The trust will not be treated as owned by the spouse for estate tax purposes if the spouse is not the beneficiary of the power and if the trust prohibits distributions discharging the spouse's legal obligations. See §2.53.

Another possibility is for the grantor to borrow the corpus of the trust for less than adequate interest or security, triggering application of IRC §675(3). If the trustee is the grantor's spouse or a related or subordinate party, a loan to the grantor or the grantor's spouse for adequate interest or security will also trigger IRC §675(3). For a form of power to make loans, see §10.81. For further discussion of §675(3), see §10.99.

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§3.42 4. IRC §677(a)(3) Provisions

Alternatively, the attorney might consider triggering the application of IRC §677(a)(3). Under that section, if trust income may be applied toward the payment of premiums on insurance policies on the life of the grantor or the grantor's spouse, without an adverse party's approval or consent, the trust is taxed as a grantor trust.

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§3.43 5. IRC §678 Provisions

If a person other than the grantor has the sole power to vest income or corpus in himself or herself, that person is treated as the grantor of the trust and, as such, is taxed on all items of income, gain, loss, deduction, and credit attributable to the interest over which he or she may exercise the power. As discussed in §3.38, a *Crummey* withdrawal power makes the powerholder the deemed owner under IRC §678, even if the withdrawal power is limited by the "5 or 5" exception. The entire trust (or separate share) will be treated as a grantor trust with respect to the *Crummey* powerholder if (IRS Letter Ruling 9226037):

- Transfers to a trust (or separate shares of a trust) do not exceed the amount the beneficiary may withdraw;
- The donor has not restricted the beneficiary's *Crummey* power with respect to any contribution; and
- The grantor of the trust does not have, and may not acquire or exercise, a power that results in the grantor's being treated as the owner of the trust under IRC §§671-677.

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§3.44 6. Special Concerns and Considerations

Following are a few particular considerations regarding grantor trusts:

- *Crummey trusts.* A planner should keep in mind that a *Crummey* withdrawal powerholder is the owner of the trust for purposes of the federal income tax. See §3.43.

- *Trusts for minors.* Instead of a *Crummey* trust, the planner may want to consider the use of a IRC §2503(c) trust for minor beneficiaries. This can be designed to be a defective trust under IRC §674(c) or §675(4)(C). See §§3.40-3.41.

- *Conversion of Nongrantor Trust to Grantor Trust*. A few more arcane trust planning strategies rely on the ability to convert a nongrantor trust into a grantor trust (or "toggle" between grantor and nongrantor status) by varying some element of the trust such as the identity of the trustee. In IRS Legal Memorandum 200923024, for example, a "trust advisor" was given the power to change the trustee of an irrevocable trust and used that power to install a trustee who was related or subordinate to the settlor within the meaning of IRC §672(c), with the consequence that the trust became a grantor trust. After conversion of the trust, the settlor took the position that annuity payments made to the settlor under a private annuity received from the trust in exchange for entity interests representing highly appreciated stock should not be recognized for income tax purposes because the settlor was both the payor and payee of the payments. While stating that the IRS will continue working to find a way to curb the apparent abuse presented by the transaction, the IRS advised that the conversion of a trust from a nongrantor trust to a grantor trust should not be treated as a transfer resulting in recognition of gain.

- *Taxation of trust after grantor's death.* The planner must consider whether a defective trust will continue to be taxed as a grantor trust after the grantor's death. In IRS Letter Ruling 9321050, the IRS ruled that, because the wife was the grantor of the trust under IRC §§671-677, IRC §678(b) precluded the husband, as the holder of a power falling under IRC §678, from being treated as the grantor after the wife's death, because the power arose at the same time that the power retained by the wife arose. This ruling implies that if a power subject to §678 comes into existence after the grantor's death, the trust should continue to be treated as a grantor trust with respect to the powerholder for federal income tax purposes.

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§3.44A H. Former Grantor Trust Taxed As Estate

A decedent's executor (if any) and the trustee of the decedent's revocable trust can elect to treat the revocable trust as part of the decedent's estate for income tax purposes. IRC §645. Technically, the election extends to any trust or portion thereof that was treated under IRC §676 as owned by the decedent by reason of a power in the decedent (but not the decedent's spouse). The trust will continue to be so treated until 2 years after death if no estate tax return is required, and otherwise until 6 months after the date of the final determination of the estate tax liability. The election can be made even though the revocable trust assets are the only assets of the "estate." The significant consequences of making the election are: (1) it becomes possible for the trust to have a fiscal year tax year; and (2) it reduces the number of required tax returns when there are estate assets other than the trust assets.

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§3.44B I. Installment Sale to "Defective" Grantor Trust

One planning strategy involves the sale of assets by the grantor to an intentionally "defective" grantor trust in exchange for a promissory note. The strategy is considered an alternative to creating a grantor retained annuity trust (GRAT) for making gifts to family members. The gift tax value of property transferred to a GRAT in which the remainder beneficiaries are family members is reduced by the value of the grantor's retained annuity interest determined under IRC §7520. IRC §2702(a)(2)(B). The GRAT produces benefits if the rate of return on the trust property is greater than the assumed rate of return under IRC §7520, which is equal to 120 percent of the federal midterm rate under IRC §1274(d). However, the death of the grantor during the term of the GRAT may cause inclusion of the trust property in the grantor's estate, negating the benefits of the GRAT.

It may be possible to achieve better results by the sale of assets to a grantor trust. The IRS takes the position that the existence of a grantor trust is disregarded for income tax purposes. Rev Rul 85-13, 1985-1 Cum Bull 184. Thus, no gain is recognized on the sale of assets to the trust and the grantor is not taxed on interest payments made by the trust. Further, the gift tax value of the promissory note given by the trust in exchange for the property is determined under IRC §7872. *Edwin H. Frazee* (1992) 98 TC 554. Section 7872 incorporates the interest rate under IRC §1274(d). IRC §7872(f). In the case of a promissory note with a term of more than 3 years and less than 9 years, the IRC §1274(d) interest rate is just equal to the federal midterm rate. Therefore, a promissory note bearing interest at the §1274(d) rate should have a gift tax value equal to its face amount.

In IRS Letter Ruling 200245053, however, the IRS ruled that a fractional-share defined value sale to a grantor trust in exchange for a promissory note violated public policy under *Commissioner v Procter* (4th Cir 1944) 142 F2d 824. The grantor was deemed to transfer the entire asset to the trust. See also *Charles H. Ward* (1986) 87 TC 78; Rev Rul 86-41, 1986-1 Cum Bull 300.

As a result, assuming that IRC §2702 does not apply to the transaction, the value of any gift to the trust is the excess of fair market value of the property over the face amount of the note. It may be prudent, however, to make a gift of cash to the trust to ensure that the entire transaction will not be treated as lacking economic substance. Advocates of this technique typically suggest a gift of 10 percent of the value of the property so that the debt is no more than 90 percent of the trust assets after the sale (producing a "debt-to-equity" ratio of 9:1), but this is a subjective judgment. The debt-to-equity ratio can also be reduced by making an additional incomplete gift to the trust. This can be accomplished by having the grantor retain a limited power of appointment over a share of the trust. For discussion of this technique, see Dunn, Such & Park, *The Incomplete Equity Strategy May Bolster Sales to Grantor Trusts*, 34 Est Plan 39 (Feb. 2007). Additional assets can be sold to the trust in later years as the debt-to-equity ratio rises with the growth of trust assets. If desired, the promissory note can provide for a balloon payment. The grantor might also retain a security interest in the property. The transaction produces benefits if the rate of return on the trust property is greater than the IRC §1274(d) rate and the trust is not included in the grantor's estate. For further discussion, see chap 13A. See also Business Succession Planning: Strategies for California Estate Planners and Business Attorneys, chaps 9-11 (Cal CEB 2010).

Some commentators contend that termination of grantor trust status may be treated as a disposition of the property for income tax purposes. See Treas Reg §1.1001-2(c), Example (5); *Bernard Madorin* (1985) 84 TC 667; Rev Rul 77-402, 1977-2 Cum Bull 222; Cantrell, *Gain is Realized at Death*, 149 Trusts & Estates 34 (Feb. 2010); Dunn & Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*, 95 J Tax 49 (2001). Grantor trust status will terminate, at the latest, on the grantor's death. Thus, heavily depreciated property that could otherwise benefit from a step-up in basis on the death of the owner may not be appropriate for sale to a grantor trust. For a contrary view, based on a supposed general rule of nonrecognition of gain at death under *Crane v Commissioner* (1947) 331 US 1, 91 L Ed 2d 1301, 67 S Ct 1047, distinguished in Chief Counsel Advice 200923024 (recognition of gain on termination of grantor trust status during the grantor's lifetime), see Gans & Blattmachr, *No Gain at Death*, 149 Trusts & Estates 34 (Feb. 2010); Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J Tax 149 (2002). For a comparison of the benefits of a GRAT to the benefits of a sale to a grantor trust, see §3.44C. For further discussion of GRATs, see chap 15.

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§3.44C J. Sale to Grantor Trust Versus GRAT

There are two primary reasons a GRAT may be more beneficial than a sale to a grantor trust. First, the decision in *Audrey J. Walton* (2000) 115 TC 589, acq 2003-44 Int Rev Bull 964, indicates that the gift tax cost of a GRAT can be reduced to zero or at least close to it. See §15.6. This matches the benefit of a sale to a grantor trust even before taking into account the fact that a significant seed money gift should be made to the trust before the sale. See §3.44B. For further discussion, see Mulligan, *The Reinvigorated GRAT: Is a Sale to a Defective Trust Still Superior?*, 29 Est Plan 379 (Aug. 2002). See also Mulligan, *The Use of Intentionally Defective Irrevocable Trusts (IDITs) in Estate Planning*, Estate Planning 2002, chap 3 (Cal CEB 2002).

Second, the increase in the estate tax applicable exclusion amount since 2001, followed by estate tax repeal in 2010 (see chap 2), gives rise to the possibility that a taxpayer will need to be more concerned about capital gain taxes than estate taxes. In a typical GRAT, the opportunity for a new basis under IRC §1014 (or IRC §1022 in 2010) is lost only to the extent that successful GRAT performance results in extra assets passing to the remainder beneficiaries. In a sale to a grantor trust, such opportunities are generally given up for the transferred assets as soon as the sale occurs. With both transactions, there are ways to ameliorate the basis problem (*e.g.*, by swapping assets between the settlor and the trust while the trust is a grantor trust), but generally a GRAT is more advantageous with respect to basis.

In addition to these two considerations, planners should be aware of the following issues when comparing a GRAT with a sale to a grantor trust. These comparisons assume that the GRAT is actually a series of rolling, short-term, zeroed-out GRATs in which the settlor uses annuity payments to establish new GRATs (see §15.4) and that the sale to the grantor trust is made in exchange for a long-term note that provides for interest payments and a balloon payment at the end of the full amount of principal. See chap 13A.

Protection against subsequent poor investment performance. In rolling GRATs, poor investment performance down the road will not eat into the benefits of early successes. However, a sale to a grantor trust remains exposed to this risk and creates the further risk that it will be necessary to use the seed money to make payments on the note.

Protection of transfer tax benefits in the event of death in a short period of time. If a sudden jump occurs in the value of the trust property immediately after funding the trust, and the settlor dies soon after, the benefit of a GRAT transaction will be lost if the settlor has not survived the term, whereas death of the settlor is generally irrelevant for transfer tax purposes in the case of a grantor trust. Of course, this consideration must be weighed against potential grantor trust income tax burdens. See §3.44B. Further, an immediate jump in value following a transfer will raise issues concerning the gift tax value of the transferred property regardless of whether the trust is a GRAT or a grantor trust.

Grantor control. When there is a sale to a grantor trust, the benefit of the transaction will be lost if the grantor trust is included in the settlor's estate for estate tax purposes. Accordingly the settlor's powers with respect to the trust must be limited. In a GRAT, however, a high percentage of the assets of each particular GRAT is returned to the grantor and the grantor's control. Further, in rolling GRATs, the settlor can change remainder beneficiaries each time a new GRAT is created.

Change of law risk. In many situations tax laws are changed in ways that "grandfather" tax treatment for transactions that have taken place in the past. Accordingly, a current sale to a grantor trust would probably be protected from any future law changes and would continue to produce benefits for the term of the note. In contrast, the benefits of a rolling GRAT strategy (see §15.4) would end quickly if a law change suddenly reduced the desirability of newly established GRATs. The zeroed-out, rolling GRAT strategy would be adversely affected, for example, by a rule providing that the gift on establishing a GRAT could not be less than 10 percent of the value of the assets transferred to a GRAT. Such a rule already applies in the context of business entity freezes. See IRC §2701(a)(4). The Supplemental Appropriations Act (HR 4899), passed by the House of Representatives on July 1, 2010, would require GRATs to have a minimum term of 10 years with a nondecreasing annuity and would preclude zeroed-out GRATs. The proposed legislation would effectively negate the rolling GRAT strategy.

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§3.44D K. Beneficiary Defective Trust

A somewhat exotic form of installment sale to a grantor trust attempts to avoid the need to make a substantial gift of seed money to the trust (as discussed in §3.44B) by using beneficiary guarantees to provide additional security for the note. Advocates of this technique assert that it can have significant advantages without adding appreciably more risk to what is admittedly an already high-risk technique. See Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts,* 92 J Tax 162 (Mar. 2000). A variation of this technique known as a "beneficiary defective trust" is intended to minimize the risk of inclusion of the sale property in the transferor's estate by having a friend or relative create a trust for the benefit of the transferor funded with an annual exclusion gift. The beneficiary is given powers over the trust that make it a grantor trust with respect to the beneficiary. To avoid the possible estate and gift tax consequences of a gratuitous guarantee by the beneficiary, the trust makes annual payments equal to the fair market value of a bona fide guarantee as determined by a qualified appraisal in exchange for a guarantee against nonpayment of the note provided by a second grantor trust created by the beneficiary. These payments in lieu of a beneficiary guarantee are intended to protect the trust from an IRS claim that the transaction lacks economic substance.

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§3.44E L. Grantor Irrevocable Life Insurance Trust (GILIT)

A variation on the installment sale technique described in §3.44B is a grantor irrevocable life insurance trust (GILIT) funded by a loan from the grantor secured by a life insurance policy on the life of the grantor with premiums to be paid from the trust assets. To avoid inclusion of the policy in the grantor's estate (see §2.63), the grantor has no right other than to the repayment of the loan at the discretion of the trustee. There is no gift to the remainder beneficiaries of the trust provided the grantor and the trust comply with regulatory notice requirements under IRC §7872, because the loan bears interest at the applicable federal rate, although a small gift can be made to the trust for which there is an allocation of GST exemption. Because the trust is a grantor trust, the grantor will pay the income taxes. If the trust produces a sufficient return, there should be enough money to pay the annual premiums and repay the loan plus accrued interest at the end of the loan term. The intended result is a transfer-tax-free dynasty trust funded with life insurance. See Harris, *Split-Dollar Loan to a Grantor Irrevocable Life Insurance Trust*, 36 Est Plan 3 (Dec. 2009).

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IV. CHARITABLE REMAINDER TRUSTS AND CHARITABLE LEAD TRUSTS

§3.45 A. Charitable Remainder Trusts (CRTs)

Two types of trust qualify as charitable remainder trusts (CRTs): charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). See IRC §664. The requirements for qualifying a trust as a charitable remainder trust are discussed in chap 18. For further discussion of CRTs, see California Estate Planning, chap 24 (Cal CEB 2002).

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§3.46 1. Taxation of CRTs

A CRT is exempt from income tax. However, a CRT is subject to a 100-percent excise tax on unrelated business taxable income (UBTI). Furthermore, if a CRT distributes property in kind to satisfy an annuity or unitrust payment, it is deemed to have engaged in a taxable sale or exchange. Treas Reg §1.661(a)-2(f). Although this treatment has no tax consequence to the trust, a taxable sale or exchange creates capital gain, which may affect the tax consequences of distributions to noncharitable beneficiaries. See §3.47.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

Additional excise taxes are imposed on a CRT to the extent it engages in any prohibited transactions, including:

- Self-dealing (*i.e.,* a direct or indirect sale or lease, furnishing of goods or services, extension of credit, payment of compensation, or transfer of property) between the CRT and a disqualified person (*i.e.,* the trustee, a substantial contributor, or a party related to either) (IRC §4941);
- Paying to influence legislation, influence a public election, or for voter registration drives, and making certain prohibited grants (IRC §4945); or
- Possessing excess business holdings (*i.e.,* the CRT, together with all disqualified persons, owns 20 percent or more of the voting stock of a corporation operating a business or a 20-percent or greater interest in an unincorporated business) (IRC §4943).

For special exceptions to the imposition of this excise tax, see Stoneman, Private Foundations—Excess Business Holdings, Tax Management Portfolios 881-2d (2003).

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§3.47 2. Taxation of Noncharitable Beneficiaries

A noncharitable beneficiary of a CRT is taxed according to a special tier system (IRC §664(b)):

- A distribution is deemed to come first from current and accumulated ordinary income, which is determined without regard to any net operating losses (NOLs). Other ordinary losses first offset current income, next are carried back to offset income earned in the earliest years of the CRT, and then are carried forward indefinitely to determine the amount of accumulated ordinary income.

- A distribution is deemed to come next from current and accumulated gains from sales of capital assets, and next from current and accumulated tax-exempt income. Consistent with this general "worst in—first out" approach, short-term capital gains are deemed distributed before long-term gains. However, qualified dividends taxed at the same rate as long-term gains are considered ordinary income and are deemed distributed before short-term gains. If long-term gains are taxed at different rates, the gains subject to tax at the higher rates are deemed distributed first. Treas Reg §1.664-1(d). See §18.31.

- A distribution in excess of the foregoing classes of income is deemed to come from principal.

Income is deemed to be distributed to the beneficiary on the last day of the taxable year of the CRT even though the beneficiary may not receive the distribution until the next taxable year.

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§3.48 3. Taxation of Charitable Beneficiaries

Charitable beneficiaries of CRTs (as well as charitable lead trusts, discussed in §§3.49-3.51) are taxed on the basis of a special tier system that is the reverse of the noncharitable beneficiary tier system. See §3.47. That is, a distribution to a charitable beneficiary other than an annuity or unitrust distribution comes first from principal, then tax-exempt income, then capital gain and, finally, ordinary income. Treas Reg §1.664-1(e).

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§3.49 B. Charitable Lead Trusts (CLTs)

A charitable lead trust (CLT) is a trust that provides for payment of the income interest to a qualified charity for a specified period of time, after which the remainder passes to the grantor, his or her spouse, or his or her heirs. There are two types of CLTs. A charitable lead annuity trust (CLAT) is a trust that pays a guaranteed annuity to a qualified charity. It can be used to permit the actuarial value of the lead interest to qualify for the gift or estate tax charitable deduction, and also an income tax deduction. See Treas Reg §1.170A-6(c)(2)(i). In a charitable lead unitrust (CLUT), the charity receives an annual payment equal to a fixed percentage of the fair market value of the property held in trust, determined annually.

There is no charitable deduction for income tax purposes for the interest passing to the charity from a CLT unless the trust is a grantor trust for income tax purposes. IRC §170(f)(2)(B).

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§3.50 1. Grantor CLTs

No immediate income tax deduction is available to the grantor at the time a CLT is created, unless the grantor is taxed on all items of income, gain, loss, deduction, and credit attributable to trust assets under the grantor trust rules. See §§3.22-3.44. Note that if the grantor designs the CLT to qualify for an immediate income tax deduction, in essence, he or she is accelerating a deduction into the current taxable year and deferring taxable income to later years.

That is because the grantor is taxed on income earned by the CLT as it is earned, but is not entitled to claim any further charitable deduction as distributions are actually made to the charity. IRC §170(f)(2)(C). In addition, the grantor may claim a gift or estate tax deduction equal to the actuarial value of the lead interest passing to the qualified charity.

Typically, the provision used to make a CLT into a grantor trust is IRC §673. Under IRC §673(a), the grantor is treated as the owner of a trust in which he or she retains a reversionary interest that exceeds 5 percent of the trust's value at its inception.

PRACTICE TIP: The drafter of a CLT should be aware of the following considerations:

- The CLT may be subject to some or all of the excise taxes discussed in §3.46.
- The grantor's final income tax return may be required to recapture part of the income tax deduction taken upon the creation of the CLT if the grantor dies during the term of the charitable lead interest. The return must recapture the portion of the deduction originally claimed that exceeds the discounted value of the taxable income of the CLT actually paid to the charity and on which the grantor was taxed. Treas Reg §1.170A-6(c)(4).
- Finally, because the trust interest passing to the charitable lead beneficiary is "for the use of" rather than "to" the charity, the charitable deduction available to the donor is limited to 30 percent of his or her adjusted gross income. IRC §170(b)(1)(B).

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§3.51 2. Nongrantor CLTs

If a CLT is not a grantor trust, the grantor does not receive an immediate income tax deduction for the lead interest passing to the charity at the creation of the CLT. The actuarial value of the lead interest passing to the charity still qualifies, however, for the federal gift or estate tax charitable deduction.

Because the donor cannot claim an income tax deduction for the lead interest, the only benefit to the donor from the creation of a nongrantor CLT is the reduction of the value of the donor's taxable estate and removal of the income from the donor's taxable income. Because the remainder interest in the CLT must pass to someone other than the donor or the donor's spouse to avoid application of the grantor-trust rules to the CLT, the donor makes a taxable gift at the time of the creation of the CLT in an amount equal to the value of the remainder interest passing to the noncharitable beneficiaries.

PRACTICE TIP: Despite the unavailability of an income tax deduction for the donor, the drafter should not overlook the possibility that the IRC §7520 valuation tables may have the effect of overvaluing the lead interest passing to the charity. If that is the case, the donor can pass a substantial after-tax amount to his or her heirs by using a CLT. See chap 18A. See chap 6 for a discussion of valuation of charitable interests.

The income earned by a nongrantor CLT is not taxed to the donor when it is received by the CLT. Rather, the CLT gets a charitable deduction for amounts that are actually paid to a charity, either in the current year or the next year. IRC §642(c). See §3.6.

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V. TRUSTS HOLDING S CORPORATION STOCK

§3.52 A. General S Corporation Trust Rules

Special rules apply to trusts that receive and hold S corporation stock. See IRC §1361-1379. Five types of trusts are eligible to hold such stock:

- Grantor trusts. See §§3.53-3.56.
- Qualified subchapter S trusts (QSSTs). See §§3.57-3.63.
- Trusts that have received assets from a deceased shareholder's estate, although this type of trust may hold S corporation stock only for a limited period.
- Special S corporation voting trusts, which are beyond the scope of this book.
- Electing small business trusts (ESBTs). See §§3.64-3.67.

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B. Grantor Trusts Holding S Corporation Stock

§3.53 1. Eligible Trusts

Any trust treated as owned entirely by one person under the grantor trust rules may hold S corporation stock. IRC §1361(c)(2)(A)(i). The IRS ruled, in IRS Letter Ruling 9037011, that the grantor's retention of an administrative power in a nonfiduciary capacity (*i.e.,* IRC §675(4)) was sufficient to make the trust a grantor trust eligible to hold S corporation stock. However, the IRS has indicated in numerous letter rulings that it will refuse to rule on whether the power to substitute property in a nonfiduciary capacity makes a particular trust a grantor trust. See §§3.41-3.41A. For further discussion, see Howell-Smith, *What Types of Trusts Are Permitted Shareholders of an S Corporation?,* 34 Est Plan 26 (June 2007).

When S corporation stock is held in a grantor trust, the deemed owner is treated as the shareholder for all purposes. Treas Reg §1.1361-1(h)(3)(i)(A). To qualify as an S corporation shareholder, the entire grantor trust must be owned by one individual who is a United States citizen or resident. Treas Reg §1.1361-1(h)(1)(i).

A trust cannot hold S corporation stock when:

- The trust is owned jointly by more than one individual, unless it is jointly owned by a husband and wife, and both are United States citizens or residents. Treas Reg §§1.1361-1(e)(2), 1.1361-1(h)(1)(i).
- One person is considered to own the income interest under the grantor-trust rules, and another person is considered to own the interest in corpus.

PRACTICE TIP: When drafting an irrevocable trust benefiting persons other than the grantor that includes defective provisions (see §§3.40-3.44), the planner should be careful if the trust will hold S corporation stock. If the grantor (see IRC §§673-677) and a beneficiary (see IRC §678(a)) are deemed the owners of the trust, the grantor, rather than the beneficiary, is considered the owner of the trust. IRC §678(b).

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§3.54 2. *Crummey* Trusts

The IRS has ruled that a *Crummey* trust with a single beneficiary during the life of the beneficiary is treated as owned by the beneficiary under IRC §678 and is therefore eligible to hold S corporation stock. IRS Letter Ruling 200011058.

The IRS has found, however, that when a *Crummey* demand power is given to someone who is not an income beneficiary, the trust does not qualify as a wholly owned, beneficiary-controlled trust. IRS Letter Ruling 8823028. Note that an income beneficiary will continue to be treated as the owner of the trust after the power lapses. See §3.38.

In addition, the creation of additional shares of such a trust for the grantor's after-born grandchildren will result in shares that are not deemed owned by the beneficiary, with the consequences that those shares cannot be eligible shareholders unless they are eligible on some other basis. Rev Rul 89-45, 1989-1 Cum Bull 267 (which predates the enactment of IRC §1361(e), which permits electing small business trusts (ESBTs) to be shareholders of S corporations). See §3.64.

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§3.55 3. Tax Treatment After Deemed Owner's Death

After the deemed owner's death, a trust that is not a QSST or a grantor trust at that time remains an eligible S corporation shareholder for 2 years. The trust is taxable on all items of income, gain, loss, deduction, and credit directly attributable to the S corporation stock for that period, using the rules applicable to nongrantor trusts, discussed in §§3.5-3.21. See IRC §§1361(c)(2)(A)(ii), (c)(2)(B)(ii).

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§3.56 4. Areas of Particular Concern

When a grantor trust holds S corporation stock, the planner should pay particular attention to application of the normal Subchapter J rules (IRC §§641-692) to the trust's treatment of income, gain, loss, deduction, and credit directly attributable to the S corporation stock. Application of the Subchapter J rules to these items may have an adverse impact on the beneficiaries.

The planner should also be aware that an S corporation may not have more than 100 shareholders. Two years after the deemed owner's death, most beneficiaries of the trust having noncontingent interests will be treated as shareholders. Treas Reg §1.1361-1(m).

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C. Qualified Subchapter S Trusts (QSSTs)

§3.57 1. General Rule

Generally, three kinds of trusts are eligible stockholders of an S corporation. First, a trust that is deemed owned by the grantor under IRC §671 qualifies if the grantor is an eligible shareholder. IRC §1361(c)(2)(A)(i). Second, as discussed below, a trust can satisfy the requirements for a qualified subchapter S trust (QSST). Third, a trust can satisfy the requirements for an electing small business trust (ESBT). See §3.54. Generally, the requirements for a QSST are less flexible than those for an ESBT, but an ESBT typically pays higher taxes. Subject to certain limitations, a QSST can be converted to an ESBT and vice versa. See Treas Reg §1.1361-1(j)(12), (m)(7).

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§3.58 2. Basic Requirements for QSST

A QSST must meet six requirements:

- There may be only one income beneficiary of the trust. IRC §1361(d)(3)(A)(i).
- The trust may not distribute principal to anyone other than the income beneficiary. IRC §1361(d)(3)(A)(ii).
- The income beneficiary's interest must terminate at the earlier of (a) his or her death or (b) the termination of the trust. IRC §1361(d)(3)(A)(iii).
- If the trust terminates while the income beneficiary is alive, the assets held in the trust may be distributed only to the income beneficiary. IRC §1361(d)(3)(A)(iv).
- The trust must be required to distribute or must actually distribute all income to one individual who is a United States citizen or resident. IRC §1361(d)(3)(B).
- The income beneficiary, or his or her legal representative, must elect to be treated as the deemed owner (IRC §678(a)) of the portion of the trust consisting of the S corporation stock. IRC §1361(d)(1)(B), (d)(2).

The IRS has ruled that the first four requirements listed above must be set forth in the trust instrument and must be met even after the trust ceases to hold S corporation stock. Rev Rul 89-55, 1989-1 Cum Bull 268. This is not true of the fifth requirement. See IRS Letter Ruling 9014008.

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§3.59 3. Requirement to Distribute All Income

All income earned by the trust must be required to be distributed or must actually be distributed to the beneficiary currently (*i.e.,* at least annually) for the trust to qualify as a QSST. IRC §1361(d)(3)(B). The trust may also qualify if the beneficiary has the power to withdraw any gifts to the trust for a limited period. The IRS has ruled that the withdrawal power causes the trust income to be taxed to the beneficiary under IRC §678 even after lapse of the power. IRS Letter Ruling 200147044. Income for these purposes means trust accounting income. See IRC §643(b).

PRACTICE TIP: The attorney should be aware of the tax problems for the income beneficiary of a QSST when the beneficiary is also taxed on capital gain realized by the S corporation (of which he or she would be treated as the deemed owner under IRC §678) that are not paid to him or her. Capital gain is not trust accounting income under the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), but the UPAIA permits the trustee to make an adjustment between principal and income to offset the income tax imposed on the income beneficiary of a QSST attributable to capital gain. Prob C §16375(a)(2).

For the trust to qualify as a QSST, the beneficiary must receive all the income under all circumstances. The IRS has found that trusts *are* QSSTs under the following circumstances:

- The trust permits the payment of income to the custodian of a minor beneficiary under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925). IRS Letter Ruling 8831020.
- The trust permits the trustee to accumulate income, as long as the trustee currently distributes all income to the beneficiary while the trust holds S corporation stock. IRS Letter Ruling 8921056.
- The trustee is permitted to accumulate income, as long as the trust does not hold S corporation stock. IRS Letter Ruling 9014008.
- The trust holds only a life tenant interest in S corporation stock. IRS Letter Ruling 200404037.

The IRS has found that trusts *are not* QSSTs in these situations:

- The trust requires the trustee to accumulate income until the beneficiary has attained age 21. IRS Letter Ruling 8921013.
- The trustee makes distributions to a grantor trust that is wholly owned by the income beneficiary of the QSST, rather than directly to the income beneficiary. IRS Letter Ruling 9014008.
- The trust is a charitable remainder trust (see §§3.45-3.48). IRS Letter Ruling 8922014.

PRACTICE TIP: When drafting a QSST, the planner should pay special attention to trusts that include spendthrift provisions. See IRS Letter Ruling 8952014 for a discussion of spendthrift clauses that prevent the trust from becoming a QSST.

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§3.60 4. One-Beneficiary Requirement

There may be only one beneficiary of a QSST. IRC §1361(d)(3)(A)(i), (d)(3)(B). A QSST may have successive income beneficiaries, however, if there is no more than one income beneficiary at any one time. Treas Reg §1.1361-1(j)(1)(iii), (j)(9). If a single trust has more than one beneficiary, and if the beneficiaries have substantially separate and independent shares of the trust, the separate shares are treated as separate trusts for purposes of meeting this requirement. Treas Reg §1.1361-1(j)(3).

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§3.61 5. QSST Election

The income beneficiary of the QSST must make an affirmative election to be treated as the deemed owner of the QSST under IRC §678, in the manner and form prescribed by the regulations. IRC §1361(d)(1)(B), (d)(2). The beneficiary must make a separate election for each S corporation whose stock is held in the QSST. Treasury Regulation §1.1361-1(j)(6) sets forth the manner and form of the election. After the QSST election has been made, it is irrevocable without the consent of the Secretary of the Treasury. See IRC §1361(d)(2)(C).

The election should be made by the current income beneficiary of the QSST, or his or her legal representative. Treas Reg §1.1361-1(j)(6)(ii). If the income beneficiary who made the election dies, each successive income beneficiary is treated as consenting to the election unless a successive income beneficiary affirmatively refuses to consent to the election. Treas Reg §1.1361-1(j)(9). In addition, because the current income beneficiary of the QSST is treated as a shareholder of the S corporation (Treas Reg §§1.1361-1(h)(3)(i)(C), 1.1361-1(j)(7)), the individual must consent to the election to treat the corporation as an S corporation. IRC §1362(a)(2); Treas Reg §1.1362-6(b)(2)(iv). Failure to have all persons who are shareholders of the S corporation (in this case, the current income beneficiary of the QSST) consent to the election invalidates the election. The IRS has authority, however, to waive the inadvertent invalidity of a qualified S corporation election. See IRC §1362(f)(1)(A). Relief from late elections may be requested under Rev Proc 2003-43, 2003-1 Cum Bull 998.

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§3.62 6. Tax Consequences of QSST

All items of income, gain, loss, deduction, and credit directly attributable to the activities of the S corporation are taxable to the income beneficiary. IRC §678(a). The income beneficiary will be taxed on this income regardless of the trust accounting income that the beneficiary is entitled to receive, which typically will only be dividends paid by the corporation. See §3.60.

The sale of the S corporation stock terminates the income beneficiary's deemed ownership under IRC §678; therefore, the gain or loss realized on the sale is subject to taxation under the normal rules applicable to trusts (see §§3.5-3.21). It is not automatically taxed to the income beneficiary of the QSST. Treas Reg §1.1361-1(j)(8).

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§3.63 7. Creative Use of S Corporations and Trusts

An S corporation may be created to hold all the assets of an existing nongrantor trust and thus avoid taxation of distributable net income (DNI) at the trust level. In such a trust, all DNI is taxed at the beneficiary level, even though the trust makes few, if any, distributions to its beneficiaries. A corporation that has been an S corporation from inception (*i.e.,* with no earnings and profits generated before it became an S corporation) may derive up to 100 percent of its gross receipts from passive investments (royalties, rents, dividends, interest, and annuities). IRC §§1362(d)(3), 1363(a).

This idea contemplates the formation of an S corporation, followed by the transfer of all of the assets held in the trust to the S corporation. The formation of the S corporation and the transfer of assets in exchange for shares may be structured to qualify as a tax-free exchange under IRC §351. The trust must be either a QSST with a sole current-income beneficiary, or a trust that creates separate shares, each of which is a QSST and each of which has a single current income beneficiary.

Through the use of an S corporation in conjunction with a QSST, all items of income, gain, loss, deduction, and credit attributable to the S corporation's activities flow through and are taxed to the current-income beneficiary of the QSST, whether the S corporation actually makes distributions to the QSST. Without distributions from the S corporation to the QSST, there is no trust accounting income to be distributed by the QSST to its current-income beneficiaries. Furthermore, to the extent it becomes appropriate to make distributions to the current-income beneficiaries, the S corporation may make the necessary distributions to the QSST. Distributions are controlled through the mechanism of declaring dividends on the S corporation stock. The use of such a plan permits the trustee to accumulate funds for the benefit of the QSST beneficiaries without incurring the adverse income tax consequences resulting when taxable income is accumulated in a trust.

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D. Electing Small Business Trusts (ESBTs)

§3.64 1. General Rule

Under IRC §§1361(c)(2)(A)(v) and 1361(e), an electing small business trust (ESBT) may hold S corporation stock. If the trust meets the statute's requirements for ESBT status, and the trustee of the trust makes the required election (see §3.65), the portion of the trust consisting of stock of one or more S corporations is subject to special rules that modify the customary rules for taxation of trusts. See §3.67 for discussion of the special taxation rules applicable to ESBTs. Subject to certain limitations, a QSST can be converted to an ESBT and vice versa. See Treas Reg §1.1361-1(j)(12), (m)(7).

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§3.65 2. Basic Requirements for ESBTs

A trust must fulfill four requirements to qualify as an ESBT:

- The trust may not have beneficiaries other than individuals, estates, or certain specified charities, including public charities (IRC §170(c)(2)), war veterans' organizations (IRC §170(c)(3)), fraternal societies, orders, or associations (IRC §170(c)(4)), and cemetery organizations (IRC §170(c)(5)).

- No interest in the trust may be acquired by purchase. IRC §1361(e)(1)(A)(ii). An interest is considered to have been purchased if its basis is determined under IRC §1012. IRC §1361(e)(1)(C).

- The trustee must make the election to be treated as an ESBT. IRC §1361(e)(3). See Treas Reg §1.1361-1(m)(2). In addition, because each potential current beneficiary of the ESBT is treated as a shareholder of the S corporation (Treas Reg §§1.1361-1(h)(3)(i)(F), 1.1361-1(m)(4)), each individual must consent to the election to treat the corporation as an S corporation. IRC §1362(a)(2); Treas Reg §1.1362-6(b)(2)(iv). Failure to have all persons who are shareholders of the S corporation (in this case, all potential current beneficiaries of the ESBT) consent to the election invalidates the election. The IRS has authority, however, to waive the inadvertent invalidity of a qualified S corporation election. See IRC §1362(f)(1)(A). Relief from late elections may be requested under Rev Proc 2003-43, 2003-1 Cum Bull 998.

- The trust may not be a QSST, a tax-exempt trust, or a charitable remainder trust. (*i.e.*, a CRT). IRC §1361(e)(1)(B)(ii)-(iii).

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§3.66 3. Determining Number of S Corporation Shareholders

The maximum number of permitted shareholders for an S corporation is 100. IRC §1361(b)(1)(A). A husband and wife are counted as one shareholder. Generally, each potential current beneficiary of a trust is treated as a separate shareholder. IRC §1361(c)(2)(B)(v). A potential current beneficiary is any person who, at any time during the period in question, is entitled to, or at the discretion of any person may receive, a distribution of income or principal. IRC §1361(e)(2). This does not include persons whose contingent interests are so remote as to be negligible, persons who may become beneficiaries in the future as a result of an exercise of a power of appointment, or persons whose rights to distributions are subject to a condition that has not occurred. Treas Reg §1.1361-1(m); IRS Notice 97-49, 1997-2 Cum Bull 304. For further discussion, see Howell-Smith, *Fewer Trusts May Qualify as ESBTs Under New Final Regs.*, 29 Est Plan 618 (2002); August, Huffaker & Agran, *Clarifications Made by ESBT Final Regulations Demonstrate the Need for More Statutory Changes*, 97 J Tax 69 (2002).

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§3.67 4. Taxation of ESBTs

Special rules apply to the income taxation of ESBTs. The portion of an ESBT that consists of S corporation stock is treated as a separate trust. IRC §641(c)(1)(A). The separate trust computes its taxable income taking into account only the following items:

- Items of income, deduction, loss, or credit that each S corporation shareholder must account for under the typical S corporation rules of IRC §1366. IRC §641(c)(2)(C)(i).
- Gain or loss from the disposition of S corporation stock. IRC §641(c)(2)(C)(ii).
- State or local income taxes and administrative expenses allocable to either or both of the above two items. IRC §641(c)(2)(C)(iii).

Taxable income is determined and taxed at the trust level and is not apportioned among the beneficiaries, even though distributions have been made to them. IRC §641(c)(2)(C). In addition, capital losses may be claimed only to the extent of capital gains (IRC §641(c)(2)(D)), and there is no exemption for purposes of determining alternative minimum taxable income of the separate share of the trust attributable to the S corporation stock (IRC §641(c)(2)(B)). See §3.9 for discussion of the alternative minimum tax. Tax is paid on the net income of the separate trust at the highest marginal tax rate applicable to trusts (IRC §641(c)(2)(A)) (currently 35 percent for ordinary income under IRC §1(e) and 15 percent for capital gains and qualified dividends under IRC §1(h)). In determining the tax treatment of the trust for assets other than the S corporation stock, the items attributable to taxation of the separate trust for the S corporation stock are excluded from distributable net income (DNI), and the normal rules for taxation of trusts apply. IRC §641(c)(3). Finally, when all or a portion of the separate S corporation stock trust terminates, unused loss carryovers and excess deductions may be taken into account by the entire trust subject to the normal rules for taxation of trusts. IRC §641(c)(4).

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VI. FOREIGN TRUSTS

§3.68 A. Definition of Foreign Situs Trust

A foreign situs trust is a trust formed and governed under the laws of a jurisdiction other than the United States. There is a two-part test for determining the situs of a trust. IRC §7701(a)(30)(E). If either part of the test is not met, the trust is a foreign trust. IRC §7701(a)(31)(B).

- Part one requires that a court located in the United States be able to exercise primary supervision over the administration of the trust. IRC §7701(a)(30)(E)(i). A trust agreement providing that the trust will be governed under the laws of any state, such as California, is probably sufficient to satisfy the first part of the test. See §§3.68A-3.68C.

- Part two requires that one or more United States persons have the authority to control all substantial decisions related to the trust. IRC §7701(a)(30)(E)(ii). See §§3.68D-3.68F.

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§3.68A 1. Court Test

A trust will meet the court test under IRC §7701(a)(30)(E)(i) if a court within the United States is able to exercise primary supervision over the administration of the trust. Treas Reg §301.7701-7(a)(1)(i).

Recognizing that it may be difficult to determine whether a court of a particular state would assert primary supervision over the administration of a particular trust, the regulations provide a safe harbor for the court test. See §3.68B. A trust that provides for automatic migration, however, will not meet the test. See §3.68C.

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§3.68B a. Safe Harbor for Court Test

Under the safe harbor, a trust will satisfy the court test if (1) the trust instrument does not direct that the trust be administered outside of the United States, (2) the trust is in fact administered exclusively in the United States, and (3) the trust is not subject to an automatic migration provision (see §3.68C). Treas Reg §301.7701-7(c)(1). An example is provided in Treas Reg §301.7701-7(c)(2). A nonexclusive list of trusts that meet the court test is provided in Treas Reg §301.7701-7(c)(4).

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§3.68C b. Automatic Migration Rule for Court Test

Despite any other provision of the regulations, a trust will not meet the court test if the trust instrument provides that a United States court's attempt to assert jurisdiction or otherwise supervise the administration of the trust will directly or indirectly cause the trust to migrate from the United States. A very limited exception to this rule provides that a trust will not fail to meet the court test solely because the trust instrument provides that the trust will migrate only in the event of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States. Treas Reg §301.7701-7(c)(4)(ii).

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§3.68D 2. Control Test

A trust will meet the control test under IRC §7701(a)(30)(E)(ii) and Treas Reg §301.7701-7(a)(1)(ii) if one or more United States persons have the authority to control *all* substantial decisions of the trust. Treas Reg §301.7701-7(d)(1). To determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.

Trusts are allowed a 12-month grace period to meet the test in the event of an inadvertent change in any person that has the power to make a substantial decision of the trust that causes the residency of the trust to change. See §3.68E. A trust that provides for automatic migration, however, will not meet the test. See §3.68F.

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§3.68E a. Twelve-Month Grace Period After Inadvertent Change in Trust Residence

If an inadvertent change regarding a person with the power to make a substantial decision of the trust that would cause the domestic or foreign residency of the trust to change, the trust is allowed 12 months after the date of the change to make necessary changes, either as to the persons who control the substantial decisions or as to the residence of those persons to avoid a change in the trust's residency. An inadvertent change means the death, incapacity, resignation, change in residency, or other change concerning a person with the power to make a substantial decision of the trust that would cause an unintended change to the residency of the trust. If the necessary change is made within 12 months, the trust is treated as retaining its prechange residency during the 12-month period. If the necessary change is not made within 12 months, the trust's residency changes as of the date of the inadvertent change. Treas Reg §301.7701-7(d)(2).

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§3.68F b. Automatic Migration Rule for Control Test

Despite any other provision of the regulations, United States persons are not considered to control all substantial decisions of the trust if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by United States persons. Treas Reg §301.7701-7(d)(3).

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§3.69 B. Taxation of Foreign Trusts; Reporting Requirements

A foreign trust is not subject to United States income tax on its income from foreign sources. It is subject to United States income tax only on income from a United States source that is fixed or determinable, annual or periodical (FDAP). In addition, it is taxed on income effectively connected with the conduct of a United States trade or business, included in its distributable net income (DNI), and not distributed to its beneficiaries. IRC §871(a).

Typically, FDAP income includes interest on United States obligations, dividends on United States stock, rent from United States assets, and United States royalty payments not effectively connected with the conduct of a United States trade or business. When retained by a foreign trust, FDAP income is taxed at a flat rate of 30 percent. It may be less if modified by treaty, but that usually occurs only when a substantial tax is payable in the treaty country on the same income. In addition, any items of income, gain, loss, deduction, and credit effectively connected with the conduct of a United States trade or business by a foreign trust are taxed to the foreign trust in the same manner as they would be taxed to a United States person (*i.e.,* income and profits stemming from the operation of the trade or business are included in the DNI of the trust and, if not distributed to the beneficiaries, are taxed to the trust at the same federal income tax rates applicable to a United States trust).

If a foreign trust owns an interest in United States real property (USRPI), and the trust does not elect to treat the USRPI as a United States trade or business, the gross rental receipts (*i.e.,* rent unreduced by expenses such as management fees, real property taxes, water and utility charges, interest on mortgages) are subject to a flat tax of 30 percent (or less if modified by treaty). IRC §871(a). If, instead, the foreign trust elects to treat the USRPI as a United States trade or business, the net rental receipts (*i.e.,* rent reduced by expenses such as management fees, real property taxes, water and utility charges, interest on mortgages) are subject to income taxes based on rates applicable to United States trusts. IRC §871(d). In either event, gain on the sale of the USRPI is taxed at the alternative minimum tax rate applicable under IRC §55(b)(1)(A). IRC §897.

Taxation of the beneficiaries of a foreign trust that is not a grantor trust for federal income tax purposes is discussed in §3.73. United States persons who make transfers to foreign trusts or are treated as owners of foreign trusts are subject to significant reporting requirements, with substantial penalties for failure to comply. IRC §§6048(b), 6677; IRS Notice 97-34, 1997-1 Cum Bull 422. See §§3.69A-3.69H.

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§3.69A 1. Annual Reporting Required for Foreign Trust With United States Grantor

Under IRC §6048(b)(1), a United States person who at any time during a taxable year is treated as the owner of any portion of a foreign trust under the grantor trust rules is responsible to ensure that, by the 15th day of the third month after the end of the trust's tax year, the trust:

- Files a return (Form 3520-A, Annual Information Return of Foreign Trust With a United States Owner) for the year setting forth a full and complete accounting of all trust activities and operations for the year, the name of its United States agent (see §3.69B), and such other information as the IRS may prescribe. Penalties for failure to file are discussed in §3.69H.

- Furnishes that information to each United States person (1) who is treated as the owner of any portion of the trust (see §3.69C) or (2) who receives (directly or indirectly) any distribution from the trust (see §3.73).

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§3.69B a. Appointment of United States Agent

The amounts required to be taken into account by a United States person under the grantor trust rules with respect to a foreign trust of which the United States person is an owner (see §3.69A) will be determined by the IRS, unless the trust agrees to authorize a United States person to act as the trust's limited agent solely for purposes of applying IRC §§7602, 7603, and 7604 with respect to (1) any request by the IRS to examine records or produce testimony related to the proper treatment of amounts required to be taken into account under the grantor trust rules, or (2) any summons by the IRS for those records or testimony. IRC §6048(b)(2)(A)-(B). Even if the foreign trust identifies a United States agent on Form 3520-A, the foreign trust may be treated as providing incorrect information and, therefore, the United States owner may be subject to penalties if either the United States agent or the foreign trust fails to comply with its obligations under the agreement. IRS Notice 97-34, 1997-1 Cum Bull 422, 428. Rules similar to IRC §6038A(e)(2), (4), dealing with enforcement of requests for certain records of foreign-owned corporations, apply in the event of noncompliance. IRC §6048(b)(2)(C).

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§3.69C b. Owner Reporting Requirements

In addition to being responsible for ensuring that the foreign trust files its annual information return, the United States owner of a foreign trust must:

- Include all items of income and deductions attributable to the portion of the trust he or she owns on his or her income tax returns for the taxable year; and
- Complete and file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, providing all documents and information requested (see Instructions to Form 3520, Part II).

If the foreign trust complied with its reporting obligations (see §3.69A), the United States owner must include with his or her own return and Form 3520 the documents and information he or she received from the foreign trust.

If the foreign trust did not meet its reporting obligations, the United States owner must provide the information requested to the best of his or her ability and must file Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR) to notify the IRS that the United States owner did not receive adequate information from the foreign trust. Similarly, if the United States owner, on his or her income tax returns, and the foreign trust, in its return, treat certain items differently, the United States owner must file Form 8082 to report the inconsistency. IRC §§6034A(c), 6048(d)(5). Penalties for failure to file are discussed in §3.69H.

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§3.69D 2. Reporting Establishment of and Transfers to Foreign Trust

Under IRC §6048(a)(1), the "responsible party" (see §3.69G) must report certain transfers made by a United States person to a foreign trust. The types of transfers that are reportable are only "gratuitous transfers" (see §3.69F) that have been specifically defined as "reportable events." See §3.69E.

The responsible party must report a gratuitous transfer to a foreign trust on Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, which requires disclosure of the amount of money or other property transferred to the trust in connection with the reportable event, the identity of the trust and of each trustee and beneficiary (or class of beneficiaries) of the trust, and any other information the IRS may require. IRC §6048(a)(2). The instructions to Form 3520 make it clear that the responsible party is the person who must ensure that the required information is provided or pay the appropriate penalties. See §3.69H.

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§3.69E a. Reportable Event

The term "reportable event," as defined in IRC §6048(a)(3)(A), includes any of the following events:

- Creation of any foreign trust by a United States person;
- Transfer of any money or property (directly or indirectly) to a foreign trust by a United States person, including a transfer by reason of death; and
- Death of a citizen or resident of the United States if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules or any portion of a foreign trust was included in the gross estate of the decedent.

Creation of a foreign trust includes a change in residence of a trust from domestic to foreign. IRS Notice 97-34, 1997-1 Cum Bull 422, 424.

The term "reportable event" does not include any transfer of property to a trust in exchange for consideration of at least the fair market value of the transferred property (see §3.69F), or any transfer or other event involving a deferred compensation trust or charitable trust described in IRC §501(c)(3). IRC §6048(a)(3)(B).

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§3.69F b. Gratuitous Transfer

A "gratuitous transfer" qualifying as a "reportable event" (see §3.69E) is a transfer other than (IRS Notice 97-34, 1997-1 Cum Bull 422, 424):

- Transfer for fair market value;
- Corporate distribution described in IRC §301, §302, §305, §355, or §356; or
- Partnership distribution described in IRC §731.

A transfer to a foreign trust may be considered a gratuitous transfer regardless of whether the transfer was treated as a gift for gift tax purposes. A distribution from one trust to another trust that is a beneficiary of the distributing trust is a gratuitous transfer. In addition, a domestic trust that becomes a foreign trust will be deemed to have made a gratuitous transfer of all its assets immediately before becoming a foreign trust. Finally, a gratuitous transfer includes any direct or indirect transfer that is structured with a principal purpose of avoiding the application of IRC §§679 and 6048.

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Source: Estate Planning/Drafting California Irrevocable Trusts/3 Income Tax: A Drafter's Guide/§3.69G c. Responsible Party

§3.69G c. Responsible Party

Under IRC §6048(a)(4), the responsible party is:

- The grantor in the case of the creation of an inter vivos trust;
- The transferor in the case of the transfer of assets to a trust, other than a transfer by reason of death; or
- The executor of the decedent's estate in the case of a transfer of assets to a trust by reason of death.

The instructions to Form 3520 indicate that the responsible party in the case of a change in residency of a trust from domestic to foreign under IRC §679(a)(5) is either the United States individual who transferred property to the trust while it was a domestic trust and is alive when the trust becomes a foreign trust, or, in all other cases, the trustee.

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§3.69H 3. Penalties for Failure to Comply With Foreign Trust Reporting Obligations

If any notice or return required to be filed by IRC §6048 is not timely filed, does not include all required information, or includes incorrect information, the person required to file the notice or return is subject to a penalty equal to the greater of $10,000 or 35 percent of the gross reportable amount, but not more than the gross reportable amount, in addition to any criminal penalty provided by law. If the failure to file continues for more than 90 days after the day on which the IRS mails notice of that failure to the person required to pay the penalty, that person will be subject to an additional penalty of $10,000 for each 30-day period (or fraction of that) during which that failure continues after the expiration of the 90-day period, but in no event more than the gross reportable amount. IRC §6677(a).

For a foreign trust with a United States owner required to report under IRC §6048(b), the general civil penalty of 35 percent of the gross reportable amount is reduced to 5 percent of the gross reportable amount. Accordingly, if a foreign trust with a United States owner fails to file its required return, the United States owner is subject to a penalty equal to 5 percent of the gross value of the portion of the trust assets treated as owned by that person. IRC §6677(b).

The term "gross reportable amount" means (IRC §6677(c)):

- The gross value of the property involved in a reportable event under IRC §6048(a). See §3.69D.
- The gross value of the portion of a foreign trust's assets at the close of the year treated as owned by the United States person in the case of a grantor trust's failure to file a required return under IRC §6048(b)(1). See §3.69A.
- The gross amount of the distributions in the case of a United States person's failure to report distributions from a foreign trust under IRC §6048(c). See §3.73.

The penalties will not be imposed for any failure that is shown to be due to reasonable cause and not willful neglect; however, that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information is not reasonable cause. IRC §6677(d).

Note that IRC §§6211-6216 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) will not apply to the assessment or collection of the penalties. IRC §6677(e).

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Source: Estate Planning/Drafting California Irrevocable Trusts/3 Income Tax: A Drafter's Guide/§3.70 C. Special Grantor-Trust Rules Applicable to Foreign Trusts

§3.70 C. Special Grantor-Trust Rules Applicable to Foreign Trusts

Internal Revenue Code §679(a)(1) provides that a United States person (*i.e.,* a citizen or resident of the United States, a domestic partnership, a domestic corporation, a domestic estate, or a domestic trust) who directly or indirectly transfers property to a foreign trust is treated as the deemed owner of the portion of the trust attributable to the property transferred if for that year there is a United States beneficiary of any portion of the trust. For example, a transfer from a domestic grantor trust to a foreign trust is treated as an indirect transfer by the person who transferred property to the domestic trust. Treas Reg §1.679-3(b). The rule applies without regard to whether the transferor retains any power or interest in the trust and also applies even if another person has the power to distribute income or principal to himself and thus would be treated as the owner of the trust under IRC §678 (see §3.38). Treas Reg §1.679-1(b). Furthermore, a nonresident alien who directly or indirectly transfers property to a foreign trust is treated as the deemed owner of the portion of the trust attributable to the property transferred if he or she becomes a resident of the United States within 5 years after the transfer, for each year in which there is a United States beneficiary of any portion of the trust. IRC §679(a)(4)(A). Under Treas Reg §1.679-2(a)(1), a trust is treated as having a United States beneficiary unless during the taxable year of the United States transferor (1) no part of the income or corpus of the trust may be paid to (or accumulated for, even if the beneficiary's interest is contingent on a future event, or applied to the benefit of) a United States person, and (2) if the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust can be paid to or for the benefit of, either directly or indirectly, a United States person. IRC §679(c)(1). If any person has the discretion of making a distribution to or for the benefit of any person, the trust is treated as having a United States beneficiary unless the terms of the trust specifically identify the class of persons to whom such distributions can be made and none of them are United States persons during the taxable year. IRC §679(c)(4). For these purposes, the terms of the trust include any agreement or understanding that may result in the income or corpus of the trust being paid to or accumulated for the benefit of a United States person. IRC §679(c)(5). The deemed distribution provision in IRC §643(i) (see §3.73) also applies to foreign grantor trusts. IRC §679(c)(6).

The determination is made annually and may take into account not only the terms of the formal trust instrument, but also written and oral understandings relating to the trust, memorandums or letters of wishes, records that relate to the actual distribution of income and corpus, and all other documents that relate to the trust, whether or not of any purported legal effect. Treas Reg §1.679-2(a)(4).

The date when the transferor is considered a resident of the United States (residency starting date) is determined under IRC §7701(b)(2)(A). IRC §679(a)(4)(C). Any beneficiary who first becomes a United States resident more than 5 years after the transfer by the nonresident alien is not treated as a United States resident in determining whether the transferor is the deemed owner of the trust under IRC §679. IRC §679(c)(3).

Section 679(a)(1) applies to the transferor of the trust only during his or her lifetime and does not apply to a transfer by reason of the transferor's death. IRC §679(a)(2)(A). Therefore, if a United States grantor creates a foreign trust during his or her lifetime, it is taxed as a grantor trust only until the death of the United States grantor. Thereafter, it is taxed as a foreign trust. Furthermore, if the foreign trust is created as a result of a United States grantor's death, IRC §679 never applies to the trust and is taxed as a foreign trust at all times.

Section 679(a)(1) does not apply to any transfer for fair market value, whether gain is realized or recognized as a result of the transfer. IRC §679(a)(2)(B). For purposes of this determination, however, an interest in the trust is not considered to be property received from the trust. Treas Reg §1.679-4(b). In applying this exception, if the foreign trust, the grantor, any beneficiary of the trust, or a person related to the grantor or a beneficiary, issues debt in connection with the transfer, the debt is not considered except as provided in regulations to be issued by the IRS. IRC §679(a)(3)(A). Actual principal payments made by the obligor, however, will be considered on and after the payment date. IRC §679(a)(3)(B).

Internal Revenue Code §679(b) prevents any attempt by a United States grantor to circumvent these rules by not initially providing benefits to a United States beneficiary. This section mandates that the foreign trust be reviewed each year to determine whether it has any United States beneficiaries, and, if it does, the general rule of IRC §679(a)(1) applies for that year. There is a statutory presumption that a foreign trust has a United States beneficiary unless the transferor submits such evidence as the IRS may require and demonstrates that the trust satisfies the statutory requirements. IRC §679(d).

Section 679 causes all income, gain, loss, deduction, and credit to be taxed to the grantor individually, regardless of the existence of a foreign trust when the grantor is a citizen, a resident of the United States, or a person who becomes a resident within 5 years after a transfer, and designates his or her spouse or children, who are also United States citizens or residents, as the beneficiaries of the foreign trust. Thus, the creation of a foreign trust to receive assets owned by a United States citizen or resident, or person who intends to become a resident within 5 years following the transfer of assets to the foreign trust, does not offer any income tax

savings to the grantor or to his or her family. For further discussion, see California Estate Planning, chap 16 (Cal CEB 2002); 31 CEB Est Plan Rep 116 (Apr. 2010); Zaritsky & Rosen, *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries*, Tax Management Portfolios 854-3d (2008).

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§3.71 D. Other Issues Connected With Creation and Funding of Foreign Trusts

The excise tax on the transfer of property to a foreign trust formerly discussed in this section has been repealed and replaced by a statute providing for recognition of gain on transfers of appreciated property to foreign trusts. See §3.75.

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§3.72 E. When Foreign Trust Is Not Taxed as Grantor Trust

The grantor trust rules apply only to the extent that a U.S. person is treated as the owner of the trust. IRC §672(f). The grantor trust rules do not apply to any portion of a trust that is treated as owned by a person other than a U.S. citizen or resident or a domestic corporation, unless the grantor has the power to revest trust assets in the grantor or the only amounts distributable are to the grantor or the grantor's spouse, among other exceptions. Treas Reg §1.672(f)-1(a)(1).

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§3.73 F. Taxation of Beneficiaries of Foreign Trust

Any fixed or determinable, annual or periodical (FDAP) income or income effectively connected with the operation of a United States trade or business that is retained by the trust is taxed to the trust under the rules discussed in §§3.69-3.72. If the trust makes any distributions to its beneficiaries during a taxable year, however, the trust may deduct from its reportable income, and each beneficiary will be taxable on, an amount equal to the lesser of the amount distributed to him or her or the distributable net income (DNI) of the trust.

Note that the DNI of a foreign trust includes items of income that, if retained by the foreign trust, would not be taxed to that trust. To account properly for the income on which a foreign trust must pay United States income tax, the foreign trust may not take a distribution deduction for income included in DNI that would not have been taxable to the trust (*i.e.,* income from sources outside the United States).

The DNI of the foreign trust also includes the following (IRC §643(a)(6)):

- Gross income from sources outside the United States, reduced by expenses attributable to the income that would have been deductible if the income and expense had occurred with respect to income from inside the United States;
- All income from inside the United States, determined without regard to treaty provisions that might otherwise exempt certain types of income from taxation if paid to a nonresident, noncitizen taxpayer; and
- All net gains from the sale or exchange of capital assets, whether those gains are credited or required to be distributed to a beneficiary during the taxable year.

For these purposes, distributions derived from a foreign trust and paid through nominees are treated as directly paid by the trust. IRC §643(h). Any property transferred to a U.S. person by an intermediary who has received property from a foreign trust is treated as property transferred directly by the foreign trust if the intermediary received the property under a plan that had as a principal purpose the avoidance of U.S. tax. Treas Reg §1.643(h)-1. Any use of trust property by the transferor, any U.S. person related to the transferor, or a United States beneficiary of the trust is treated as a distribution of the fair market value of such property unless the trust is paid the fair market value of such use within a reasonable period of time. IRC §643(i).

The amounts distributed from the foreign trust to each beneficiary (1) have the same character (*e.g.,* ordinary income or capital gains) in the hands of the beneficiary as they had in the trust, (2) are added to all the beneficiary's other income that must be reported for federal income tax purposes, and (3) are taxed to the beneficiary at the top marginal federal income tax rates applicable to the beneficiary for all purposes. Under IRC §6048(c)(1), a United States person who receives a distribution from a foreign trust must complete and file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. The United States person must compute the amount of the distribution to be treated as an accumulation distribution (either under the actual or default treatment) and any applicable interest surcharge. See §3.74. The United States person must also report taxable distributions on his or her income tax return. Penalties for failure to file are discussed in §3.69H.

To the extent that the 30-percent tax is withheld on the FDAP income earned by the foreign trust during the year, each United States beneficiary of that trust is entitled to claim a credit equal to his or her share of the amount of tax withheld. The beneficiary must add the amount of the tax, however, that has been withheld and that is allocable to his or her share to the amount of distributions made from the foreign trust to him or her during the year. Each beneficiary may also elect to claim either a deduction or a credit for foreign taxes paid on income of the trust that he or she must report. IRC §901(b)(5). The beneficiary must add to the amount distributed to him or her, his or her share of the foreign taxes paid by the trust. A beneficiary's failure to add his or her share of the foreign taxes paid by the trust to the amount distributed to him or her is treated as an election to deduct the foreign taxes paid by the trust.

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§3.74 G. Consequences of Using Foreign Trusts to Defer or Avoid Tax

In general, any tax benefit that might be realized from the creation and funding of a foreign trust by a United States grantor is far outweighed by the adverse income tax consequences that would result from the application of IRC §§679 and 684 during the grantor's lifetime, and the consequences that would result from the application of IRC §668(a) after the grantor's death. For example, the tax imposed by IRC §684 can be avoided only to the extent that the grantor funds the foreign trust with cash or with assets that have not appreciated in value. See §3.75. Furthermore, the taxation of income and gains to the United States grantor under IRC §679 can be avoided only to the extent that the foreign trust, once funded, is invested in assets that will not produce any current income or realize any gains during the grantor's lifetime. See §3.70.

Creation of a testamentary foreign trust after the death of the United States grantor may permit deferral of payment of income tax on non-United States-situs income earned by the foreign trust (which can grow tax free if the trust is formed and administered in a tax haven situs), but only for income that is from a foreign source and is accumulated in the trust. Similarly, a foreign trust created by a non-United States grantor to benefit United States beneficiaries may permit deferral of income tax on non-United States-situs income accumulated in the trust. For these purposes, a foreign trust may include a trust with a United States trustee, provided that a non-United States person controls a substantial decision of the trust. See §3.68D. Note that the non-United States person may be given powers that ordinarily would result in grantor trust treatment. See §3.70. A foreign trust also has the advantage that the beneficiaries will be taxed at favorable rates on distributions attributable to capital gains. See §3.73. However, careful planning may be required to avoid the application of the throwback rules to distributions of accumulated income.

Any income accumulated in the foreign trust that is distributed to the beneficiaries is subject to the throwback rules. IRC §§665-668. In essence, the throwback rules tax each beneficiary on all accumulation distributions made to the beneficiary from the foreign trust. Accumulation distributions are distributions from the trust that would be principal under the normal rules of trust accounting, but that actually consist of undistributed net income of the trust earned in prior taxable years. In addition, the amount of the accumulation distribution includes the amount of taxes paid by the trust on the undistributed net income that is considered to have been distributed to the beneficiary. IRC §665(b). The entire accumulation distribution is treated as ordinary income to the beneficiary, even though some of the accumulation may consist of recognized capital gain. IRC §666(a). Finally, an interest charge at the rate charged on underpayments of tax under IRC §6621(a)(2) is imposed on accumulation distributions made from foreign trusts. IRC §668(a). The charge is not deductible for federal income tax purposes. IRC §668(c). Some practitioners have suggested, however, that the tax and interest charge can be avoided if the distribution can be characterized as a gift of a specific sum of money or property in no more than three installments according to the terms of the trust instrument under IRC §663(a). See Williamson & Jacoby, *Accumulation Distributions From Foreign Trusts Can Be Avoided Through Specific Gifts*, 96 J Tax 40 (2002).

Others have noted that the tax on accumulation distributions does not apply if distributions do not exceed trust accounting income for the taxable year. IRC §665(b). The trustee may be able to invest in assets that will generate trust accounting income that can be used to offset distributions in selected years. For further discussion of foreign trust planning opportunities, see Harrison, Kirschner & McCaffrey, *U.S. Taxation of Foreign Trusts, Trusts With Non-U.S. Grantors and Their U.S. Beneficiaries*, Estate Planning 2010, chap 7 (Cal CEB 2010); McCaffrey, *Death Tax Planning in a Flat World—Planning Principles for Clients With International Interests*, Estate Planning 2008, chap 7 (Cal CEB 2008).

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§3.75 H. Gain on Transfers of Appreciated Property to Foreign Trusts

Except as provided in regulations, gain is recognized on the transfer of appreciated property to a foreign trust in an amount equal to the excess of fair market value over adjusted basis. IRC §684. Gain is recognized immediately. Treas Reg §1.684-1(a)(1). The regulation preamble and Treas Reg §1.684-1(d), Example (4) (transfer in exchange for a private annuity) make clear that the gain recognition cannot be postponed under other provisions of the Code. Under Treas Reg §1.684-1(a)(2), there is no recognition of losses under the statute and gain is recognized on an asset-by-asset basis so that gains cannot be offset by losses. (The limitation on recognition of losses will often be little more than a nuisance inasmuch as losses can always be recognized by a bona fide sale to a United States person—or even, as noted below, a sale to an unrelated foreign trust.) The regulations except certain transfers from the general rule of gain recognition. The exceptions include transfers to grantor trusts, transfers to charitable trusts, transfers included in the gross estate of the transferor, and transfers to unrelated trusts for fair market value. Treas Reg §1.684-3. In IRS Letter Ruling 200338015, the IRS ruled that the statute did not apply to a foreign trust established by a nonresident alien who then moved to the United States, even though the donor ended up being a United States person who had made a transfer to a foreign trust under IRC §679 when a United States trustee was appointed and the trust ceased to be a grantor trust. The statute applies only to a transfer to a foreign trust by a United States person, and the donor was not a United States person at the time the trust was created and funded.

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4

Generation-Skipping Tax Problems of Irrevocable Trusts

Jon J. Gallo

I. INTRODUCTION TO GST TAX

A. Generation-Skipping Transfer (GST) Tax Dangers §4.1

B. Scope of Chapter §4.2

II. GST TAX FUNDAMENTALS FOR IRREVOCABLE INTER VIVOS TRUSTS

A. Purpose of GST Tax; Repeal of GST Tax §4.3

B. GST Tax Definition of "Transferor" §4.4

C. Generation Assignments §4.5

D. Rates of Tax: Tax-Exclusive Versus Tax-Inclusive Taxation §4.6

E. GST Tax Events Involving Irrevocable Trusts §4.7

1. Direct Skips on Creation of Trust §4.8

2. Taxable Distributions §4.9

a. Taxable Distributions Involving General Powers of Appointment §4.10

b. Trustee Payment of GST Tax Attributable to Taxable Distributions §4.11

3. Taxable Terminations §4.12

F. Multiple Skips: GST Tax at Each Generation §4.13

III. AVOIDING GST TAX

A. Qualified Tuition or Medical Expenses §4.14

B. Limited Annual Exclusion §4.15

C. Predeceased Ancestor Exception §4.16

D. GST Exemption

1. Amount of GST Exemption §4.17

2. Inclusion Ratio Concept §4.18

3. Relevance of GST Tax Transferor §4.19

4. Determination of Number of Trusts; Division of Trusts §4.20

5. Allocation of GST Exemption; Need for Action §4.21

6. Allocation Procedure: Lifetime Direct Skips §4.22

7. Allocation of Exemption to Transfers to Trusts That Are Not Direct Skips; Notice of Allocation §4.23

a. Timely Allocations §4.24

b. Late Allocation on IRS Form 709 §4.25

c. Late Allocation to Lifetime Transfer on IRS Form 706 §4.26

d. Deemed Allocation to Lifetime Transfer to GST Trust §4.26A

e. Retroactive Allocation to Lifetime Transfer §4.26B

f. Default Postdeath Late Allocation to Lifetime Transfer §4.27

g. Special Rules for Charitable Lead Annuity Trusts §4.28

h. Estate Tax Inclusion Period (ETIP) Exception to General Rules §4.29

8. Recalculation of Inclusion Ratio §4.30

IV. FILING RETURNS AND PAYING TAX

A. Direct Skips §4.31

B. Taxable Distributions and Terminations §4.32

V. GST TAX STRATEGY FOR IRREVOCABLE TRUSTS §4.33

A. Making Maximum Use of Limited Annual Exclusion §4.34

B. Making Trusts Fully Exempt or Fully Nonexempt §4.35

C. Maximizing Benefits of Exempt Trusts §4.36

D. "Layering" Nonexempt Trusts §4.37

E. Paying Medical Expenses and Tuition From Nonexempt Trusts §4.38

F. Paying Estate or Gift Tax Instead of GST Tax §4.39

G. Using Wait-and-See Allocation Strategy §4.40

H. Avoiding Creation of ETIPs §4.41

I. Determining Responsibility for Allocating GST Exemption §4.42

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I. INTRODUCTION TO GST TAX

§4.1 A. Generation-Skipping Transfer (GST) Tax Dangers

The generation-skipping transfer (GST) tax poses significant dangers for drafters of irrevocable trusts and their clients. However, the repeal of the GST tax in 2010 represents an opportunity to make outright gifts with favorable tax consequences. Most remarkably, an irrevocable trust may be subject to a GST tax at a flat rate equal to the maximum IRC §2001 estate tax rate even though no estate or gift tax is imposed and the client's net worth is significantly less than his or her GST exemption equal to the IRC §2010 estate tax applicable exclusion amount.

To avoid this undesirable result, practitioners creating irrevocable trusts must understand the interaction of the following rules:

- The IRC §2503(b) gift tax annual exclusion generally does not apply for GST purposes unless a trust has only one beneficiary. See §4.15.

- The GST exemption operates differently from the IRC §2010 unified credit and the IRC §2505 gift tax applicable exclusion amount, which automatically shelter transfers at death until they exceed the estate tax applicable exclusion amount and shelter lifetime transfers until they exceed $1 million, even if the taxpayer fails to file correctly prepared tax returns. GST exemption is not automatically allocated to all irrevocable trusts having skip persons as beneficiaries, although deemed allocation may be elected for any trust under IRC §2632. If deemed allocation is not elected with respect to such a trust, a GST tax may be owed for even a small trust unless an affirmative allocation of GST exemption is made for each transfer to the trust. See §4.21.

- Additional risks are posed by the *Crummey* withdrawal powers (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) commonly used to obtain gift tax annual exclusions for transfers to irrevocable trusts. These powers usually lapse from 45 to 60 days after the transfer. If the amount subject to the lapse exceeds the IRC §2514(e) "$5000 or 5-percent" safe harbor, the excess amount will be treated as having been distributed to the powerholder and then transferred back to the trust. Treas Reg §26.2652-1(a)(5), Example 5. If the powerholder is a grandchild or another skip person, a constructive GST taxable distribution to the grandchild will result, which will be taxed at a flat rate equal to the maximum estate tax rate. See §4.10.

- The "separate share" and "separate trust" rules make it difficult for practitioners to identify how many trusts they are working with for GST tax purposes. In the context of inter vivos trusts, a single trust may actually be many trusts if the trust has substantially separate and independent shares for different beneficiaries within the meaning of Treas Reg §§1.663(c)-3, 26.2654-1(a)(1); IRC §2654(b)(2). See §4.20.

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§4.2 B. Scope of Chapter

This chapter gives a brief overview of the GST tax in the context of irrevocable trusts. Considerable attention is paid to the methods for protecting clients from the risks described in §4.1 (*i.e.,* by carefully taking the steps necessary to allocate a client's GST exemption and by exercising caution with respect to the use of *Crummey* clauses). The chapter also discusses trust design strategies that not only avoid disaster but also maximize the tax savings available through efficient use of the exemption.

NOTE: For purposes of the GST tax, the term "trust" includes (1) analogous arrangements such as life estates and remainders, and (2) insurance and annuity contracts creating successive interests in different beneficiaries. The term does not include a trust that is treated as part of a decedent's estate under IRC §645. IRC §2652(b)(1), (3). This chapter is concerned only with express inter vivos irrevocable trusts.

For more complete discussion of the tax, see Harrington, Plaine & Zaritsky, Generation-Skipping Transfer Tax: Analysis With Forms (2d ed 2001); California Will Drafting, chap 15 (3d ed Cal CEB 1992); California Estate Planning, chap 11 (Cal CEB 2002).

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II. GST TAX FUNDAMENTALS FOR IRREVOCABLE INTER VIVOS TRUSTS

§4.3 A. Purpose of GST Tax; Repeal of GST Tax

The GST tax is intended to increase the likelihood that family wealth will be subject to a transfer tax at each generation. The estate and gift taxes fail to do this in many ways. For example, a gift from the transferor to a grandchild is not subject to an estate tax or a gift tax at the level of the intervening generation. Similarly, a transfer from the transferor to a trust that pays income to a child for life, with the remainder going to a grandchild, normally will not be subject to a transfer tax when the child dies.

The GST tax plugs the gaps in the system, attempting to emulate the additional estate or gift tax that would have been imposed if generation-skipping transactions had been restructured to consist of a taxable transfer to a child, followed by a second taxable transfer from the child to a grandchild. The GST tax is repealed in 2010, when the estate tax is repealed. IRC §2664. The gift tax remains in effect with a reduced tax rate of 35 percent. The estate tax and GST tax are restored in 2011. The restoration of the GST tax in 2011 makes outright gifts to grandchildren advantageous in 2010 even at the cost of paying gift tax on the gift because, unlike gifts in trust, there will be no future transfer to which the GST tax might apply. Outright gifts to grandchildren are necessary because it is uncertain whether GST exemption can be applied even retroactively to trust transfers in 2010. Under the plain language of IRC §2664, the GST exemption provisions of IRC §2632 arguably do not apply to transfers in that year.

California has a pick-up tax, to take advantage of the credit for taxes paid to a state for generation-skipping transfers. Rev & T C §16710; IRC §2604. The credit resembles the credit against federal estate tax under IRC §2011 for state death taxes paid. See §2.84.

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§4.4 B. GST Tax Definition of "Transferor"

One of the most important concepts of the GST tax is that of the "transferor." The identity of the GST tax transferor is important for purposes of applying the generation assignment rules in order to determine whether particular persons are skip persons. In addition, only the GST exemption of the GST tax transferor will protect against imposition of GST tax on a transfer attributed to that transferor. Identifying the GST tax transferor can become complicated because a single trust will often have multiple GST tax transferors and the identity of the GST tax transferor is likely to change over the life of a trust.

Under IRC §2652(a), the GST tax transferor is always the person who last made a transfer of the property that was subject to estate or gift tax. A transfer is considered to be subject to estate or gift tax even if (1) it is subject to an exclusion such as the IRC §2503(b) gift tax annual exclusion or (2) no tax is due because of the unified credit. The only exception to this "person who last made a transfer" rule involves qualified terminable interest property (QTIP) trusts. If an IRC §2652(a)(3) reverse QTIP election is made, the original transferor will remain the GST tax transferor notwithstanding the fact that the trust is taxed in the estate of the beneficiary spouse (or is subject to a gift by the beneficiary spouse if that spouse makes an inter vivos transfer of the lifetime income interest). If a reverse QTIP election is not made, the original transferor will remain the GST tax transferor until one these events. See IRS Letter Ruling 199929040. If a reverse QTIP election is made for the entire QTIP trust, the beneficiary spouse cannot apply GST exemption to any portion of the trust even if the trust is later divided into fully exempt and nonexempt trusts, because the original transferor had insufficient remaining GST exemption to fully exempt the entire QTIP trust. See IRS Letter Ruling 200508001.

NOTE: The identity of the transferor may be uncertain for trust property included in estates of decedents dying in 2010, such as property subject to a child's testamentary general power of appointment, as discussed in §4.39. It is uncertain whether the death of a child holding a general power of appointment in 2010 causes a change in the identity of the GST tax transferor of the trust under IRC §2652(a), because the trust property arguably is not subject to estate tax in that year.

An irrevocable trust will have two transferors if it is funded with community property or a married couple elects to make split separate property gifts in accordance with IRC §2513. Treas Reg §26.2652-1(a)(4). In such cases, the trust will not be fully exempt from GST tax unless *both* spouses allocate GST exemption to the transfer.

After initial creation, the number of transferors may quickly increase if the trust instrument gives beneficiaries *Crummey* withdrawal powers (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82). To the extent that the lapse of the powers results in taxable gifts by the powerholders (see §4.10), the powerholders become GST tax transferors. Other general powers of appointment will similarly result in a change of transferor when the powerholder is deemed to make a transfer subject to estate or gift tax as a result of dying while holding the power or earlier exercising or releasing the power.

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§4.5 C. Generation Assignments

The GST tax is generally imposed when property passes to a "skip person" (or, more precisely, when no person who is not a skip person has a present interest in the property). A skip person is an individual who is assigned to a generation that is two or more generations below the generation of the transferor. IRC §2613(a)(1).

If the transferee or beneficiary is a lineal descendant of the grandparents of the transferor or of the transferor's spouse, or is married to such a relative, the generation assignment is based on the family tree, regardless of the ages of the individuals involved. IRC §2651(b). The issue of a transferor's step-siblings, however, are not lineal descendants of the grandparents of either the transferor or the transferor's spouse. See IRS Letter Ruling 200150003. For individuals who are not related to the transferor or to the transferor's spouse, generation assignment is determined by comparing the dates of birth of the transferor and the individual. IRC §2651(d).

The transferor's generation includes nonrelatives whose dates of birth are within 12½ years after that of the transferor. IRC §2651(d)(1). Nonrelatives whose dates of birth are between 12½ years and 37½ years after the transferor's date of birth are regarded as belonging to the first generation below the transferor. IRC §2651(d)(2). Nonrelatives whose dates of birth are between 37½ and 62½ years after that of the transferor are regarded as belonging to the second generation below the transferor. IRC §2651(d)(3).

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§4.6 D. Rates of Tax: Tax-Exclusive Versus Tax-Inclusive Taxation

Ignoring exemptions and exclusions, the GST tax is imposed on GSTs at the maximum federal estate tax rate in effect at the time of the transfer. IRC §2641. That rate is 45 percent in 2007-2009. IRC §2001(c). Although there is a single nominal rate, the effective rate depends on the type of transfer because of different methods of calculation. As discussed in §§4.7-4.12, there are three types of GSTs: direct skips, taxable terminations, and taxable distributions. IRC §2611(a).

The GST tax on direct skips is computed using a comparatively favorable tax-exclusive method, thereby emulating the calculation of the gift tax. The method is tax exclusive because the tax payable by the transferor is calculated by multiplying the rate by the net after-tax value of the property received by the transferee. IRC §2623. In contrast, the tax on taxable terminations and taxable distributions is computed using the more onerous tax-inclusive method, thereby emulating the calculation of the estate tax. The method is tax inclusive because the tax, payable from the transferred property, is calculated by multiplying the rate by the combined value of *both* the net property received by the recipient and the value of the property used to pay the tax. IRC §§2621-2622.

The impact of the method of calculation is significant. For example, using a tax-exclusive calculation, the GST tax imposed on a $1 million gift is $450,000. The tax is 45 percent of $1 million. Using a tax-inclusive calculation, the GST tax imposed on a devise of $1 million (net after taxes) increases to $818,182, with the tax being 45 percent of $1,818,182.

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§4.7 E. GST Tax Events Involving Irrevocable Trusts

Three taxable events can occur as the result of the funding and subsequent administration of an irrevocable inter vivos trust: direct skips (see §4.8), taxable distributions (see §§4.9-4.11), and taxable terminations (see §4.12).

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§4.8 1. Direct Skips on Creation of Trust

A direct skip is a transfer to a skip person that is subject to estate or gift tax. IRC §§2612(c)(1), 2613(a). For purposes of this definition, a transfer is subject to estate or gift tax even if no tax is imposed by reason of a credit or statutory exclusion. Treas Reg §26.2652-1(a)(2), (a)(5), Example 1.

In the irrevocable trust context, the trust itself is a skip person if there is no beneficiary with a present interest in the trust at the time of a transfer who is not a skip person. A beneficiary has a present interest in a trust if the beneficiary is a mandatory or permissible recipient of current distributions of income or principal. IRC §2652(c)(1). For purposes of applying this rule, the interests of nominal beneficiaries who are given an interest primarily for the purpose of postponing or avoiding the GST tax are ignored. IRC §2652(c)(2).

If an irrevocable trust is a skip person, the transfer of assets to the trust will be a direct skip and (in the absence of any exemptions, credits, or exclusions) will be subject to both gift tax and the GST tax. Direct skips are taxed on a tax-exclusive basis, which means that the GST tax is calculated on the net value of the property transferred to the skip person. IRC §2623. See §4.6.

NOTE: For purposes of the GST tax, a transfer of property to an irrevocable trust subject to *Crummey* withdrawal rights (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) is a transfer to the trust and not to the powerholders. Treas Reg §26.2652-1(a)(5), Example 5.

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§4.9 2. Taxable Distributions

Generally, a taxable distribution is a distribution from an irrevocable trust to a skip person, unless the distribution is either a taxable termination or a direct skip. IRC §2612(b).

EXAMPLE: If *T* establishes an irrevocable trust that provides for sprinkling distributions in the trustee's discretion to a child and/or a grandchild during the child's lifetime, a distribution to the grandchild during that period will be a taxable distribution. The transferee is responsible for the GST tax, which is computed by multiplying the rate by the total amount of the distribution. IRC §§2603(a)(1), 2621(a).

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§4.10 a. Taxable Distributions Involving General Powers of Appointment

General powers of appointment, such as *Crummey* withdrawal powers (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82), can give rise to actual or constructive taxable distributions. If a person holds a *Crummey* withdrawal power or other general power of appointment as defined in IRC §§2041 and 2514, the exercise or release of the power will result for tax purposes in a deemed distribution to the powerholder, followed by a gift to the appointee or back to the trust. This result assumes that the deemed gift is complete for gift tax purposes under Treas Reg §25.2511-2(b), which may not be the case if, for example, the powerholder still has some continuing power to control ultimate disposition of the property subject to the release.

If the gift is complete, the exercise or release of a power held by a skip person will result in a constructive taxable distribution for GST tax purposes except to the extent that, under IRC §2514, there is no gift for gift tax purposes. Treas Reg §26.2612-1(c)(1). Internal Revenue Code §2514(e) provides:

(e) Lapse of Power — The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts:

(1) $5,000, or

(2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied.

The value of property subject to a lapse of a power that is not treated as a taxable release of the power is commonly referred to as the "five-or-five" amount, which functions as a "safe harbor." Care must be taken if the powerholder holds powers under more than one trust, because the five-or-five amount is determined after aggregating the trusts. Rev Rul 85-88, 1985-2 Cum Bull 201. For example, transferors cannot increase the $5000-per-year limit by having multiple trusts.

A secondary consequence of a lapse of a power that exceeds the five-or-five amount is that the deemed gift of the excess amount back to the trust causes the powerholder to become a transferor of the trust for GST tax purposes. See §4.4.

The operation of these rules can be illustrated by example:

EXAMPLE: Assume that *T* establishes an irrevocable life insurance trust for the benefit of *T*'s child, *C,* and *T*'s grandchild, *GC*. On *T*'s death, the policy proceeds will be distributed to *C,* if living, and otherwise to *GC*. Under the terms of the trust, both *C* and *GC* each have a *Crummey* withdrawal right over $10,000 whenever *T* makes a contribution to the trust. The power lapses in 45 days if it is not exercised. *T* makes an initial contribution of $20,000 to the trust, and both *C* and *GC* allow their withdrawal rights to lapse. If there is no reason why a gift to the trust would be "incomplete" under Treas Reg §25.2511-2(b), the lapse results in both beneficiaries being deemed to have received distributions of $5000 (the excess amount over the five-or-five safe harbor). Each is deemed to have made a gift of this amount back to the trust. A taxable distribution occurs with respect to the power held by *GC,* and both beneficiaries are now transferors of one-fourth of the trust. Treas Reg §§26.2612-1(c)(1), 26.2652-1(a)(5), Example 5.

As a result of these considerations, *Crummey* withdrawal powers generally should not permit withdrawal of more than the five-or-five amount each year, taking into consideration all trusts giving such a power to the powerholder. Alternative solutions to the related gift tax consequences of *Crummey* power lapses, discussed in chapter 12, may be inadequate if the *Crummey* power is held by a skip person. The strategy of avoiding a gift by preventing the gift from being complete is usually insufficient because the gift will always become complete sooner or later—if only on the death of the powerholder or the distribution of the trust. A "hanging power" (see §12.98) will be effective only if it fully lapses over the years without exceeding the annual five-or-five amount. Whether this will occur is often a matter of speculation.

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§4.11 b. Trustee Payment of GST Tax Attributable to Taxable Distributions

The transferee is responsible for the payment of the GST tax attributable to a taxable distribution. IRC §2603(a)(1). If the trustee pays the GST tax, the payment is an additional taxable distribution that is deemed to be made on the last day of the taxable year of the trust in which the original taxable distribution was made. IRC §2621(b). This rule simply enforces the concept that taxable distributions are to be taxed using the tax-inclusive method.

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§4.12 3. Taxable Terminations

A taxable termination is the termination of a beneficiary's interest in an irrevocable trust as a result of death, lapse of time, or other reason unless (a) a nonskip person has an interest in the property immediately after that termination or (b) no distributions may be made to skip persons at any time after the termination. IRC §2612(a)(1).

EXAMPLE: If *T* establishes an irrevocable trust paying income to *T*'s child, *C,* for life, with the remainder going to *T*'s grandchild, *GC,* the death of *C* causes a taxable termination. The tax is paid by the trustee. IRC §2603(a)(2).

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§4.13 F. Multiple Skips: GST Tax at Each Generation

The general purpose of the GST tax is to ensure that a transfer tax is imposed at each generation. The statute does not fully accomplish this goal. For example, the tax on a direct skip to a great-grandchild (or a trust for one or more great-grandchildren) is the same as the tax on a direct skip to a grandchild (or a trust for one or more grandchildren). Similarly, the tax on a taxable distribution to a great-grandchild is the same as the tax on a taxable distribution to a grandchild.

This legislative grace generally does not apply in the case of taxable terminations, which can be imposed at each generation. Under IRC §2653, if property is still held in trust after a GST, the GST tax still applies to subsequent transfers, but the transferor is reassigned to the generation one generation higher than the highest generation of any person having an interest in the trust.

EXAMPLE 1: Assume that a transferor, *T,* makes a transfer in trust for a child, *C,* for life and then for a grandchild, *GC,* for life, with the remainder going to *GC*'s issue. When *C* dies, there is a taxable termination, tax is paid, and *T* is reassigned to *C*'s generation. As a result, *GC* is no longer a skip person, and distributions to *GC* after the reassignment are not taxable, but a taxable termination will occur at *GC*'s death.

EXAMPLE 2: Assume that *T* makes a transfer directly to a trust for *GC* for life, with remainder going to *GC*'s issue. An immediate GST tax is imposed on the direct skip transfer to a trust having no nonskip person beneficiaries. As a result of imposition of the tax, *T* is immediately reassigned to *C*'s generation. Distributions to *GC* will not be taxed, because *GC* now is only one generation below *T,* but a taxable termination will occur at *GC*'s death.

This discussion applies only to trusts that are not fully exempt from GST tax. An exempt trust remains exempt until there is a violation of the rule against perpetuities or the trust acquires a new transferor for GST tax purposes.

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III. AVOIDING GST TAX

§4.14 A. Qualified Tuition or Medical Expenses

A transfer that qualifies for the gift tax exclusion covering payments of qualified tuition or medical expenses under IRC §2503(e) is not subject to the GST tax. IRC §2611(b)(1). Thus, the payment of tuition or medical expenses of a skip person is not a GST. Because there is no monetary limitation on such payments, significant amounts can be transferred for the benefit of grandchildren and other skip persons without incurring the GST tax. In IRS Letter Ruling 200602002, the IRS ruled that prepayment of a grandchild's private school tuition for future years qualified for the IRC §2503(e) gift tax exclusion and the IRC §2611(b)(1) GST tax exclusion.

The exclusion is not available for the transfer of property *to* a trust for skip persons, intended to provide them with educational or medical benefits. The exclusion is available, however, for distributions *from* trusts that would otherwise be taxable distributions if the distributions are accomplished by direct payment of the skip person's tuition or medical expenses.

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§4.15 B. Limited Annual Exclusion

An outright transfer to an individual skip person that qualifies for the IRC §2503(b) gift tax annual exclusion will similarly be exempt from GST tax to the extent of the exclusion. Unfortunately, this rule does not apply to transfers to trusts, unless (IRC §2642(c)):

- The trust has only one beneficiary;
- No portion of the trust principal or income may be distributed to a person other than the beneficiary;
- If the trust terminates during the beneficiary's lifetime, distribution of the entire trust must be made to him or her; and
- If the trust does not terminate during the beneficiary's lifetime, the trust assets must be includable in the beneficiary's estate (*i.e.*, either the beneficiary has a general power of appointment or the remaining trust assets will be distributed to the beneficiary's probate estate).

In IRS Letter Ruling 200114026, the IRS recognized a state court reformation based on scrivener error that gave each grandchild a testamentary general power of appointment over that grandchild's trust. Accordingly, each trust will have an exclusion ratio of zero if all transfers to the trust qualify for the annual exclusion. The purpose of this rule is to prevent attempts to create large GST-exempt trusts by giving *Crummey* withdrawal powers (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) to multiple beneficiaries, a common *gift tax* strategy. Naming persons who will take if the beneficiary fails to exercise a general power of appointment does not violate the "one-beneficiary" requirement. Even though a trust appears to have multiple beneficiaries, it may be treated as a group of separate single beneficiary trusts for GST tax purposes. See §4.20.

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§4.16 C. Predeceased Ancestor Exception

Under IRC §2651(e), a grandchild or other descendant of the transferor or the transferor's spouse or former spouse is reassigned to the generation level of his or her deceased parent (and lower generations are similarly reassigned) if the lineal parent is deceased at the time of the transfer from the transferor. The rule extends to other descendants of the transferor's parents (*e.g.* a grandniece or grandnephew will be reassigned to the generation of that person's deceased parent), but only if the transferor has no living descendants at the time of the transfer.

The statutory rule has been modestly extended by a regulation which provides that the predeceased ancestor exception will apply even though the child does not die before the transfer if he or she dies within 90 days after the transfer and receives no interest in the trust as a result of failing to survive longer. Treas Reg §26.2651-1(a)(2)(iii). In the event a transfer is subject to estate or gift tax more than once, the relevant date for determining generation assignments under the deceased-ancestor rule is the date of the first transfer. (If, for example, a settlor of a qualified personal residence trust (QPRT) fails to survive the term, with the consequence that the residence is included in the settlor's estate, the relevant date is the date of the gift rather than the date of death.) Treas Reg §26.2651-1(a)(3). An irrevocable inter vivos trust usually cannot contain a 90-day survival condition, because this would conflict with the need for *Crummey* clauses to confer unconditional immediate rights of withdrawal (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82). In the rare case, however, in which a child actually dies within 90 days after creation of an irrevocable inter vivos trust, it may be possible to trigger application of the deceased ancestor rule, at the modest cost of an annual gift tax exclusion, by having the child's executor make a disclaimer to satisfy the requirement that the child must never have an interest in the trust.

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D. GST Exemption

§4.17 1. Amount of GST Exemption

Each transferor possesses a GST exemption equal to the IRC §2010(c) applicable exclusion amount (or $1 million plus cost-of-living adjustments for transfers after 2010), which can be allocated by the transferor (intentionally or by default) to exempt up to that amount of transferred property from the GST tax. IRC §2631(a). GST exemption is not automatically allocated with respect to every irrevocable trust giving a nonskip-person beneficiary a present interest, but the transferor may elect deemed allocation for transfers to any trust. IRC §2632(c). If the election is not made for the trust on a timely filed gift tax return for the transfer, a GST tax may be owed for even a small trust even though the transferor has a net worth of far less than the applicable exclusion amount unless a retroactive allocation can be made under IRC §2632(d), although relief from late elections may be allowed under IRC §2642(g).

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§4.18 2. Inclusion Ratio Concept

Although GSTs are subject to tax at a flat rate, equal to the highest marginal estate tax rate in effect at the time of the transfer, the tax is actually computed by multiplying this rate by what is known as the "inclusion ratio." IRC §§2001, 2641. The inclusion ratio is one minus the "applicable fraction." IRC §2642(a).

Conceptually, the applicable fraction can be thought of as the "exemption ratio." For a single transfer, the numerator of the applicable fraction is the amount of exemption applied to the transfer on the relevant valuation date, and the denominator is the value of the transferred property on the same date. If the values are the same, the applicable fraction is one, and the inclusion ratio is therefore zero. Accordingly, the trust is fully exempt from GST tax because the tax rate is multiplied by zero.

The basic strategy of all GST tax planning is that any particular trust should be either completely exempt (have an inclusion ratio of zero) or completely nonexempt (have an inclusion ratio of one). See §4.35. Assuming that it is desirable to have a completely exempt trust, the practitioner should make sure that the amount of exemption allocated equals the value of the transferred property on whatever date is the relevant date for determining the inclusion ratio. See §4.23. (If the annual gift tax exclusion applies because of compliance with the single beneficiary rules described in §4.15, the amount of exemption required to produce a zero inclusion ratio is reduced accordingly.

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§4.19 3. Relevance of GST Tax Transferor

An individual's allocation of GST exemption to a trust will protect only the portion of the trust for which that same person is the transferor for GST tax purposes. Many trusts have multiple transferors for such purposes, and the transferors can change over the life of the trust. See §4.4.

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§4.20 4. Determination of Number of Trusts; Division of Trusts

Effective allocation of GST exemption requires knowing how many trusts there are for GST tax purposes. Often, this is *not* the obvious number of one. For example, when a trust has multiple transferors, the share treated as transferred by each transferor is treated as a separate trust for GST tax purposes, including exemption allocation purposes. Treas Reg §26.2654-1(a)(2). Also, under the "separate share" rule, a single trust may actually be many trusts if the trust has substantially separate and independent shares for different beneficiaries within the meaning of Treas Reg §1.663(c)-3. IRC §2654(b)(2); Treas Reg §26.2654-1(a)(1)(i). Under Treas Reg §1.663(c)-3, the applicability of the separate share rule generally depends on whether distributions of the trust are to be made in substantially the same manner as if separate trusts are created, so that distributions from the share of a trust held for the benefit of one beneficiary will not affect the share of the trust held for another beneficiary. Trusts created by mandatory severance or division on the occurrence of an event not within the discretion of the trustee or any other person as provided in the trust instrument are treated as separate trusts if the trusts resulting from the severance or division are recognized as separate trusts under state law. Treas Reg §26.2654-1(a)(1)(iii), (a)(5), Example 8.

When a trust or share of trust that is a single trust for GST tax purposes is divided on a fractional basis by court order or according to the trust terms into two (or more) trusts and the terms of the new trusts, in the aggregate, provide for the same succession of interests as the original trust, the division is a qualified severance resulting in treatment of the trusts as separate trusts under IRC §2642(a)(3). See, *e.g.,* IRS Letter Rulings 200543037, 200506018, 200441022 (belated division of QTIP trust into exempt and nonexempt trust will be a qualified severance; estate granted extension of time to make reverse QTIP election for exempt trust). Detailed requirements for a qualified severance are provided in Treas Reg §26.2642-6(d). Trusts that do not meet the requirements of a qualified severance may be treated as separate trusts after the date of severance provided that the trusts resulting from the severance are recognized as separate trusts under state law. Treas Reg §26.2642-6(h). The nonqualified severance will still result in two (or more) trusts having the same inclusion ratio as the original trust, but thereafter it will be possible to allocate exemption to only one of the resulting trusts.

EXAMPLE: Assume that a settlor establishes a trust that permits discretionary distributions of income and principal to his or her children, with the grandchildren being entitled to distributions if a child dies. On the death of the settlor, the remaining trust estate will be distributed to issue per stirpes. The settlor has two living children. No GST exemption is initially allocated to the trust because it is assumed that no distributions will ever be made to skip persons. Following the unexpected death of one child, the trustee, as required by the trust instrument, splits the trust into two equal separate trusts on a fractional basis: one for the living child and one for issue of the deceased child. The division is a qualified severance because the living child or issue of that child and the issue of the deceased child each succeed to half of the original trust. If the settlor wants to exempt the trust for the issue of the deceased child, the settlor need only make an exemption allocation to that trust. See §4.23.

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§4.21 5. Allocation of GST Exemption; Need for Action

In the context of the typical irrevocable trust, the GST exemption functions differently from the IRC §2505 gift tax applicable exclusion amount, which automatically shields gifts until the value of gifts exceeds $1 million. This gift tax protection exists regardless of whether (a) it is desired by the transferor or (b) returns are filed.

In contrast, use of the GST exemption is not mandatory and occurs only by default in the case of direct skips and transfers to GST trusts. IRC §2632(b), (c). In the common case in which a transfer to a trust is not a direct skip because at least one nonskip person has a present interest in the trust when it is created, and the trust is not a GST trust, a GST tax will be owed if a taxable distribution or taxable termination occurs before the effective date of an allocation of GST exemption, unless the transferor has elected deemed allocation (see §4.26A) or a retroactive allocation can be made under IRC §2632(d) (see §4.26B). The allocation of GST exemption is made under IRC §2632(a) by complying with detailed requirements for filing a gift tax return with a preparer-drafted attachment called a notice of allocation. The deemed allocation election for the trust is made on a timely filed gift tax return for the transfer and a retroactive allocation is made on a timely filed gift tax return for a transfer in the year of the beneficiary's death, although relief from late elections may be allowed under IRC §2642(g). Relief is generally obtained by applying for a private letter ruling. IRS Notice 2001-50, 2001-2 Cum Bull 189; Prop Treas Reg §26.2642-7. If no gift tax return was required for gift tax purposes for the year or years for which relief was sought because the transfers were fully excluded from taxable gifts by the IRC §2503(b) annual exclusion, the application is made by attaching a notice of allocation to a gift tax return for the year of the transfer. Rev Proc 2004-46, 2004-2 Cum Bull 142. So far, it appears that the IRS is exercising its IRC §2642(g) authority in a fair, reasonable, and even generous manner. See, *e.g.,* IRS Letter Rulings 200717002, 200636091, 200629016, 200620003, 200519032, 200451001, 200316031, 200245018, 200242017.

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§4.22 6. Allocation Procedure: Lifetime Direct Skips

The simplest form of GST exemption allocation involves allocation to lifetime direct skips. To the extent that the transferor has remaining GST exemption available, the law provides for automatic allocation of enough exemption to give the direct skip an inclusion ratio of zero, thereby making the transfer wholly exempt. IRC §2632(b)(3). This protects outright transfers to skip persons and transfers to trusts having only skip person beneficiaries.

In this context, it is important to remember that a transfer to a trust that gives beneficiaries *Crummey* withdrawal rights (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) is treated as a transfer to the trust as a whole for GST tax purposes and not as a transfer to the powerholders. Treas Reg §26.2652-1(a)(5), Example 5. Accordingly, the transfer to the trust does not result in direct skips to the skip person *Crummey* powerholders, and there is no automatic allocation of GST exemption to the trust if any nonskip person has a present interest in the trust.

The transferor can avoid an automatic allocation of exemption to a direct skip by filing a timely gift tax return, attaching a statement indicating the extent to which the automatic allocation will not apply, and paying the GST tax due as a result. IRC §2632(b)(3); Treas Reg §26.2632-1(b)(1). This is rarely done but may be desirable when the transferor wants to preserve the exemption so that it can be allocated to a trust that will be subject to future taxable distributions and taxable terminations, both of which are effectively taxed at a higher rate than direct skips because the tax is computed on a tax-inclusive basis. See §4.6. For direct skips in 2010, automatic allocation does not apply. For direct skips to generation-skipping trusts, this means that GST tax may apply on future taxable events (*e.g.*, distributions to great-grandchildren) with respect to the trust.

Because allocation is automatic for direct skips, it is not necessary to file a gift tax return for GST tax purposes if no return is required for gift tax purposes. If no return is filed, however, it is important to memorialize the consumption of GST exemption in some other manner. Otherwise, the transferor may some day attempt to apply GST exemption that is no longer available. The amount of exemption consumed by an automatic allocation is the value of the transferred property for gift tax purposes. This amount is reduced by the applicable amount of the IRC §2503(b) gift tax annual exclusion only if the gift is an outright gift or is a gift to a trust having only one beneficiary, as described in §4.15.

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§4.23 7. Allocation of Exemption to Transfers to Trusts That Are Not Direct Skips; Notice of Allocation

Lifetime transfers that are not direct skips include (a) transfers to trusts benefiting both skip and nonskip persons and (b) transfers to nonskip persons for life (or a term of years), with remainder going to skip persons (*e.g.*, a transfer to the transferor's child for life, with the remainder going to a grandchild). Unless there is a deemed allocation (see §4.26A) or retroactive allocation (see §4.26B) of GST exemption for these transfers, a GST tax will be imposed if there is a taxable distribution or taxable termination before there is an effective allocation of exemption.

The principal method for allocating GST exemption is to file an IRS Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return) with an attached statement called a notice of allocation. This procedure is used even when no gift tax return is required for gift tax purposes. This notice should contain not only the information described on the next to last page of the Instructions for Form 709 but also, if applicable, the additional value and inclusion ratio information described in Treas Reg §26.2632-1(b)(4)(i). The total amount of exemption allocated by the notice of allocation is then reported on Schedule C, Part 2, Line 6. This assumes that the gifts are not indirect skips subject to automatic allocation under IRC §2036(c). The total amount of automatic allocation is reported on Schedule C, Part 2, Line 5.

CAVEAT: IRS Form 709 is confusing with respect to transfers to trusts that are not direct skips. These transfers should be listed in Schedule A, Part 1 (not Part 2). They should not be listed in Schedule C, Parts 1 or 3, because these parts relate to the computation of GST tax on direct skips. Similarly, the exemption allocated on the notice of allocation is not included in the amount shown on Schedule C, Part 2, Line 4.

In general, the transferor will want to allocate to a trust an amount of exemption equal to the value of the transferred property on a specified date. See §§4.24-4.25. To avoid the risk of an insufficient allocation of exemption resulting from an inaccurate valuation of the transferred property, prudent practitioners state in the notice of allocation that the amount of exemption actually being allocated is the amount necessary to reduce the inclusion ratio of the trust to zero. This is expressly permitted by Treas Reg §26.2632-1(b)(4)(i).

The notice of allocation should nevertheless make an estimate of the amount of exemption allocated, which can then be used for the required entry on Schedule C, Part 2, Line 6. The preparer should then place an asterisk next to the Line 6 entry and write the following at the bottom of the page: "Amount Estimated. See Notice of Allocation." The estimate should be as accurate as possible because the transferor will need to rely on it when calculating the amount of GST exemption that remains available for future transfers.

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§4.24 a. Timely Allocations

Allocations of GST exemption to lifetime transfers other than direct skips are divided into two categories: "timely" and "late." Timely applications are *always* made by appropriately completing IRS Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return), including the attached notice of allocation, and filing the return on or before the date required for reporting the transfer if it were a taxable gift. Treas Reg §26.2632-1(b)(4)(ii). Form 709 is used even if the transferor dies shortly after the gift and the allocation is made by the personal representative of the transferor's estate.

If the allocation is timely, life is relatively simple because of the following factors:

- *Value of property for inclusion ratio purposes.* The value of the transferred property for the purpose of determining the inclusion ratio will be the fair market value on the date of the transfer.

- *Effective date.* The effective date of the exemption allocation will be the date of the transfer even though Form 709 may be timely filed much later. Accordingly, the allocation will be deemed to occur before any GST taxable events occur even if the taxable events actually take place before Form 709 is filed.

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§4.25 b. Late Allocation on IRS Form 709

Late allocations of GST exemption can be made before death or afterwards and are sometimes made by default after death if the transferor fails to otherwise allocate all available exemption. Sometimes late allocations are desirable for strategy reasons.

Allocation on a late IRS Form 709 may be accomplished by the transferor or the personal representative of the transferor's estate. The personal representative has the alternative of making the late allocation on IRS Form 706 if the personal representative is confident that it is not necessary for the allocation to be effective before the estate tax return can be filed. Treas Reg §26.2632-1(d)(1). The following rules apply to late allocations.

- *Value of transferred property for inclusion ratio purposes.* The basic rule for late allocations is that the value of the property for purposes of determining the inclusion ratio is the value on the date on which the return is filed. This general rule is subject to an election that permits the taxpayer to use the value on the first day of the month in which the late return is filed unless the property involved is life insurance and the insured has died. Treas Reg §26.2642-2(a)(2). Note that the "date the return is filed" valuation rule makes a late allocation desirable if asset values have dropped since the date of the transfer and no GST taxable events have occurred in the interim. The value of a term life insurance premium may drop almost to zero between the time the premium is paid and the extended due date for filing a gift tax return. This may justify taking a "wait-and-see" approach with respect to allocation decisions, in which the decision of whether to file timely or late is put off until the last possible day and the return intentionally filed one day late if the insured is still healthy. (This approach may actually necessitate filing two returns if a timely return is needed for gift tax purposes.)

- *Effective date.* A late exemption allocation is effective on the day on which the return is filed. For the benefit of those who like to live dangerously, a special rule provides that the exemption allocation is deemed to take effect before any taxable termination or taxable distribution occurring on the same day. Treas Reg §26.2632-1(b)(4)(iii), Example 4.

- *Allocating correct amount of exemption.* As for a timely allocation, a late allocation can be made according to a formula that allocates the amount of exemption necessary to reduce the inclusion ratio to zero. Treas Reg §26.2632-1(b)(4)(i). This approach is highly recommended—particularly for life insurance, which may be difficult to value accurately. See §4.23.

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§4.26 c. Late Allocation to Lifetime Transfer on IRS Form 706

A timely allocation of exemption to a lifetime transfer is always made on IRS Form 709, but a late allocation made by a transferor's executor after the transferor's death can be made on either Form 709 or Form 706 (using Schedule R instead of a notice of allocation). The allocation is effective on the date of filing unless the transferred property is included in the gross estate, in which case the allocation is effective as of the date of death. In either case, the value on the effective date is used to determine the inclusion ratio. Treas Reg §26.2632-1(d)(1). Normally, such an allocation is made on Form 709 to avoid delaying the effective date until it is practical to file the estate tax return.

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§4.26A d. Deemed Allocation to Lifetime Transfer to GST Trust

The transferor is deemed to make allocations of GST exemption to lifetime transfers to trusts that are defined as indirect skips if the trust is a GST trust. IRC §2632(c). An indirect skip is a transfer to a trust subject to GST tax. A GST trust is a trust that could have a generation-skipping transfer with respect to the transferor unless the trust is not a GST trust under one of six tests. For example, a trust with both skip and non-skip person beneficiaries is generally a GST trust. Transfers to the trust are indirect skips and the transferor is deemed to make allocations of exemption to the transfers to the extent necessary to reduce the inclusion ratio to zero, unless the transferor elects not to have deemed allocation apply. Even if the trust is not a GST trust, the transferor may elect deemed allocation for transfers to the trust. Either election may be made on a timely filed gift tax return for the first transfer to the trust or any later transfer. Generally, the statement attached to the return must identify the trust in question (or the separate share that is treated as a separate trust for GST tax purposes), and specifically describe or otherwise clearly identify the transfers to be covered by the election. Treas Reg §26.2632-1(b)(3). Relief from late elections may be allowed under IRC §2642(g). See §4.21. Once an election is made, deemed allocation will apply or not apply to any transfer or transfers to the trust for which the election is made. Treas Reg §26.2632-1(b)(2). Choices concerning deemed allocation can be changed, but the changes will not be retroactive. Generally, the transferor should either elect deemed allocation (or make affirmative allocations of GST exemption for each transfer to the trust) or elect not to have deemed allocation apply because it may be difficult to determine whether the trust is a GST trust. On the benefits of proper affirmative allocations, see Zeydel, *Handling Affirmative and Deemed Allocations of GST Exemption*, 34 Est Plan 12 (Feb. 2007).

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§4.26B e. Retroactive Allocation to Lifetime Transfer

In some cases, if a trust beneficiary with a generation assignment lower than the transferor's generation assignment dies before the transferor, the transferor can make retroactive allocations of GST exemption to previous transfers to the trust. IRC §2632(d). The inclusion ratio will be calculated using the value of the previous transfers at the time of the transfer. The recalculated inclusion ratio is effective immediately before death. (The difference between the effective date and the valuation date prevents using the beneficiary's death to retroactively avoid GST taxes incurred earlier for other reasons.) Retroactive allocation is available only if the deceased beneficiary is a descendant of a grandparent of the transferor or the transferor's spouse. The allocation is made on a timely filed gift tax return for a transfer in the year of the beneficiary's death, although relief from late elections may be allowed under IRC §2642(g). If the allocation is not made on a timely filed gift tax return, the transferor is subject to regular late allocation rules, which generally require using the value of the previous transfers on the allocation date. See §4.25.

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§4.27 f. Default Post-Death Late Allocation to Lifetime Transfer

If a transferor's GST exemption is not entirely used by the time that IRS Form 706 is due, the default allocation rules of IRC §2632(e) may result in allocation of exemption to property subject to an inter vivos transfer. This result may rescue some situations in which a taxpayer has unwittingly initiated an inter vivos transfer that will produce a GST in the future.

EXAMPLE: Assume that an inter vivos transfer was made to a child for life, with the remainder going to a grandchild, but, fortuitously, the child is still alive when the transferor's estate tax return is due (with extensions). In this circumstance, the default rule allocation of GST exemption will occur before the child's death results in a taxable termination.

The default allocation rules typically do not work well whenever more than $1 million is held by trusts having the potential for later GST taxable events. The default rules dissipate the exemption by allocating it to all the trusts on a prorata basis, contrary to the basic GST tax strategy rule of ensuring that the trusts are either completely exempt or completely nonexempt. See §4.35.

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§4.28 g. Special Rules for Charitable Lead Annuity Trusts

Under IRC §2642(e), the inclusion ratio for a charitable lead annuity trust (1) is not determined until the end of the term of the charitable annuity and (2) is based on the value of the trust estate at that time. During the annuity term, exemption allocated to such a trust bears interest at the rate used to value the charitable deduction for gift tax purposes.

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§4.29 h. Estate Tax Inclusion Period (ETIP) Exception to General Rules

The estate tax inclusion period (ETIP) rule is intended to prevent taxpayers from using grantor retained income trusts (GRITs) (including personal residence trusts and similar devices) as methods for leveraging the GST exemption. Under this rule, an allocation of GST exemption is typically not effective until the ETIP ends. The valuation date for inclusion ratio purposes is similarly delayed. IRC §2642(f).

The ETIP is the period after the actual transfer during which, should death occur, the value of the transferred property would be includable (other than by reason of IRC §2035) in the gross estate of the transferor or the spouse of the transferor. If any part of a trust is subject to an ETIP, the entire trust is subject to an ETIP. Treas Reg §26.2632-1(c)(1)(iii).

Under these rules, it is quite possible to have an ETIP even when the trust is not a standard retained interest trust. Most notably, giving a spouse a "five-or-five" withdrawal power or a *Crummey* withdrawal power (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) will generally result in an ETIP. A narrow exception is provided in Treas Reg §26.2632-1(c)(2)(ii)(B), which permits giving a spouse a withdrawal power over an amount of transferred property not exceeding the greater of $5000 or 5 percent of the trust corpus as long as the withdrawal right terminates no later than 60 days after the transfer to the trust. A typical five-or-five withdrawal power will fail the test because it is not limited to property transferred to the trust in the previous 60 days. Similarly, a *Crummey* power that remains in effect until the end of a calendar year will fail the test if a transfer is made to the trust more than 60 days before the end of the year.

If a trust is subject to an ETIP, the exemption allocation rules are typically applied as if the transfer to the trust was made on the date on which the ETIP ends, and the rules for making a *timely* allocation of exemption will apply if the necessary gift tax return is filed by the due date for reporting gifts made in the year in which the ETIP ends.

An exception to this timing scheme exists when a trust makes a taxable distribution to a skip person before the end of the ETIP. If that occurs, exemption can be allocated to the trust using a gift tax return that is timely for gifts made during the year of the distribution, and an inclusion ratio will be determined solely for purposes of taxing the particular taxable distribution. Subsequently, the exemption remains allocated to the trust, but the inclusion ratio will fluctuate with changes in the value of the trust estate until the end of the ETIP. Treas Reg §26.2632-1(c)(1)(ii), (c)(3)(iii), (c)(5), Example (2).

ETIP situations should not be confused with those in which property will be included in the transferor's taxable estate because a transfer was not complete for gift tax purposes. For example, a transfer to a revocable trust does not create an ETIP, and a transfer out of the revocable trust during the settlor's lifetime would be treated as a transfer by the settlor, with no need to allocate exemption to the trust. Similarly, the ETIP rules do not apply when transferred property will be included in the transferor's estate solely because of the limited "transfer within three years of death" provisions of IRC §2035. This situation typically occurs when an insured transfers a life insurance policy within 3 years of death. A timely allocation of exemption can be made in the usual manner in this situation, and the transferred property will generally retain the resulting inclusion ratio following inclusion of the property in the estate, unless there is a postdeath allocation of more exemption. Treas Reg §26.2642-4(a)(3).

As noted, the ETIP rule is intended to prevent taxpayers from using retained interest trusts for the purpose of leveraging generation-skipping transfers. It is sometimes suggested that the rule can be effectively circumvented by creating a retained interest trust for the benefit of children, with the children then transferring the remainder interest to a trust benefiting grandchildren. See, *e.g.,* Oshins & Sederbaum, *Generation-Skipping and the GRAT: Sale or Gift of the Remainder*, 30 Est Plan 259 (June 2003). The IRS is likely to challenge such transactions, successfully or otherwise, contending that the children's retransfer was not an independent transaction—with the consequence that the settlor should be treated as creating a trust for the benefit of the grandchildren rather than the children.

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§4.30 8. Recalculation of Inclusion Ratio

A trust will have an inclusion ratio of zero at all times if there is a timely allocation of exemption to each transfer to the trust, equaling the value of the gift on the date of the gift. If a timely allocation is not made, the trust may be partially exempt—contrary to basic strategy rules. See §4.34. If it is desirable to correct this situation by making a late allocation (plus a timely allocation for any new gifts to the trust), the practitioner must determine the existing inclusion ratio of the trust and the current value of the trust assets to determine the additional amount of exemption that must be allocated to the trust. The rules for determining the inclusion ratio are stated in Treas Reg §26.2642-4, pertaining to recalculation of the applicable fraction. In a nutshell, the rules follow the principles of the following example:

EXAMPLE: The settlor creates a generation-skipping trust, funds it with $50,000, and makes an allocation of $40,000 of GST exemption to the trust on a timely filed gift tax return. As a result, the initial inclusion ratio is 1/5. (Literally, the inclusion ratio is one minus the applicable fraction. The numerator of the applicable fraction is $40,000, and the denominator is $50,000.) Over the next year, the trust assets appreciate 20 percent to $60,000. This appreciation does not change the inclusion ratio but causes the values of the exempt and nonexempt portions to similarly increase 20 percent to $48,000 and $12,000, respectively.

At that point, the settlor adds $20,000 to the trust but does not make a timely allocation of exemption. This increases the value of the nonexempt share to $32,000 and increases the value of the total trust to $80,000. The new inclusion ratio is $32,000 divided by $80,000. If the settlor later wishes to make the trust fully exempt, this can be accomplished by allocating to the trust additional GST exemption equal to 32/80ths of the value of the trust assets at the time of the allocation.

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IV. FILING RETURNS AND PAYING TAX

§4.31 A. Direct Skips

If an inter vivos gift to an irrevocable trust is a direct skip, the GST is reported on the transferor's gift tax return (IRS Form 709), and any tax owed is paid by the transferor. IRC §2603(a)(3); Treas Reg §26.2662-1(b)(3), (c)(1). Payment of the GST tax is not an additional transfer subject to the GST tax but is an additional taxable gift. IRC §2515.

If a transfer from an irrevocable trust to a beneficiary is a direct skip, as may occur on the death of a spouse who is a beneficiary of a qualified terminable interest property trust, the transfer is reported on the estate tax return (IRS Form 706), Schedule R-1, filed for the individual in whose estate the trust is included for estate tax purposes. Treas Reg §26.2662-1(b)(3)(ii)(B). The tax is paid by the trustee. IRC §2603(a)(2).

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§4.32 B. Taxable Distributions and Terminations

If the GST event is a taxable termination, the event is reported on IRS Form 706GS(T) (Generation-Skipping Transfer Tax Return for Terminations), and the trustee pays the GST tax. IRC §2603(a)(2); Treas Reg §26.2662-1(b)(2), (c)(1). If the GST event is a taxable distribution, the distributee reports the event and pays the tax, using IRS Form 706GS(D) (Generation-Skipping Transfer Tax Return for Distributions). IRC §2603(a)(1); Treas Reg §26.2662-1(b)(1), (c)(1). The trustee provides the distributee with the information needed for the return, using IRS Form 706GS(D-1) (Notification of Distribution from a Generation-Skipping Trust).

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§4.33 V. GST TAX STRATEGY FOR IRREVOCABLE TRUSTS

Sections 4.34-4.42 contain a brief overview of strategies to help address the problems posed by the GST tax.

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§4.34 A. Making Maximum Use of Limited Annual Exclusion

As discussed in §4.15, the $13,000 (plus further cost of living adjustments after 2009) IRC §2503(b) gift tax annual exclusion does not apply for GST tax purposes if there is a transfer to a trust having more than one beneficiary. IRC §2642(c). Accordingly, it is highly desirable to establish separate trusts for each skip person the transferor wants to benefit. To satisfy the requirements of IRC §2642(c), all distributions must be made to the beneficiary and amounts remaining in the trust at the beneficiary's death must be includable in the beneficiary's gross estate for tax purposes (*e.g.*, be subject to the beneficiary's testamentary general power of appointment). The multiple trusts may be established by a single trust instrument, which should state that any transfer to the trust is to be allocated equally to all the trusts unless the transfer instrument states otherwise. The *Crummey* clause (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) can provide for withdrawal of the full amount of the annual exclusion because there will be no gift on the lapse due to the testamentary general power of appointment.

Creating separate trusts for each beneficiary imposes higher administrative burdens, but these can be minimized by authorizing common investment. The lack of distribution flexibility can be addressed by using single beneficiary trusts in combination with a large wholly GST tax-exempt family "pot" trust.

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§4.35 B. Making Trusts Fully Exempt or Fully Nonexempt

The most fundamental rule of drafting and administering trusts that may be subject to GST tax is to create trusts that are either entirely exempt from the GST tax (trusts with inclusion ratios of zero) or entirely subject to the GST tax (trusts with inclusion ratios of one). Trusts with blended inclusion ratios (an inclusion ratio greater than zero but less than one) should be avoided. The rationale is simple: To the extent consistent with transferor objectives, the trust(s) should favor distributing GST *exempt* property to skip persons, and GST *nonexempt* property to nonskip persons.

This approach requires two trusts, one of which is fully exempt and one of which is not. If there is a single trust that is, for example, 50-percent exempt, every distribution to a skip person triggers a GST tax, and every distribution to a nonskip person consumes assets that are partially exempt.

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§4.36 C. Maximizing Benefits of Exempt Trusts

Generally, a trust that is exempt from GST tax because it has an inclusion ratio of zero will remain exempt until the transferor makes a new contribution to the trust or there is a change in the GST tax transferor. Changes in values of trust assets as a result of investment or distributions do not change the inclusion ratio, and distributions and taxable terminations will not generate a GST tax regardless of the generation assignment of the distributees. Accordingly, one generation of tax is avoided if the trust is distributed to grandchildren, two generations of tax are avoided if the trust is distributed to great-grandchildren, and so forth.

It is usually preferable to distribute to as low a generation as possible. An exception to this rule may exist when the distributions can be made to a beneficiary whose estate is small enough to incur little if any estate tax. In this circumstance, including the trust estate property in the beneficiary's taxable estate may obtain a new basis for capital gains tax purposes under IRC §1014.

Because the exempt trust will likely continue in existence for a long period, it should be drafted in a manner that provides considerable flexibility. The beneficiaries should be given broad limited powers of appointment to be able to respond to changed circumstances. Similarly, trustees should be subject to removal by beneficiaries or third party "trust protectors."

The exempt trust should pay as few benefits as possible to nonskip persons. Such persons should be provided for by nonexempt trusts.

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§4.37 D. "Layering" Nonexempt Trusts

In the context of the current discussion, the term "layering" is used to refer to a strategy of establishing different trusts for different generations of family members. The simplest example involves setting up a nonexempt trust for children and an exempt trust for lower generation family members.

The concept can be extended further in cases in which the transferor wants to make GSTs in excess of the amount that the transferor is able to protect by use of the IRC §2631(c) GST exemption. At that point, separate trusts should be established for each generation of skip persons. This approach is advantageous for two reasons:

- Because the tax on a direct skip is lower than that on a taxable distribution or taxable termination, it is undesirable to have any nonskip persons as beneficiaries of a nonexempt trust that primarily benefits skip persons.
- A single unlayered trust will often result in a GST tax at every generation. See §4.13. In contrast, only one tax is levied on a direct skip no matter how many generations are skipped.

EXAMPLE: Assume that a transferor establishes a $3-million nonexempt sprinkling trust for the benefit of grandchild, *GC,* and great grandchild, *GGC.* The initial transfer to the trust will be a taxable direct skip (the trust has no present interest beneficiary who is not a skip person), the tax will be paid, and the generation assignment of the transferor will drop down to one level above that of *GC* (one generation higher than the highest generation of the persons having an interest in the trust). IRC §2653. See §4.13. The unfortunate result is that *GGC* will remain a skip person and all distributions to *GGC* will be subject to a second GST tax, either as taxable distributions or as a result of the taxable termination that will occur on *GC*'s death. If, instead, the transferor establishes separate trusts of $1.5 million each for *GC* and *GGC,* there will still be a direct skip when each trust is established, but there will now be a $1.5-million fund that can be distributed to *GGC* without payment of a second GST tax.

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§4.38 E. Paying Medical Expenses and Tuition From Nonexempt Trusts

As noted in §4.14, payments made directly to providers for education tuition and medical care are not subject to GST tax. IRC §2611(b)(1). Accordingly, these items can be paid from a trust that is not exempt. Paying these expenses of skip persons from a nonexempt trust avoids unnecessary depletion of the transferor's GST exemption. Nonexempt trusts should permit such payments even if they do not otherwise allow for distributions to skip persons.

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§4.39 F. Paying Estate or Gift Tax Instead of GST Tax

One planning technique often recommended to minimize transfer taxes on a typical nonexempt trust (as described in §4.12) giving all income from the trust to a child for life with the remainder going to a grandchild—with the result that the death of the child causes a taxable termination—is to give the child a general power of appointment over the trust at death. This causes inclusion of the trust in the child's estate under IRC §2041 and causes the child to become the new GST transferor. So long as the child's estate tax rate is less than the maximum estate tax rate used to calculate the GST tax on taxable terminations, this results in a transfer tax savings. This technique no longer produces a savings in most cases because the estate tax rate is generally the same on all estates in excess of the IRC §2010(c) applicable exclusion amount.

However, payment of estate tax rather than GST tax on termination of the trust may still produce a transfer tax savings if the grandchild dies within a few years after the child, with the consequence that the grandchild's estate is eligible for the IRC §2013 prior transfer property (PTP) credit for a portion of the estate tax paid by the child's estate. See §2.86. There is no similar credit for GST tax paid if the death of a trust beneficiary that causes a taxable termination occurs shortly before the death of the remainder beneficiary. Further, making trust distributions to the child followed by gifts from the child to the grandchild rather than making distributions to the grandchild may produce a transfer tax savings because the tax rate on lifetime taxable gifts between $1 million and $1.5 million (41 percent on the first $250,000 in excess of $1 million and 43 percent on the next $250,000) is less than the estate tax rate (45 percent) used to calculate the GST tax on taxable distributions. However, the potential tax savings are modest ($15,000 on a taxable gift of $1.5 million ($210,000 gift tax plus $450,000 estate tax versus GST tax of $225,000 plus $450,000)). Note that payment of estate or gift tax will not produce a transfer tax savings if the remainder beneficiaries are more than two generations below the original transferor. For further discussion, see McCaffrey, *Drafting and Planning to Minimize the Generation-Skipping Transfer Tax*, Estate Planning 2005 §§3.29-3.33 (Cal CEB 2005).

Of course, giving the child a general power of appointment may have drawbacks. The child may exercise the power in a way not desired by the original transferor, and the general power also subjects the trust to the claims of the child's creditors. Prob C §682.

Because of these considerations, many practitioners recommend that the trust instrument should not simply grant beneficiaries general powers of appointment over nonexempt trusts, but instead give an independent trustee the power to confer a general power of appointment. Because it may be desirable to include only a portion of the trust in the child's estate, the trustee's authority should include the power to grant a general power of appointment over only a fractional share of the trust.

A variation of this approach involves use of the so-called Delaware Tax Trap, under which the child is given a nongeneral power of appointment that can be exercised in a manner that starts the running of a new perpetuities period. In California and some other states, this apparently can be accomplished by giving the child a testamentary power of appointment that can be exercised in a way that gives another person an immediately exercisable general power of appointment. To the extent that the child exercises the power in that manner, the property subject to the exercise will be included in the child's estate under the rarely used provisions of IRC §2041(a)(3). See Blattmachr & Pennell, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J Tax'n 242 (1988); Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 Est Plan 68 (2001).

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§4.40 G. Using Wait-and-See Allocation Strategy

Many trusts are structured in a manner that makes a GST unlikely but certainly not impossible. For example, a trust may provide for complete distribution to a child when the child attains age 30, with the trust estate passing to grandchildren only if the child fails to survive. Or a life insurance trust funded with term insurance may provide for a per stirpes distribution on the death of the insured. If the children are healthy, the GST exemption is likely to be wasted if the transferor allocates exemption to every transfer to the trust in order to maintain a zero inclusion ratio.

This result is particularly likely for term life insurance trusts that may never make any distributions to anyone if the insurance is not kept in force until the insured's death. In such situations, it may be appropriate to take a "wait-and-see" approach to exemption allocation, with the intention of allocating exemption later if a child becomes ill or it appears that a GST is more likely than originally assumed. The risks of such an approach include the possibility that the GST will occur before the exemption is allocated or that the insured of a life insurance trust will become seriously ill, thereby greatly increasing the value of the insurance policy and the amount of exemption needed to exempt the trust.

Using the wait-and-see allocation strategy requires (1) a common sense assessment of the likelihood that a GST will occur, (2) an understanding of appropriate GST drafting techniques, and (3) an open discussion with the client of the risks. Because this strategy may appear to be a poor one after, *e.g.*, the unexpected premature death of a child, prudent practitioners document their clients' informed consent to this approach, although in this case the risk that a GST will occur before the exemption is allocated may be mitigated by the availability of retroactive allocation. See §4.26B.

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§4.41 H. Avoiding Creation of ETIPs

The estate tax inclusion period (ETIP) rule is discussed in §4.29. As noted there, the rule delays the determination of the inclusion ratio—a potentially disastrous result if the trust estate is likely to increase in value, as may happen to a dramatic extent for life insurance trusts.

An ETIP can be created inadvertently by giving a spouse a withdrawal power, including a *Crummey* power (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82), that does not meet the requirements of Treas Reg §26.2632-1(c)(2)(ii)(B). The regulation permits giving a spouse a withdrawal power over an amount of transferred property not exceeding the greater of $5000 or 5 percent of the trust corpus as long as the withdrawal right terminates no later than 60 days after the transfer to the trust.

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§4.42 I. Determining Responsibility for Allocating GST Exemption

Because there is no automatic allocation of GST exemption to transfers to an irrevocable trust having multiple beneficiaries, at least one of whom is a nonskip person, that does not meet the statutory definition of "GST trust" under IRC §2632(c), the plan for establishing the typical irrevocable trust also must include a plan for ensuring that proper procedures will be followed for allocating GST exemption in later years. The plan should be signed by the client and any family member, certified public accountant, or other third party who has responsibility for carrying out the plan. The plan should do the following:

- Remind the client that gift tax returns are necessary for GST exemption allocation purposes even if the gifts to the trust are protected for gift tax purposes by the IRC §2503(b) gift tax annual exclusion;
- Identify the person who will prepare the necessary gift tax returns (IRS Form 709) and notices of allocation;
- Identify the person who will notify the preparer in writing of each transfer to the trust, including indirect transfers such as the payment of insurance premiums;
- In "wait-and-see" and estate tax inclusion period (ETIP) situations in which GST exemption is not initially allocated, identify the events that may trigger the need for action (*e.g.,* the serious illness of a child whose death may eventually result in trust distributions to a grandchild) and the person responsible for taking action if the events occur; and
- Provide appropriate instructions concerning preparation of the gift tax returns, including instructions to ensure that the GST exemption of the spouse is also allocated to the trust if the transferred property is community property or a separate property gift is split in accordance with IRC §2513.

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5

Trust Planning: Permanent Trusts

John R. Cohan

I. INTRODUCTION TO TRUST PLANNING
- A. Permanent Trusts Distinguished From Other Trusts §5.1
- B. Purposes Served by Permanent Trusts
  - 1. General Purposes; Family Trusts §5.2
  - 2. Balancing Personal and Tax Objectives §5.3
  - 3. Tax Purposes of Permanent Trusts
    - a. Reducing Settlors' Taxable Estate §5.4
    - b. Preventing Inclusion of Trust Property in Beneficiaries' Taxable Estates §5.5
    - c. Planning for Generation-Skipping Transfer Tax
      - (1) Provisions of GST Tax §5.6
      - (2) Effect of GST Tax on Irrevocable Trust §5.7
    - d. Reducing Settlors' Income Tax §5.8
    - e. Achieving Grantor Trust Status
      - (1) Grantor Trust Powers §5.9
      - (2) Power Granted to Special Trustee to Add Beneficiaries of Named Class §5.10
- C. Funding the Trust §5.11
- D. Reciprocal Trusts §5.12
- E. Permanent Trust Gifting Strategy §5.12A

II. BASIC PRINCIPLES VERSUS SETTLORS' HOPES
- A. Clients' Pipe Dream §5.13
- B. Pipe Dream Trust §5.14
- C. Diagnosis of Pipe Dream Trust
  - 1. Basic Estate Tax Principles §5.15
  - 2. Basic Gift Tax Principles §5.16
  - 3. Basic Income Tax Principles §5.17
  - 4. Road to Reality §5.18
  - 5. Support of Dependents and Payment of Legal Obligations §5.19
    - a. Scope of Obligation to Support
      - (1) Support of Minors §5.20
      - (2) Education Expenses §5.21
      - (3) Support of Parents and Adult Children §5.22
      - (4) Statutory Limits on Trustee's Powers to Discharge Support Obligations §5.23
    - b. Estate Tax Principles §5.24
    - c. Gift Tax Principles §5.25
    - d. Income Tax Principles §5.26
    - e. Independent Trustee's Discretionary Power to Discharge Support Obligation §5.27
- D. Flexibility Versus Control §5.28
- E. Single Versus Multiple Trusts §5.29
  - 1. Considerations Favoring One Trust §5.30
  - 2. Considerations Favoring Multiple Trusts §5.31

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I. INTRODUCTION TO TRUST PLANNING

§5.1 A. Permanent Trusts Distinguished From Other Trusts

The term permanent trusts, as used in this chapter, refers to all trusts that are not revocable and that are designed and used to avoid estate taxes on a settlor's death and may be used to shift the income tax burden on trust assets from the settlor to the trust beneficiaries. The permanent trust is designed for the following purposes:

- Prolonged management of permanently and irrevocably transferred assets;
- Immediate removal of the transferred property from a settlor's estate for estate tax purposes (accomplished at the price of making an immediate gift for gift tax purposes); and
- To ensure that the income from trust assets will no longer be includable in the settlor's taxable income for income tax purposes, (see chap 3 on income taxation of trusts), although irrevocable trusts are sometimes drawn intentionally to cause the trust income to be taxed to the settlor. See §§3.40-3.44, 5.9-5.10.

Many people are reluctant to give up the degree of control over the trust and its assets necessary to achieve these tax objectives. This chapter emphasizes the counseling process and drafting techniques that deal with these problems.

Permanent trusts may be distinguished from the following types of trusts:

- Revocable trusts, in that permanent trusts are not revocable and often the income is not payable or taxable to the settlors;
- Trusts for minors (see chap 12) and special needs trusts (see chap 13), which are drafted to meet the peculiar problems posed by the legal disability or incapacity of minors and disabled persons—and to satisfy the settlors' desire to take advantage of the annual gift tax exclusion for gifts of present interests to those persons; and
- Specialized trusts, such as irrevocable life insurance trusts (see chap 11), dynasty trusts (see chap 13A), charitable remainder trusts (see chap 18), charitable lead trusts (see chap 18A), and grantor retained interest trusts (see chaps 14-17), which are designed to accomplish specific estate tax objectives.

In California, a trust is revocable unless the trust specifically provides that it is irrevocable. See §8.6 for form and discussion. Before permitting clients to part irrevocably with a portion of their property, the attorney should be satisfied that the clients will be economically secure and emotionally comfortable after the transfer. The trust's impact on the personal relationship between the settlors and the beneficiaries should also be carefully considered. Finally, the wisdom of making substantial wealth available to children should be discussed with the clients.

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B. Purposes Served by Permanent Trusts

§5.2 1. General Purposes; Family Trusts

The basic purpose of a permanent trust is to transfer the legal ownership and management of property to one or more trustees for the beneficial purposes set forth in the trust instrument. To the extent the trust continues after the settlors' deaths, it becomes a substitute for a will (or revocable trust) with respect to the trust principal. Often, a permanent trust provides for more than one generation of family members. For a discussion of the tax on generation-skipping transfers, see chap 4. On generation-skipping dynasty trusts, see chap 13A.

To mitigate the potential disadvantage of rigid long-term arrangements frequently encountered in permanent trusts, the trustee may be given discretionary powers that:

- Allow payment of trust income and principal for support, health, education, maintenance, comfort, happiness, and other desirable purposes, thereby permitting personal attention to the family's changing needs (see §9.17);
- Allow payments to one or more beneficiaries to the exclusion of other beneficiaries, enabling the trustee to make decisions based on relative merit (see §9.9);
- Permit termination of the trust after it has served its usefulness (see, *e.g.*, §§9.5-9.7, 9.21); and
- Provide for the care of minors and disabled persons (see §9.47).

Additional flexibility may be achieved through limited powers of appointment. See §§9.54-9.55.

CAVEAT: Although the possibilities are unlimited, the planner must carefully consider the estate tax, gift tax, generation-skipping transfer (GST) tax, and income tax consequences, both federal and state, of any plan, so that a tax disaster does not occur.

Tax planning has been simplified since the repeal of California's inheritance and gift taxes and the restructuring of the California income tax to incorporate by reference the federal income tax law in many areas, including most provisions pertaining to the income taxation of estates and trusts. See Rev & T C §17024.5.

However, the California income tax rates applicable to trusts have not undergone the same compaction as federal tax rates. Therefore, it remains possible to reduce the combined state and federal tax burden of the settlor and beneficiaries by accumulating modest amounts of income in permanent trusts. See chap 3.

The effect of state income tax laws other than California's should be considered if any trustees or beneficiaries are not California residents. See Rev & T C §§17742-17745. The planner should also be mindful of the unique effect of California and other income tax laws on trusts created in other states. See chap 20.

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§5.3 2. Balancing Personal and Tax Objectives

In the counseling process, the attorney's major goal is to help the clients evaluate the tax benefits and economic or emotional disadvantages of any plan. Although the following are not questions of law, they provide the planner with information that is essential when preparing a satisfactory family trust for a substantial gift.

- Will the clients feel economically secure after the gift?
- Will the children's incentive to achieve be impaired?
- Is it better to distribute trust principal outright at an early age to make a child "sink or swim," or is it better to protect the child from possible indiscretion?
- Should children (and grandchildren) be protected from the indiscretion or undue influence of future spouses by retaining their capital in trust for life?
- Should all beneficiaries be treated equally?

The attorney also performs a valuable service by formulating compromises between the settlors' conflicting aims. This requires a thorough understanding of the tax implications of various possibilities, an open and receptive mind to the settlors' wishes (which may be contrary to the attorney's personal philosophy), and a sensitivity to possible future developments in the law. For example, one compromise of the settlors' conflicting desire to provide for their daughter-in-law and also to protect their grandchildren against a possible stepfather is to let their son address the problem at a later time by giving their son a limited power of appointment, possibly limited to income for the daughter-in-law. See §9.55.

CAVEAT: The drafter must avoid inadvertently including those provisions (*e.g.,* support provisions and trustees' powers) that may cause unexpected adverse estate and income tax consequences to persons other than the settlors (*e.g.,* the beneficiaries). See §§5.19, 9.50-9.53.

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3. Tax Purposes of Permanent Trusts

§5.4 a. Reducing Settlors' Taxable Estate

In general, property of a properly drafted permanent trust will not be included for federal estate tax purposes in a settlor's gross estate, regardless of the time of a settlor's death, although any gift tax paid on the transfer of property to the trust may be included in the settlor's estate if the settlor dies within 3 years of the transfer. See IRC §2035. As a necessary corollary, a completed gift for gift tax purposes will have been made when the transfer was made. For discussion of various gift tax considerations, see §§2.8-2.46. If the settlors retain some rights, however, all or part of the trust property may be subject to estate tax on their deaths or on the surviving settlor's death.

EXAMPLES:

- The settlors' retention of the right to income for their respective lifetimes. See §§2.48-2.62.
- Retention of a lesser income interest. Compare *Estate of Gizella Wells*, TC Memo 1981-574 with *Estate of Marguerite M. Green* (1975) 64 TC 1049, acq in result 1976-2 Cum Bull 2.
- Retention of certain interests other than income interests, or certain powers. See §5.15.

Moreover, even though the principal of a trust may be subject to federal estate tax, a federal gift tax may still be imposed at the time of the trust's creation or a later transfer to the trust. A double tax is avoided by means of a credit without interest for the gift tax paid against the estate tax later imposed. IRC §2012. Retention of these and other types of interests, rights, and powers also may cause the settlors to be taxed on the income of the trust. See §5.17.

The reduction of the settlor's taxable estate through lifetime gifts that reduce the settlor's available estate tax applicable exclusion amount for transfers at death, or that even result in payment of gift tax, may be beneficial for two reasons:

- First, the transfer to the trust freezes the value of the transferred assets, which might have appreciated during the settlor's lifetime or which might have produced income that would be included in the settlor's estate. This increases the ultimate value of assets in the hands of the transferees that can be shielded by the settlor's unified credit applied to the transfer.
- Second, gift tax paid on transfers in excess of the $1 million gift tax applicable exclusion amount more than 3 years before death will be removed from the settlor's estate. This reduces the total estate and gift taxes generated by the transfer of the settlor's property, provided that the settlor retains sufficient assets to use the settlor's remaining unified credit.

Many clients with sufficient resources may be willing to apply the unified credit required to shield $1 million of lifetime gifts, but most clients may be reluctant to pay the gift tax triggered by larger gifts. However, some clients may be willing to make larger than usual taxable gifts and pay gift tax in 2010 when the gift tax rate is 35 percent and the generation-skipping transfer (GST) tax does not apply. The settlor can shield additional assets by making annual exclusion gifts for the benefit of family members and others. See §5.12A.

If settlors intend that the trust property remain subject to estate tax, the planner generally should not use a permanent trust. In this circumstance, a revocable trust is generally more desirable because the settlors can retain absolute control. See Drafting California Revocable Trusts (4th ed Cal CEB 2003). If the sole purpose of the trust, however, is to protect a spendthrift settlor against his or her own indiscretion, an irrevocable trust providing lifetime benefits to the settlor, but no tax advantages, is a suitable vehicle although it provides only limited protection from creditors. See §§9.64-9.68. With such an irrevocable trust, the drafter should be careful to avoid the imposition of gift tax for the actuarial present value of the remainder interest. This can be accomplished by giving the settlor a limited testamentary power of appointment. See §9.55.

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§5.5 b. Preventing Inclusion of Trust Property in Beneficiaries' Taxable Estates

Property of a permanent trust usually is not subject to federal estate tax on a beneficiary's death except in the following circumstances:

- The beneficiary has a vested interest in the trust principal that is not subject to divestment;
- The beneficiary is given a general power of appointment (see §9.55); or
- The property is distributable to the beneficiary's estate.

Property that might have been included in a beneficiary's taxable estate may be subject to generation-skipping transfer (GST) tax when it is not subject to the estate tax. See chap 4. To the extent that each settlor of a trust can shield an amount equal to the IRC §2010(c) applicable exclusion amount from GST tax by applying the settlor's GST exemption (IRC §2631), it is possible to postpone federal estate taxes otherwise payable by the beneficiaries for several generations or perhaps indefinitely, by preventing each successive beneficiary from receiving any interest in the trust that would subject the trust property to inclusion in his or her estate (see §§4.7-4.13).

For property that can potentially be shielded by the settlor's GST exemption, the question may arise whether certain property should be given outright to a child at a certain age, or whether the property should be retained in trust during the child's lifetime to save estate tax that otherwise might be payable on the child's death. See §§5.6-5.7. Unless the family is unusually wealthy, the consulting editor believes that avoiding the emotional hardships to the child and avoiding the child's loss of complete control of the assets frequently outweigh a potential tax saving many years away. Moreover, there is no assurance that before the child's death the law will not be changed adversely with retroactive effect. See chap 4. As one way of protecting against such adverse changes in the tax law, the settlors may wish to give the trustee, or another person, the power to terminate the trust to give the beneficiary full management powers and possession if the settlors' tax objectives are thwarted. Giving the beneficiary a limited power of appointment also provides a means to deal with future changes in the law without adverse gift tax consequences.

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c. Planning for Generation-Skipping Transfer Tax

§5.6 (1) Provisions of GST Tax

Although estate tax may be avoided on a beneficiary's death, the generation-skipping transfer (GST) tax may be imposed on property not sheltered by the GST exemption. The advantage obtained by postponing estate tax would be eliminated when persons who are two or more generations younger than the settlors ultimately receive interests in the trusts. Regardless of their respective ages, the settlors are both treated as being in the same generation as relatives who share a common grandparent with either settlor. See IRC §2651(b)(2).

The GST tax is imposed, with certain exceptions, if the child is given a right to trust income or a discretionary interest in the trust for life and, at his or her death, the trust assets are distributed to or held in further trust solely for beneficiaries one or more generations younger than the child (*i.e.,* grandchildren or great-grandchildren). These are called skip persons. IRC §2613(a). Subject to several exceptions, a GST tax is imposed on taxable terminations, taxable distributions, and direct skips. See chap 4.

- A taxable termination occurs when the present interest in a trust of a "non-skip person" (defined under IRC §2613(b) as not a skip person) terminates and thereafter only skip persons have present interests in the trust. See IRC §2612(a).
- A taxable distribution is any distribution from a trust to a skip person other than a taxable termination. See IRC §2612(b).
- A direct skip is any transfer subject to the estate or gift tax to a skip person or to a trust in which only skip persons have present interests. See IRC §§2612(c), 2613(a).

The tax rate on a generation-skipping transfer is a flat rate, which is equal to the *maximum* federal estate tax rate, unless all or part of any applicable GST exemption causes the effective rate to be reduced. See IRC §§2631-2632. This exemption also covers generation-skipping transfers of more than one generation, *i.e.,* multiple skips. For a detailed discussion of the GST tax, see chap 4.

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Source: Estate Planning/Drafting California Irrevocable Trusts/5 Trust Planning: Permanent Trusts/§5.7 (2) Effect of GST Tax on Irrevocable Trust

§5.7 (2) Effect of GST Tax on Irrevocable Trust

Before implementing an irrevocable trust, the drafter must consider the effects of the generation-skipping transfer (GST) tax on the trust. If all or a portion of each grantor's GST exemption will be allocated to the trust (currently or in the future), and the entire trust will not be sheltered from the imposition of the generation-skipping transfer tax because of this allocation, the drafter should create two separate trusts under the trust instrument: one with an inclusion ratio of one, and one with an inclusion ratio of zero. Otherwise, the single trust will have a fractional inclusion ratio that creates problems, like a changing fraction. For appropriate forms, see California Will Drafting, chap 15 (3d ed Cal CEB 1992). See also Drafting California Revocable Trusts §§4.184-4.221 (4th ed Cal CEB 2003).

CAVEAT: To have different inclusion ratios, the drafter generally must divide the original trust into two or more trusts *before* the grantor's GST exemption is allocated. Then the drafter can allocate the exemption entirely to the resulting trust or trusts, which will be shielded from the imposition of a GST tax.

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§5.8 d. Reducing Settlors' Income Tax

Frequently, the drafter must ensure that income from a permanent trust is taxed to the beneficiaries, or, less likely, to the trust, and not to the settlors. However, some clients may desire to be taxed personally on trust income. Payment of income tax allows the settlors to further reduce their taxable estate without making additional taxable gifts. The creation and taxation of grantor trusts, in which trust income may be taxed to the settlors, are discussed in chap 3. For a form designed to achieve grantor trust treatment, see §5.11. See also chap 13A on dynasty trusts. Unless otherwise expressly indicated, this chapter assumes that the settlors do not want to be taxed on trust income.

PRACTICE TIP: Some practitioners believe that the use of a grantor trust for a long-term permanent trust is inappropriate because it raises serious issues of estate tax inclusion. Such trusts are believed more appropriate for short-term trust vehicles, such as grantor retained annuity trusts (GRATs). Others, including the consulting editor, believe that grantor trusts are an important estate planning tool.

Explicit retention of an income interest by the settlors causes that income to be taxed to the settlors. See §3.29. In addition, retention of certain rights and powers by the settlors or by other related parties (IRC §672) and inclusion of certain discretionary and administrative provisions in the trust instrument cause the income of the trust to be taxed to the settlors. See §§3.27-3.28. Retention of these interests, rights, and powers may also cause the property to be subject to estate tax, but the rules governing these two taxes differ substantially.

A properly drafted irrevocable trust can shift taxable income to the beneficiaries if nontax considerations permit (*e.g.*, no spendthrift adult beneficiary). The settlors can retain the taxable incidences if they are willing to pay the income tax with their own funds, and the current law relating to a lack of gift tax consequences remains unchanged.

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e. Achieving Grantor Trust Status

§5.9 (1) Grantor Trust Powers

A settlor may want to be taxed on the income of an irrevocable trust, without risking inclusion of the trust in the settlor's estate for estate tax purposes. This can be accomplished by granting a power that is treated differently under the income and estate tax regimes. For example, as discussed in §5.10, a settlor's brother may be designated a special trustee with the power to add beneficiaries of a named class to the trust. This causes the settlor to be treated as the owner of the trust under IRC §674 (see IRC §672) for income tax purposes, but not for estate tax purposes, because there is no analog in the estate tax law for inclusion of property in a decedent's estate because of powers exercised by another person over that property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/5 Trust Planning: Permanent Trusts/§5.10 (2) Power Granted to Special Trustee to Add Beneficiaries of Named Class

§5.10 (2) Power Granted to Special Trustee to Add Beneficiaries of Named Class

Before implementing an irrevocable trust, the drafter must consider the effects of the generation-skipping transfer (GST) tax on the trust. The power to add beneficiaries creates a grantor trust, regardless of who holds it. See IRC §674(c). Other powers, such as the power to have the settlors borrow from a trust without adequate interest or security, are defective only if held by a nonadverse party. See IRC §675(2). The fact that there are two settlors in respect to community property transferred to the trust is not a problem as long as the required relationship exists in respect to one spouse. IRC §672(e).

If the power to add beneficiaries (or a similar power) is released, the settlors cease to be treated as owners of the trust unless other provisions of the trust instrument produce this result. The cessation of grantor trust status may have other undesirable income tax consequences in the view of the IRS, such as the acceleration of an installment obligation, or the realization of gain from the negative basis of property held in the trust. See form in §9.11A.

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§5.11 C. Funding the Trust

Under IRC §672(e), any power held by a settlor's spouse is treated as being held by the settlor in determining the income tax consequences of the trust. When community property is used to fund a permanent trust, the husband and wife are each considered to be the creator of one half of the trust. Giving either spouse prohibited interests, rights, or powers over a trust funded with community property causes each spouse to be subject to income tax on the entire trust. IRC §672(e). Similarly, if one spouse's separate property is used to fund a trust over which the other spouse has prohibited interests, rights, or powers, the spouse who has relinquished control over his or her property will still be subject to income tax. For this reason, it is often recommended that spouses establish trusts with separate property, as discussed in §5.12.

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§5.12 D. Reciprocal Trusts

Community property can be divided into equal shares of separate property of the husband and wife respectively without adverse tax consequences. See IRC §1041; *Jean C. Carrieres* (1975) 64 TC 959, acq 1976-2 Cum Bull 1, aff'd (9th Cir 1977) 552 F2d 1350. See also *Hazel E. Balding* (1992) 98 TC 368. Community property is often split into separate property in connection with insurance trusts to achieve various income and estate tax benefits. If the husband acts as trustee of the wife's trust, however, or the wife acts as trustee of the husband's trust, there will be no *income tax* advantages to such a split because of IRC §672(e). Additionally, when the trusts contain reciprocal beneficial provisions or powers that would have adverse tax consequences if retained by the settlor-spouse, no *estate tax* purposes will be achieved because each spouse will be considered the creator of the trust established by the other for tax purposes. *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730. See also *Exchange Bank & Trust Co. v U.S.* (Fed Cir 1982) 694 F2d 1261.

In *Estate of Bruno Bischoff* (1977) 69 TC 32, the Tax Court applied the reciprocal-trusts doctrine to trusts created by a husband and wife for their grandchildren with each spouse as trustee of the other spouse's trust. Although neither spouse had any beneficial interest in the trust property, each had the power to control the beneficial enjoyment of trust income. Therefore, the reciprocal trust created by the other settlor was included in the deceased settlor's estate. In *Estate of Green v U.S.* (6th Cir 1995) 68 F3d 151, however, the court did not apply the reciprocal-trusts doctrine to two trusts created by a husband and wife for the benefit of their two grandchildren with each spouse as trustee of the other spouse's trust. The trustee had limited discretionary power to reinvest and time the distribution of trust corpus and income until each respective beneficiary of the trust reached age 21. In *Adolph K. Krause* (1972) 57 TC 890, aff'd (6th Cir 1974) 497 F2d 1109, cert denied (1975) 419 US 1108, 42 L Ed 2d 804, 95 S Ct 780, the court applied the reciprocal-trusts doctrine to trusts created by a husband and wife for the benefit of their children and grandchildren, respectively, with each spouse as trustee of the other spouse's trust. Each spouse retained a discretionary right to receive trust income from the other spouse's trust. In contrast, in a case in which a husband and wife each established trusts for their children that were similar except for the wife's limited power of appointment over the trust created by the husband, the reciprocal-trusts doctrine was held not to apply. *Estate of Herbert Levy,* TC Memo 1983-453.

In IRS Letter Ruling 200426008, the IRS ruled that the reciprocal trust doctrine will not cause assets of life insurance trusts created by a husband and wife to be included in each other's estate. The husband's trust provided for discretionary distributions to the wife, and the wife's trust provided for distributions to the husband. Both trusts provided for distributions to the couple's son. Based on the decision in *Levy*, the IRS ruled that the reciprocal trust doctrine did not apply because of differences in the terms of the two trusts. As a consequence, neither spouse will be treated as the settlor of the trust established by the other spouse.

NOTE: Despite the implications of IRS Letter Ruling 200426008, practitioners cannot be certain that modest (or even fairly significant) differences in trusts executed at the same time by closely related parties will prevent the application of the reciprocal trust doctrine. Under *Lehman v Commissioner* (2d Cir 1940) 109 F2d 99, it remains clear that trusts established by different settlors for the benefit of each other can be "uncrossed" if each trust was established in consideration of the other. It is also important to keep in mind that some courts have applied the reciprocal transfer doctrine in cases in which neither transferor retained or received any interest or benefits. See, *e.g., Estate of Schuler v Commissioner* (8th Cir 2002) 282 F3d 575; *Sather v Commissioner* (8th Cir 2001) 251 F3d 1168. Both cases involved transfers by siblings, each of whom attempted to increase the number of available annual gift exclusions by making transfers not only to the transferor's own children, but also to the children of the other transferors.

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§5.12A E. Permanent Trust Gifting Strategy

The foregoing observations suggest a permanent trust gifting strategy in which all clients with sufficient resources are advised to consider making $1 million of lifetime gifts (where appropriate, generation-skipping gifts) shielded by the settlor's gift tax applicable exclusion amount (and $1 million of the settlor's GST exemption).

These gifts are supplemented by annual exclusion gifts (and gifts for educational and medical expenses) that do not use any additional applicable exclusion amount but which may require allocation of GST exemption if the gifts are made to trusts with multiple skip-person beneficiaries, as may be appropriate if the settlor does not have another use for the GST exemption.

Clients with larger resources are advised to consider making additional lifetime taxable gifts (allocating additional GST exemption as needed) and paying the resulting gift tax. These clients are advised to consider using grantor trusts for this purpose and paying the income taxes on trust income taxable to the settlor as a way of making additional, nontaxable gifts to the trust beneficiaries. However, clients making taxable gifts and paying gift tax are advised to retain at least enough assets to use the remaining estate tax applicable exclusion amount that cannot be used for lifetime gifts.

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II. BASIC PRINCIPLES VERSUS SETTLORS' HOPES

§5.13 A. Clients' Pipe Dream

Often, clients want a trust to meet conflicting purposes. If they are completely candid, they will say:

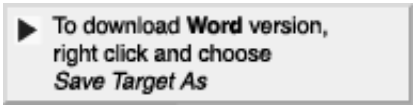
- They want a gift that helps their children and saves taxes.
- They also want a chance to use the property themselves in case of adversity.
- They desire management power over the trust estate.
- They wish to decide later when the children will receive the property.

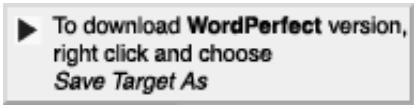
The interaction between this pipe dream and reality, *i.e.,* the restrictions in the tax law, are discussed in the following sections:

- The type of trust clients dream about and its tax consequences are discussed in §§5.14-5.27.
- Some alternatives for all trusts are analyzed in §§5.28-5.31.
- Trusts that meet some of the clients' wishes with lessened tax consequences are discussed in chap 9, together with a discussion of the estate, gift, and income tax consequences of each.
- A complete form of sprinkling trust illustrating the broad powers an independent trustee can possess is set forth in App A.
- In contrast, in App B, the settlor is trustee with more limited powers.

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§5.14 B. Pipe Dream Trust





The pipe dream trust would name one spouse or both spouses as trustees and include a provision like this:

During the lifetime of the survivor of the settlors, the trustee may pay to or apply for the benefit of the settlors and any of their issue any sum that the trustee determines in his or her absolute discretion. On the death of the survivor of the settlors, the trust estate as then constituted will be distributed free of trust to whomever of the settlors' then-living issue the settlors have appointed by will or other written instrument, and in default of this appointment, to the settlors' then-living issue by right of representation.

This pipe dream is a helpful starting point because it reflects the insecurities, real and imagined, that clients must overcome before they can create a trust that is effective for tax purposes. If they persist in their pipe dream of retaining an interest in the trust for their own security, the planner should recommend a revocable trust.

The pipe dream is also a useful frame of reference for the basic tax rules in drafting trusts.

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C. Diagnosis of Pipe Dream Trust

§5.15 1. Basic Estate Tax Principles

A settlor's gross estate includes not only a trust from which the income is payable to the settlor for life, but also a trust from which the settlor may demand the income at any time, as occurs in the pipe dream trust. IRC §2036(a)(1). A settlor's gross estate also includes a trust in which the settlor has the right to designate the person who shall "possess or enjoy" the property or its income. IRC §2036(a)(2). This power is equivalent to a power to amend the trust, which causes the imposition of estate tax under IRC §2038(a)(1). A settlor's uncontrolled power to cause distribution of property at any time to particular persons, even though restricted in identity, is also a power to amend the trust. Any of these powers causes adverse estate tax consequences if it exists at the time of a settlor's death, even though the power was retained for another period (*e.g.,* 25 years), which did not end before a settlor's death.

Under IRC §§2036 and 2038, trust property is included in a settlor's gross estate for federal estate tax purposes if the settlor has retained the prohibited rights or powers, either alone or in conjunction with any person (even an adverse party). See §§2.49-2.65. The powers of a spouse are usually irrelevant for estate tax purposes; IRC §672(e) only applies for income tax purposes. If a settlor acts as trustee or cotrustee, and the trustee or trustees are given unlimited discretionary power to accumulate or distribute income or to distribute principal, or both, the trust property is included in the settlor's gross estate for federal estate tax purposes to the extent of the settlor's contribution to the trust (*e.g.*, one half), even though the settlor is not a beneficiary. *U.S. v O'Malley* (1966) 383 US 627, 86 S Ct 1123, 16 L Ed 2d 145; *Industrial Trust Co. v Commissioner* (1st Cir 1947) 165 F2d 142; *Biscoe v U.S.* (D Mass 1957) 148 F Supp 224. Even if the ultimate beneficiary is the same as the income beneficiary, the settlor's retained right to determine *when* the beneficiary receives principal causes trust principal to be included in the settlor's gross estate. IRC §2038(a)(1); *Lober v U.S.* (1953) 346 US 335, 98 L Ed 15, 74 S Ct 98. If the powers to accumulate or distribute income or principal are limited by a sufficiently ascertainable standard, the property of the trust is not included, at least when the trust beneficiaries are nondependent beneficiaries. *Estate of Ralph Budd* (1968) 49 TC 468, acq 1973-2 Cum Bull 1; *Estate of Robert W. Weir* (1951) 17 TC 409, acq 1952-1 Cum Bull 4, nonacq 1966-2 Cum Bull 8.

Retention of these interests, rights, and powers is only briefly discussed because, ordinarily, retention of any such explicit interests, rights, and powers is not intended, and careful drafting can guard against their retention.

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§5.16 2. Basic Gift Tax Principles

A settlor makes a gift only after placing the property beyond his or her own control. Treas Reg §25.2511-2. The settlor may do so by transferring title to another person or to an entity that the settlor does not control. In the pipe dream trust, the settlor-trustee has retained the power both to reacquire the property and to determine which persons from among a group of persons will receive the property. Either power is enough to avoid a completed gift. Treas Reg §25.2511-2(c).

If a third party is named trustee of the pipe dream trust, however, and the settlors relinquish the power to appoint who will receive the property on their deaths, a completed gift will have occurred because the settlors will have given up control over who will receive the property. Vesting a third-party trustee with the power to distribute the property to the settlors does not by itself avoid the imposition of the gift tax. Treas Reg §25.2511-2(b). Moreover, a completed gift can occur even though the trust is subject to estate tax at one settlor's death and the settlors will be subject to income tax on trust income. Estate taxes are reduced later by the estate tax credit (IRC §2012) for gift taxes paid on property included in the gross estate.

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§5.17 3. Basic Income Tax Principles

The pipe dream trust runs afoul of almost every code section that causes settlors to be taxed on trust income. Settlors are treated as owners of trusts when:

- They have a reversionary interest in either income or principal if, at the inception of the trust, the value of this interest exceeds 5 percent (for either income or principal). IRC §673. The settlors of the pipe dream trust retain the power to obtain 100 percent of the trust income and principal at any time.
- They or a nonadverse party may appoint income or principal, unless a statutory exception applies. IRC §674. The statutory language is couched in terms of retention of a power to designate beneficial enjoyment; limited powers may be fatal, and the statutory exceptions are some of the most intricate in the tax law. The examples in chap 9 deal with the exceptions in IRC §674. In the pipe dream trust, the settlors' power as trustees to select who shall receive property and when they shall receive it is the most blatant example of a power to designate beneficial enjoyment or to appoint trust property.
- They or a nonadverse party have a power to revoke, to the extent of that power. IRC §676. The settlors' unrestrained right to help themselves to both principal and income of the pipe dream trust constitutes a power to revoke for tax purposes. Treas Reg §1.676(a)-1.
- Income may be distributed, in the discretion of a settlor or a nonadverse party, to the settlor or his or her spouse or be applied to pay life insurance premiums on policies covering a settlor or his or her spouse. IRC §677. The pipe dream trust falls squarely within this rule.

Under IRC §§674(a) and 675-677, settlors are treated as owners of the trust not merely when the a settlor acts as the trustee or as one of several trustees. These sections also apply when any person acts as the trustee who is not an adverse party or whose acts are not subject to an adverse party's approval or consent. Exceptions to the apparent broad scope of IRC §674(a) are set out in IRC §§674(c)-(d), but these exceptions do not apply when a settlor acts as a trustee. For a discussion of the exceptions, see chap 9.

The rules that disregard a trust for income tax purposes are commonly known as grantor trust rules. In their present form, they are loosely based on principles enunciated in *Helvering v Clifford* (1940) 309 US 331, 60 S Ct 554, 84 L Ed 788. In the 1940s, the IRS formulated detailed regulations based on this case. Because their validity was questioned, these regulations with modifications were enacted into the Internal Revenue Code in 1954. In 1986 changes to the Code sought to correct perceived abuses of the Clifford trust (*i.e.*, a trust for a specified term, with trust assets reverting to the settlor on expiration of the term). A settlor is now taxed on trust income if the settlor or his or her spouse retains a reversionary interest greater than 5 percent. IRC §673.

The most significant rule relating to powers to designate beneficial enjoyment is IRC §674. This section's guiding principle is that the more independent the trustee, the more flexibility is permitted; conversely, the less independent the trustee, the greater rigidity is required. The forms in chap 9 illustrate typical solutions used to resolve the dilemmas posed to clients by IRC §674 and provide solutions to most death tax problems. They have been designed to help the attorney guide clients when they must decide to give up either part of their desired control or the flexibility of their pipe dream. For tax problems involving transfers of property to a trust in exchange for a private annuity, see *Stern v Commissioner* (9th Cir 1984) 747 F2d 555; *La Fargue v Commissioner* (9th Cir 1982) 689 F2d 845. See also §2.57.

For a detailed discussion of the grantor trust rules, maximizing the settlors' control over trust distributions, and the use of two-tiered trusts to maximize the settlors' control and minimize income tax, see chap 3.

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§5.18 4. Road to Reality

Clients who wish to save transfer taxes cannot retain any beneficial interest in the trust for themselves. See IRC §2036. A beneficial interest includes both the direct benefit of payments from the trust (as discussed in §5.15) and the indirect benefit of discharging the settlors' legal obligations to their creditors or to their minor children. See §§5.19-5.27.

The clients must choose whether they want flexibility, with decision making left to others, or rigidity, retaining the right to make decisions. For further discussion, see §5.28.

The attorney, more frequently than the client, must decide whether a single trust or several trusts will accomplish the clients' objectives. See §§5.29-5.31.

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§5.19 5. Support of Dependents and Payment of Legal Obligations

The clients' pipe dream includes the hope that they may discharge their legal obligations, especially their legal obligations to support others, by using a trust, without being taxed on its income and without having the trust property included in their gross estates. To some extent this pipe dream has reality.

The lawyer's pipe dream is that he or she can advise clients on the extent of a parent's duty to support his or her minor child, the duty to pay for an adult child's higher education, and the use of a trust to pay for higher education.

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a. Scope of Obligation to Support

§5.20 (1) Support of Minors

Family Code §§3900-4203 sets out the duty of support. The major provisions of those sections are stated here for easy reference.

- The father and mother of a minor child have an equal responsibility to support their child in the manner suitable to the child's circumstances. Fam C §3900. A minor is defined as an individual who is under 18 years of age. Fam C §6500.
- The father and mother also have a duty to support a child after he or she turns 18, if the child is unmarried, is a full-time high school student, and is not self-supporting, until the child completes the twelfth grade or attains the age of 19 years, whichever occurs first. Fam C §3901(a).
- The father and mother have an equal responsibility to maintain, to the extent of their ability, a child of whatever age who is incapacitated from earning a living and without sufficient means. Fam C §3910(a).
- In any proceeding concerning the support of a minor child or a child for whom support is authorized under either Fam C §3901 or §3910, the court may order either or both parents to pay an amount necessary for the child's support. Fam C §4001.
- A statewide uniform guideline is adopted at Fam C §§4050-4076 to ensure that California remains in compliance with the federal regulations for child support guidelines. The formula for the statewide uniform guideline for determining child support is set forth under Fam C §4055.

There is no duty to support a grandchild. Fam C §3930. Payments from a trust to support a grandchild, however, may have consequences to the grandchild's parents. See chap 4. Because under California law the obligation to support a spouse and minor children is not affected by adequacy of the spouse's or the minor children's resources (see Fam C §§3900, 4300), the income of a trust used for support is includable in the income of the supporting spouse or parent, regardless of the settlor's or the trustee's identity. For example, if a grandfather establishes a trust for the support of his grandchildren, the income of the trust to the extent used for this support is taxed to the parents of the grandchildren during the grandchildren's minority. See Treas Reg §1.662(a)-4; *Agnes K. May* (1947) 8 TC 860, acq 1947-2 Cum Bull 3.

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§5.21 (2) Education Expenses

The California legislature, by reducing the age of majority from 21 to 18, seems to permit children to be sent to college safely with a trust created by their parents, based on the assumption that the parents have no obligation to provide a college education for their children or to support adult children. See Fam C §§150, 3901(a). Courts in other jurisdictions have from time to time cast doubt on this assumption based on their local law. See, *e.g.*, *Frederick C. Braun, Jr.,* TC Memo 1984-285.

In *Jones v Jones* (1986) 179 CA3d 1011, 1017, 225 CR 95, the California Court of Appeal ruled that "to the extent that an obligation devolves upon a parent to provide education to an *adult* child, it is limited to the completion of a high school education." *Christopher Stone,* TC Memo 1987-454 is also a decision under California law. Under former CC §196 (now Fam C §§3900-3902), parents have the responsibility to support and educate their *minor* child in the manner suitable to the child's circumstances, taking into consideration the respective earnings or earning capacities of the parents. The Tax Court cited CC §196 in its ruling that income from a trust that was used for private school expenses of the grantor's children (through high school) was taxable to the grantor. The facts in *Stone* do not conflict with the opinion in *Jones.* There appear to be no California cases in which a child or someone acting on his or her behalf has successfully sued a parent to pay for private school. Therefore, under current law, absent an obligation imposed by a contract, a property settlement agreement, or a court decree on dissolution of marriage to pay these expenses, parents seem not to have an obligation under California law to send their children to private school. However, the law is unclear. See Fam C §§150, 3900, 3901. Nevertheless, the situation can be improved by distributing trust funds directly to responsible children to do with as they wish.

CAVEAT: When trust funds are to be used for a child's education, the settlors (or the child's parents, if they are not the settlors) should not enter into any contracts or arrangements with the educational institution to pay tuition, fees, or other costs. Otherwise, the trust income will be taxable to the settlors under IRC §677 (see *Morrill v U.S.* (D Me 1964) 228 F Supp 734) or will be taxed to the parents under IRC §662, because the contract creates a legal obligation to pay these educational costs. See Treas Reg §1.662(a)-4.

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§5.22 (3) Support of Parents and Adult Children

The clients' pipe dream is a reality regarding the support of parents. Any amount that, under the terms of the trust instrument, is used to fully or partially satisfy a legal obligation of any person is included in that person's gross income. Treas Reg §1.662(a)-4. For tax purposes, however, "legal obligation" includes the obligation of support only if that obligation, as determined under applicable state law, is not affected by the adequacy of the dependent's own resources. Trusts for the support of parents and adult children should not have adverse income tax consequences to the settlors because, under California law, support is due to parents and adult children only if their own resources are inadequate. Fam C §§3910, 4400. If the settlors should move to another state, however, their duty of support might be enlarged by the laws of their new domicile. This problem is discussed in §5.23.

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§5.23 (4) Statutory Limits on Trustee's Powers to Discharge Support Obligations

Probate Code §16081 provides that a discretionary power conferred on a trustee must be exercised in a reasonable manner. See §9.63. California statutory law prevents exercise of a discretionary power to discharge the powerholder's legal obligations except as otherwise specifically provided in the trust instrument. Prob C §16082. To avoid any possible doubt and as a reminder to the trustee, a trust provision should specifically prohibit the trustee from discharging his or her obligation of support by making distributions from the trust.

If a trustee makes distributions that satisfy the obligation of support, the trustee will not be treated as having a general power of appointment over the trust corpus as discussed in §5.24. Such illegal distributions are ignored for estate tax purposes. See, *e.g., Estate of Harry Bloch, Jr.* (1982) 78 TC 850.

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§5.24 b. Estate Tax Principles

Retention of the right to have the principal of a trust applied to discharge a settlor's legal obligation is tantamount to retention of the right to "possession or enjoyment" of the property, as those terms are used in IRC §2036, and causes the property of the trust to be subject to estate tax. IRC §2036; Treas Reg §20.2036-1(b)(2).

A trustee who has the power to apply the principal of the trust to discharge his or her own legal obligations is considered to have a general power of appointment over the trust property. Treas Reg §20.2041-1(c). This power subjects the property of the trust to estate tax on the trustee's death. IRC §2041.

Several cases in the estate tax field have considered trusts containing support elements. The critical question in each case is whether the settlors have retained an enforceable right to have the trust property, either income or principal, applied to discharge their legal obligation of support. See, *e.g., Commissioner v Dwight's Estate* (2d Cir 1953) 205 F2d 298, cert denied (1953) 346 US 871; *Estate of Jack F. Chrysler* (1965) 44 TC 55, rev'd on other grounds (2d Cir 1966) 361 F2d 508; *Estate of William H. Lee* (1960) 33 TC 1064; *Estate of Stephen L. Richards,* TC Memo 1965-263, aff'd (10th Cir 1967) 375 F2d 997. As long as there are minor children, if the settlors have retained an enforceable right to have the trust property applied to discharge their legal obligation of support, estate taxes are incurred on each settlor's death, even though no trust property was in fact so applied before the settlor's death, and regardless of who acted as trustee. Therefore, an independent trustee's power to discharge the settlors' support obligations must be discretionary. See §5.27.

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§5.25 c. Gift Tax Principles

Payments made to discharge the legal obligation to support a dependent are not gifts to the extent of the legal obligation. *Crittenden Trust v U.S.* (ED Wis 1952) 52-2 USTC ¶10,870, 44 AFTR 1208. This rule applies both to minor children and to indigent parents. Inconsistency of the income and gift tax rules has other precedents in the law. See *Farid-Es-Sultaneh v Commissioner* (2d Cir 1947) 160 F2d 812.

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§5.26 d. Income Tax Principles

Although adverse estate tax consequences may result from the mere power to discharge a taxpayer's obligation of support, adverse income tax consequences occur only to the extent that the income of a trust is actually used for this purpose.

Trust income is not considered taxable to a settlor merely because that income may be applied or distributed for support or maintenance of a beneficiary (other than the settlor's spouse) whom a settlor is legally obligated to support, except to the extent that income is so applied or distributed. IRC §677(b). See §3.37. Similar rules apply when a person other than the settlor, in the capacity of trustee or cotrustee, has a power to apply trust income for the support of the trustee's dependents. IRC §678(c). See §9.53.

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§5.27 e. Independent Trustee's Discretionary Power to Discharge Support Obligation

Estate taxes are avoided if a third party merely has discretion to make payments that will discharge a settlor's support obligations. *Commissioner v Estate of Douglass* (3d Cir 1944) 143 F2d 961. When an independent trustee has the power to use trust funds or income to discharge the settlor's legal obligations, the drafter must ensure that this power is totally discretionary with the trustee and that there is no express or implied obligation that the trust will be so used. In *Estate of Joseph G. Gokey* (1979) 72 TC 721, an irrevocable trust provided that the trustee "shall" make distributions for the support, care, welfare, and education of the beneficiaries, who were the settlor's minor children. The court found:

- The trustee had a nondiscretionary obligation to use trust income to support the minor children; therefore, the trust assets were includable in the settlor's estate under IRC §2036.
- The phrase "support, care, welfare, and education" was an ascertainable standard under applicable state law, which could be enforced against the trustee.
- Other language in the trust indicating that payments were to be made in the manner the trustee considered to be in the beneficiaries' "best interest" did not make the trust discretionary, because that language pertained only to the manner of making payments, not to the obligation to make them.

For forms limiting the trustee's power to discharge a support obligations, see §§9.11, 9.27.

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§5.28 D. Flexibility Versus Control

Many clients desire flexibility in a trust to meet changing conditions, *e.g.,* family illness, family members' financial ability, or the beneficiaries' maturity. The clients' pipe dream is to retain control as well as flexibility. As indicated in §5.15, a settlor's power to designate new beneficiaries, to change the respective interests of existing beneficiaries, or to amend the trust causes adverse estate tax consequences. Thus, the clients' wish for complete flexibility can be realized only if they will trust a third person to exercise the powers that create the flexibility. Some clients will choose rigidity, rather than trust a third party. Income tax provisions frequently limit even the powers certain third parties may be given. See §5.17. Several of the options available under IRC §674 (see chap 9) often severely limit the degree of control the settlors may retain even indirectly by reason of certain relationships (*e.g.,* a brother or an employee of a controlled corporation). See IRC §672(c)(2). The settlors' lawyer, accountant, doctor, and partner are excluded from these prohibited categories with few exceptions, even though they often may be as amenable to the clients' wishes as the clients' siblings or employees.

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§5.29 E. Single Versus Multiple Trusts

When drafting a trust it often becomes necessary, at the outset or at a later time, to divide the trust property into separate portions or shares. The question then arises whether each share constitutes a portion of one trust or each constitutes a separate trust. When determining the proper way to proceed, the drafter should consider the factors discussed in §§5.30-5.31, among others.

For generation-skipping transfer (GST) tax purposes, if a separate trust is used to benefit each child and his or her issue, the result will be a taxable termination for the separate trust at that child's death. If one trust is used to benefit all children and their issue, and the trust does not establish separate and independent shares for each child, the imposition of the GST tax will be postponed because the taxable termination will not occur until the last child dies. The postponement, however, does not necessarily produce a tax benefit. See chap 4. Separate shares for different beneficiaries will be treated as separate trusts for GST tax purposes. IRC §2654(b).

A separate trust for each child and that child's issue will often be preferable when the trust probably will be distributed to the child. It is rarely desirable in those circumstances to allocate sufficient GST exemption to exempt a single large trust, but the attempt to exempt a smaller trust for a seriously ill child might be prudent. This can be done if that child's trust has been a separate trust for GST tax purposes at all times or is the result of a mandatory severance. Treas Reg §§26.2654-1(a)(1), 26.2654-1(a)(5), Example 8. See §4.20.

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§5.30 1. Considerations Favoring One Trust

With one trust, only one fiduciary income tax return need be filed, and accounting will be simplified. Trustees often charge a smaller fee to administer one trust divided into several shares than to administer several trusts. Sometimes, it may be wise not even to divide the trust into shares. Lack of division allows the trustee to apportion the income and principal based on each individual beneficiary's needs. This alternative cannot be used when a settlor acts as a trustee.

The compaction of trust income tax rates makes income tax considerations fairly academic. A single trust for a group of beneficiaries, one of whom has become dissolute, facilitates the distribution of all trust income to the other beneficiaries, avoiding the high trust tax bracket.

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§5.31 2. Considerations Favoring Multiple Trusts

The compaction of trust income tax rates makes accumulation of some income in a trust uneconomic, after considering the added administrative cost. Multiple trusts aid in family squabbles by limiting distributions to a particular beneficiary to his or her share of the family's wealth. In addition, the college expense of child *A* is not paid for in part by beautician child *B*. Multiple trusts inhibit clearing out trust income when the beneficiary is young or irresponsible. Moreover, separate trusts for each beneficiary permit the trustee to tailor investment policies to fit each beneficiary's needs.

Multiple trusts, or at least separate shares under the separate-share rule, may make it easier to avoid making distributions in ways that result in unfair income tax results. For example, when two beneficiaries of a single trust receive the same sum of money in two separate years, the first beneficiary may receive only ordinary income, while the second beneficiary may receive only tax-free funds. Use of separate trusts causes each beneficiary to be taxed on his or her own share of trust income, regardless of the year in which he or she receives distribution.

The separate-share rule achieves the same result, but in some matters is not quite as effective. See Treas Reg §1.663(c)-1. Both the creation of separate trusts and the separate-share rule destroy the flexibility of providing from a common fund for each of several beneficiaries, according to their respective needs. A settlor who wishes to act as trustee may not retain the power to allocate between several different beneficiaries. See §5.15. Thus, such a settlor must continue to choose separate trusts for each beneficiary with limited discretion in himself or herself as trustee. See §§9.25-9.30.

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6

Valuing Interests in Property

Belan K. Wagner
Paul E. Hoelschen, Jr.

I. INTRODUCTION TO VALUATION

A. Scope of Valuation Chapter §6.1

B. Trusts With Interests Requiring Valuation §6.2

C. Necessity for Valuing Interests §6.3

D. How to Value Interests

1. Use of IRS Valuation Tables §6.4

2. Locating Tables and Publications

a. List of Valuation Tables §6.5

b. IRS Publications Containing Valuation Tables §6.6

c. Requests for Actuarial Computation by IRS §6.7

3. Components of Valuation Tables §6.8

a. Interest Rates §6.9

b. Mortality Factor §6.10

4. Example of Valuation of Life Estate §6.11

5. Procedures for Transfers After November 30, 1983, and Before May 1, 1989 §6.12

6. Procedures for Transfers After April 30, 1989, and Before May 1, 1999 §6.13

7. Procedures for Transfers After April 30, 1999, and Before May 1, 2009 §6.13A

II. GUIDE TO CHAPTER SECTIONS DISCUSSING VALUATION OF SPECIFIC INTERESTS §6.14

III. SINGLE LIFE REMAINDER FACTORS (TABLE S)

A. Overview of Single Life Remainder Factors §6.15

B. Example of Computation of Present Value of Single Life Annuity, Income, and Remainder Interests §6.16

C. Annuities §6.17

D. Life Interests §6.18

E. Remainders or Reversionary Interests §6.19

F. Charitable Gifts §6.20

IV. TERM CERTAIN REMAINDER FACTORS (TABLE B)

A. Overview of Term Certain Remainder Factors §6.21

B. Example of Computation of Present Value of Annuity, Income, and Remainder Interests for Term Certain §6.22

C. Annuities §6.23

D. Income for Term Certain §6.24

E. Remainders or Reversionary Interests §6.25

F. Contingent Remainder Interests §6.26

G. Charitable Contribution Deductions §6.27

V. ADJUSTMENT FACTORS FOR ANNUITIES (TABLE K)

A. Overview of Annuity Adjustment Factors §6.28

B. Examples of Computations Using Table K Factors §6.29

VI. CHARITABLE REMAINDER UNITRUST SINGLE LIFE REMAINDER FACTORS—ADJUSTED PAYOUT RATES (TABLES U(1), F)

A. Overview of CRUT for Single Life §6.30

B. Example of Computation of Charitable Remainder Unitrust Interest—Single Life, Adjusted Payout §6.31

VII. CHARITABLE REMAINDER UNITRUST; TERM OF YEARS (TABLES D, F)

A. Overview of CRUT Remainder Factors for Term of Years §6.32

B. Example of Computation of Charitable Remainder Unitrust Interest Postponed for Term of Years; Adjusted Payout Rate §6.33

VIII. CHARITABLE REMAINDER UNITRUST; TWO MEASURING LIVES (TABLES U(2), F)

A. Overview of CRUT Remainder Factors for Two Measuring Lives §6.34

B. Example of Computation of Charitable Remainder Unitrust With Two Measuring Lives §6.35

IX. LIMITATIONS ON APPLICATION OF STANDARD VALUATION FACTORS

A. Limitations on Valuing High Yield Annuities, Unproductive Property, Inadequately Preserved Property, and Transfers to Trust in Cases of Terminal Illness §6.36

B. Example of Computation Involving Application of Limitations to Valuation of High Yield Annuity §6.37

X. SELECTING COMPUTER SOFTWARE PROGRAMS §6.38

A. Desirable Features of Estate Planning Software §6.39

B. Use of Electronic Spreadsheets §6.40

XI. SELECTED IRS VALUATION TABLES §6.41

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I. INTRODUCTION TO VALUATION

§6.1 A. Scope of Valuation Chapter

This chapter discusses the valuation of term and remainder interests in property created after April 30, 2009. In most cases these interests are valued by using Internal Revenue Service actuarial tables promulgated under IRC §7520. Older tables apply for transfers before May 1, 1989 (see §6.12), for transfers between April 30, 1989, and May 1, 1999 (see §6.13), and for transfers between April 30, 1999, and May 1, 2009 (see §6.13A). A transition rule applies if the valuation date of the transfer is after April 30, 2009, but before July 1, 2009, and a §7520 interest rate is selected for the months of May or June 2009. For these transfers, the value may be determined under either the current or former rules. Temp Treas Reg §§1.664-4T(e)(2)(ii), 20.2031-7T(d)(3)(ii), 25.2512-5T(d)(3). See §6.9. Because the IRS often has the right to redetermine gift tax valuations when computing the estate tax, older rules and tables continue to be relevant in audit situations.

This chapter also discusses special circumstances in which the standard actuarial tables may not apply. For illustrations of the special valuation methods, see §6.37.

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§6.2 B. Trusts With Interests Requiring Valuation

In planning a trust, the practitioner must determine not only the value of assets transferred to the trust but also the valuation of interests created by the trust. The trust may create a partial interest in property such as an annuity, a life estate, a term of years, a remainder, or a reversionary interest. These types of interests also may be created by will or deed of gift. The types of trusts that may involve such interests include the following:

- Grantor retained income trusts (GRITs), which give the grantor the right to receive whatever income the property produces for the shorter of the grantor's life or a stated term.
- Qualified personal residence trusts (QPRTs), which give the grantor the right to occupy and receive rent from the property for the shorter of the grantor's life or a stated term.
- Grantor retained annuity trusts (GRATs), which give the grantor the right to receive a fixed amount each year, regardless of how much income is actually produced, for a stated term.
- Grantor retained unitrusts (GRUTs), in which the grantor retains the right to receive a fixed percentage of the annually determined net fair market value of the trust assets for a stated term.
- Charitable lead annuity trusts (CLATs), in which a fixed amount is paid to charity for the life of an individual or for a term of years, with the remainder passing to noncharitable beneficiaries when the charity's interest expires.
- Charitable remainder annuity trusts (CRATs), which pay a noncharitable beneficiary a fixed annuity each year for the beneficiary's life or for a term of years not to exceed 20 years, with the remainder passing to the charitable beneficiaries when the noncharitable beneficiary's interest expires.
- Charitable remainder unitrusts (CRUTs), which pay a noncharitable beneficiary a fixed percentage of the annually determined net fair market value of the trust assets for the beneficiary's life or for a term of years not to exceed 20 years, with the remainder passing to the charitable beneficiaries when the noncharitable beneficiary's interest expires.

On grantor retained interest trusts (GRITs, GRATs, and GRUTs), see chaps 14-16. On QPRTs, see chap 17. On charitable remainder trusts, see chap 18. On charitable lead annuity trusts, see chap 18A.

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§6.3 C. Necessity for Valuing Interests

Creating or transferring partial property interests inevitably results in federal income, estate, and gift tax consequences. To calculate the tax effect of the partial property interest, a practitioner often must be able to determine its value. Some of the significant tax effects of transferring partial property interests in trust, which may require valuation of the interests, include the following:

- *Gift tax consequences of retained interest trusts.* Under former law, when a grantor transferred property to a trust but retained an income interest in the property, the value of the property for gift tax purposes was the value of the property transferred less the value of the retained interest. Under current special valuation rules, however, when a grantor transfers property in trust to (or for the benefit of) a family member, the value of any interest retained by the grantor is zero. IRC §2702(a)(2)(A). (Former law may still apply when a grantor transfers property in trust for the benefit of someone other than a family member. See chap 14.) The result is that the entire value of the transfer property is taxable as a gift, unless the property comes within one of the exceptions to the rule. In particular, when the retained interest is a "qualified interest," the special valuation rule does not apply. See IRC §2702(a)(2)(B). A qualified interest is the right to receive a fixed amount or a fixed percentage of the trust annually, such as in a GRAT or GRUT. IRC §2702(b)(1)-(2). See chaps 15-16. In addition, qualified personal residence trusts (QPRTs) are excluded from the zero valuation rule. IRC §2702(a)(3)(A)(ii). See chap 17. For discussion of the estate and gift tax consequences of the special valuation rules, see chap 2.

- *Estate tax consequences of retained interest trusts.* The value of some or all of the property held in a grantor retained interest trust (such as a GRIT, GRAT, or QPRT) may be included in the grantor's gross estate for federal tax purposes. The value of the property subject to inclusion depends on various factors. See IRC §§2033, 2036, 2038.

- *Gift tax consequences of charitable lead trusts*. A gift tax deduction is allowed for the value of the qualifying annuity interest in a charitable lead annuity trust (CLAT) when the gift is complete for gift tax purposes. IRC §2522. See chap 18A.

- *Estate tax consequences of charitable lead trusts*. Property in a charitable lead annuity trust (CLAT) typically is not includable in the grantor's estate. Accordingly, no estate tax charitable deduction is available. If, however, the CLAT is includable in the grantor's estate, estate tax deductions for the value of the remaining income interest passing to charity may be available. IRC §2055(e). See chap 18A.

- *Gift tax consequences of charitable remainder trusts.* The grantor of a charitable remainder trust (such as a CRAT or CRUT) is entitled to a charitable gift tax deduction for the value of the remainder interests given to the charity. IRC §2522(c). See chap 18.

- *Estate tax consequences of charitable remainder trusts.* The estate of a grantor of a charitable remainder trust is typically entitled to an estate tax deduction for the value of the remainder interest passing to the charity. IRC §2055(e). See chap 18.

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D. How to Value Interests

§6.4 1. Use of IRS Valuation Tables

To determine the tax effects of creating or transferring a partial interest in property, the practitioner must ascertain the fair market value of the interest, which is generally its present value as determined under IRC §7520. Temp Treas Reg §20.7520-1T(a)(1). To calculate the present value, the practitioner must determine the factor for the partial interest. These factors are contained in the actuarial tables promulgated by the IRS under IRC §7520. The factors in the tables are derived by using the appropriate §7520 interest rate (on calculation of interest rates, see §6.9) and either the mortality component for the valuation date of the interest being valued or the term of years, as applicable. Temp Treas Reg §§20.2031-7T(d), 25.2512-5T(d). The interest rate together with the mortality rate and term of years are the three components of the valuation tables. See §§6.8-6.10. The different tables available are listed in §6.5.

The factors for partial interests in property are expressed as decimal fractions. Generally, the fraction represents the ratio of the partial interest in the property to the entire interest.

EXAMPLE: *A* places $100,000 in a trust that is to pay income to *B* for life and the remainder to *C*. The factor for *B*'s income interest might be 0.60, and the factor for *C*'s remainder might be 0.40. In that situation, *A* has made a gift of $60,000 to *B* and $40,000 to *C*.

The IRS valuation tables must be used to determine the present value of annuities, life estates, term interests, and remainder or reversionary interests except for transfers involving high yield annuities, unproductive property, or a donee who is terminally ill. See §6.36.

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Source: Estate Planning/Drafting California Irrevocable Trusts/6 Valuing Interests in Property/ 2. Locating Tables and Publications/§6.5 a. List of Valuation Tables

2. Locating Tables and Publications

§6.5 a. List of Valuation Tables

The valuation tables are set forth in several places in IRS materials. Some tables are in Treas Reg §20.2031-7(d), and some are in Treas Reg §1.664-4(e). Certain tables are available only in IRS publications. For transfers in trust that occur after April 30, 2009, tables that must be used to value annuities, unitrust interests, life estates, terms of years, remainders, and reversionary interests when the interest rate components are between 4.2 and 14 percent are set forth in Temp Treas Reg §20.2031-7T(d). Tables for valuing a remainder interest, either for a term certain or for a single life, in a CRUT when the interest rate components are between 4.2 and 14 percent are set forth in Temp Treas Reg §1.664-4T(e). See TD 9448, 2009-20 Int Rev Bull 942. Tables that must be used when the interest rate components are below 4.2 percent or above 14 percent are generally available only in IRS publications that contain factors for interest rates starting at 0.2 percent and rising to 20 percent, although supplemental valuation tables for interest rates up to 2.0 percent are also contained in Notice 2009-18, 2009-10 Int Rev Bull 648. The examples in this chapter refer to these tables. However, the examples in chaps 14-18 were calculated using a computer software program, as virtually all valuation calculations are made in practice. See §6.38.

The tables apply to valuation of interests in property under several Internal Revenue Code sections, including IRC §§170 (charitable contributions and gifts), 642 (special rules for credits and deductions), 664 (charitable remainder trusts), 2031 (value of gross estate), 2055 (transfers for public, charitable, and religious uses), 2512 (valuation of gifts), 2522 (charitable gifts), and 2624 (valuation of generation-skipping transfers).

The following are the IRS valuation tables:

- *Table B: Term Certain Remainder Factors.* This table contains actuarial factors for valuing an annuity, an income interest, or a remainder interest for a term certain. Treas Reg §20.2031-7(d)(6).

- *Table J: Adjustment Factors for Term Certain Annuities Payable at the Beginning of Each Interval.* This table contains term certain annuity interval adjustment factors used in determining the present value of annuities, life estates, remainders, and reversions. Treas Reg §20.2031-7(d)(6).

- *Table K: Adjustment Factors for Annuities Payable at the End of Each Interval.* This table contains adjustment factors based on the timing and frequency of payments for annuities payable at the end of each interval. It is used to determine the present value of annuities, life estates, remainders, and reversions. Treas Reg §20.2031-7(d)(6).

- *Table S (Based on Life Table 2000CM): Single Life Remainder Factors Applicable After April 30, 2009.* This table includes single life factors for calculating the present value of annuities, life estates, remainders, and reversions. Temp Treas Reg §20.2031-7T(d)(7).

- *Table 2000CM (Applicable After April 30, 2009).* This table is a mortality table based on the 2000 census used to determine the present value of annuities, life estates, remainders, and reversions. Temp Treas Reg §20.2031-7T(d)(7). See §6.10. Various factors in the other tables are based on this mortality data. Tables B, J, K, and D, which are not based on mortality experience, are not changed by the adoption of Table 2000CM.

- *Table D: Term Certain Remainder Factors.* This table is used to ascertain the present value of a remainder interest postponed for a term of years in a unitrust payable for a term certain. Treas Reg §1.664-4(e)(6). For interest rates below 4.2 percent, see IRS Pub 1458.

- *Tables F: Payout Factors.* Tables F (4.2-14.0) are designed to compute the adjusted payout rate for CRUT valuations based on interest rates from 4.2 percent to 14 percent. Treas Reg §1.664-4(e)(6). Additional Tables F are provided in IRS Pub 1458.

- *Table U(1): Unitrust Single Life Remainder Factors.* This table is used to calculate the present value of a remainder interest in a CRUT for one life. Temp Treas Reg §1.664-4T(e)(7). For interest rates below 4.2 percent, see IRS Pub 1458.

- *Table R(2): Factors for Determining the Present Worth of an Annuity, a Life Estate, or a Remainder Interest Payable at the Death of the Last To Die of Two Persons.* This table is used to calculate the present value of a remainder interest in a CRUT for two lives and also contains factors applicable to valuing a remainder interest in property transferred to a pooled income fund. IRS Pub 1457.

- *Table H: Commutation Table.* This table is based on interest rates from 0.2 percent to 20 percent. IRS Pub 1457.
- *Table U(2): Factors for Determining the Present Worth of a Remainder Interest in a Unitrust That Terminates at the Death of the Last To Die of Two Persons.* This table applies only when the payout percentage during the joint lives is the same as that during the life of the survivor. IRS Pub 1458.
- *Table C: Commutation Factors for Reducing Assurances.* This table is used for valuing remainder interests in depreciable property, based on interest rates from 0.2 percent to 20 percent. IRS Pub 1459.

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§6.6 b. IRS Publications Containing Valuation Tables

Most of the IRS valuation tables necessary for valuing partial property interests in trust are set forth in the regulations. See §6.5. All the tables, however, are also set forth in three IRS publications available at no charge electronically on the IRS website at http://www.irs.gov. For links to the tables, type in the IRS website address and the following: /retirement/article/0,,id=206601,00.html. Some tables can be found only in these publications, which include (see Temp Treas Reg §1.7520-1T(c)(2)):

- IRS Pub 1457, Actuarial Valuations Version 3A (2009), which supplements Temp Treas Reg §20.2031-7T. This publication includes Tables S, R(2), B, K, H, and 2000CM. The publication also includes standard actuarial factors not covered in the tables and explains how to compute factors for unusual situations.

- IRS Pub 1458, Actuarial Valuations Version 3B (2009), which contains unitrust remainder factors for one and two lives and terms certain for the same range of payout rates. This publication contains Tables U(1), U(2), D, and F.

- IRS Pub 1459, Actuarial Valuations Version 3C (2009), which contains depreciation adjustment factors for valuing gifts of real property. This publication contains Table C.

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§6.7 c. Requests for Actuarial Computation by IRS

A client who requires a special factor for valuing a property interest may ask the IRS for a ruling containing the needed actuarial computation. The request must be accompanied by an account of the facts (including a statement of the date of birth for each measuring life, the date of the gift, and any other applicable dates) and a copy of the trust and other relevant documents. The request must comply with the instructions for requesting a ruling, which are published periodically in the Internal Revenue Bulletin, and include payment of the required user fee. Temp Treas Reg §20.2031-7T(d)(4).

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§6.8 3. Components of Valuation Tables

The valuation tables consist of two major components:

- The rate at which income is considered to be earned on the property; and either
- The life expectancy of individuals whose lives are used to measure the term of the property interest; or
- The term of years during which payments are to be made.

Valuations made under IRC §7520 thus include an interest rate component and a mortality or actuarial component. Both of these refer to the date of transfer of the property or date of valuation.

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§6.9 a. Interest Rates

The IRS valuation tables contain factors to be used for valuing transfers of interests in property based on several different interest rates. According to the IRS, property produces income at a rate determined at the time of the transfers, and the rate remains constant over the term of the particular interest. If an interest in property (*e.g.*, a residence or a rare coin collection) produces no income, the IRS nevertheless equates the value of its annual use value to income at the specified interest rate.

The interest rate for a particular month is 120 percent of the federal midterm rate, compounded annually, in effect under IRC §1274(d)(1) for the month in which the valuation date falls, rounded to the nearest two-tenths of 1 percent. IRC §7520(a). The IRS announces the federal midterm rate for each month in a news release about 1 week before the first day of the month in which the rate is effective and also provides the applicable IRC §7520 rate for the month.

If an income, an estate, or a gift tax charitable contribution deduction is allowed for any part of property transferred, the taxpayer may elect to use either (1) the federal midterm rate for the month of the transfer or (2) the federal midterm rate for either of the 2 months preceding the month in which the valuation date falls. The taxpayer must, however, use the same rate for both the income and the remainder interests. IRC §7520(a). If a charitable contribution deduction is not allowed, the interest rate that must be used is the rate for the month of the transfer. IRC §7520(a).

The following chart illustrates the interest rates for a gift made in trust, with valuation months of January, February, and March 2010:

IRC §7520 Interest Rate		
	120% of federal rate midterm	
Valuation month	*Compounded annually*	*Rounded*
Jan. 2010	2.95%	3.0%
Feb. 2010	3.39%	3.4%
Mar. 2010	3.23%	3.2%

Two examples illustrate how the interest factor is determined for a transfer during one of these months:

- *D* transfers property to a CRAT on March 1, 2010. To determine the present value of the charitable gift, *D* may use the interest rates for January, February, or March 2010: 3.0, 3.2, or 3.4 percent.
- *D* transfers property to a 10-year GRIT on March 1, 2010. The interest rate to use for computing the present value of the remainder interest is 3.2 percent.

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§6.10 b. Mortality Factor

For valuing transfers of interests made after April 30, 2009, the IRS uses a mortality table based on the 2000 census known as Table 2000CM, contained in Temp Treas Reg §20.2031-7T(d)(7). For purposes of computations using the valuation tables, a person's age is rounded to his or her nearest birthday, *not* his or her attained age.

A mortality table permits life expectancies to be calculated. It assumes the birth of a specified number of individuals and then lists how many of those individuals are expected to be living at the start of each succeeding year. Table 2000CM assumes that about 50,000 of every 100,000 babies born will attain age 80. The table makes the same assumptions for men and women and assumes that no one lives past age 110.

If more than one life is involved in valuing the interest (*i.e.,* if the valuation depends either on the continuation or termination of more than one life or on a term certain concurrent with one or more lives), a special factor must be used. This factor is computed on the basis of an interest rate determined as explained in §6.9. Life contingencies must be determined for each person involved from the values of Table 2000CM. See §6.34.

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§6.11 4. Example of Valuation of Life Estate

As an illustration of how the value of a partial property interest is determined, the following steps are required to calculate the appropriate value of a life estate (the same steps would be used to value a term of years or remainder interest):

- Determine the federal midterm rate for the month when the transfer occurs. See §6.9.
- Calculate 120 percent of the federal midterm rate and round to the nearest 0.2 percent (midway rates are rounded up) by reference to the appropriate IRS announcement.
- Locate the appropriate age column in the appropriate interest rate table to arrive at the factor needed to value the interest being transferred. The factor is based on the IRC §7520 interest rate and, with respect to life estates or annuities for life, the age of the annuitant or beneficiary. If the interest is for a fixed term of years, the valuation factor is based on the actual term.

The value of a particular life estate should be calculated as follows:

EXAMPLE: *M* was born on October 1, 1932. A transfer to a trust creating a life estate for *M* occurred on March 15, 2010. The value of assets transferred to the trust as of the date of the transfer was $100,000. To calculate the value of *M*'s life estate:

- Determine 120 percent of the federal midterm rate for March 2010 compounded annually (3.23 percent) and round to the nearest 0.2 percent (3.2 percent).
- Go to Table S in IRS Pub 1457 and select the table for 3.2 percent. Determine *M*'s age as of her nearest birthday (even though *M* was 77 years, 5 months, and 14 days old, *M*'s age is considered to be 77 for these purposes). Determine the factor for a life estate, which is equal to 1 less the remainder factor (1 – 0.74382 = 0.25618).
- Multiply the fair market value of assets transferred to the trust by the factor ($100,000 × 0.25618). The actuarial value of *M*'s life estate on March 15, 2010, is $25,618. The value of the remainder interest is $74,382.

Valuation of life estates is explained in more detail in §6.18.

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§6.12 5. Procedures for Transfers After November 30, 1983, and Before May 1, 1989

For transfers made after November 30, 1983, and before May 1, 1989, the fair market value of annuities, unitrust interests, life estates, terms of years, remainders, and reversions for federal estate and gift tax purposes is the present value determined by methods described in Treas Reg §§20.2031-7A(d) and 25.2512-5A(d). The fair market value of a remainder interest in a CRUT is its present value determined by methods described under Treas Reg §1.664-4A(d). The fair market value of a life interest or term of years in a CRUT is the fair market value of the property as of the date of valuation less the fair market value of the remainder interest on that date. The fair market value of interests in a pooled income fund (see Treas Reg §1.642(c)-5) is the value of the interests as determined under Treas Reg §1.642(c)-6A(d). For transfers made after November 30, 1983, and before May 1, 1989, the IRS uses a mortality table set forth in Treas Reg §20.2031-7A(d)(6).

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§6.13 6. Procedures for Transfers After April 30, 1989, and Before May 1, 1999

For transfers made after April 30, 1989, and before May 1, 1999, the fair market value of annuities, unitrust interests, life estates, terms of years, remainders, and reversions for federal estate and gift tax purposes is the present value determined by methods described in Treas Reg §§20.2031-7A(e) and 25.2512-5A(e). The fair market value of a remainder interest in a CRUT is its present value determined by methods described under Treas Reg §1.664-4A(e). The fair market value of a life interest or term of years in a CRUT is the fair market value of the property as of the date of valuation less the fair market value of the remainder interest on that date. The fair market value of interests in a pooled income fund (see Treas Reg §1.642(c)-5) is the value of the interests as determined under Treas Reg §1.642(c)-6A(e). For valuing transfers of interests made after April 30, 1989, and before May 1, 1999, the IRS uses a mortality table based on the 1980 census known as Table 80CNSMT, contained in Treas Reg §20.2031-7A(e)(4).

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§6.13A 7. Procedures for Transfers After April 30, 1999, and Before May 1, 2009

For transfers made after April 30, 1999, and before May 1, 2009 (and charitable transfers made after April 30, 2009, using interest rates from March or April 2009), the fair market value of annuities, unitrust interests, life estates, terms of years, remainders, and reversions for federal estate and gift tax purposes is the present value determined by methods described in Treas Reg §§20.2031-7A(f) and 25.2512-5A(f). The fair market value of a remainder interest in a CRUT is its present value determined by methods described under Treas Reg §1.664-4A(f). The fair market value of a life interest or term of years in a CRUT is the fair market value of the property as of the date of valuation less the fair market value of the remainder interest on that date. The fair market value of interests in a pooled income fund (see Treas Reg §1.642(c)-5) is the value of the interests as determined under Treas Reg §1.642(c)-6A(f). For valuing transfers of interests made after April 30, 1999, and before May 1, 2009, the IRS uses a mortality table based on the 1990 census known as Table 90CM, contained in Treas Reg §20.2031-7A(f)(4).

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§6.14 II. GUIDE TO CHAPTER SECTIONS DISCUSSING VALUATION OF SPECIFIC INTERESTS

The following outline will guide the practitioner to appropriate sections of this chapter for the valuation of transfers:

Type of transfer	*Sections*
Annuity for Life and Remainder	
Paid annually at end of year	6.15-6.17
Paid semiannually, quarterly, monthly, or weekly	6.28-6.29
Remainder	6.19
Annuity for Term Certain and Remainder	
Paid annually at end of year	6.21-6.23
Paid semiannually, quarterly, monthly, or weekly	6.28-6.29
Remainder	6.25
Income for Term Certain and Remainder	
Income	6.21, 6.24
Remainder	6.25
Life Estate and Remainder (Single Life)	
Life Estate	6.18
Remainder	6.19
Charitable Gifts (Examples)	
Charitable Lead Annuity Trust	
Single Life	6.37
Term Certain	6.27
Charitable Remainder Annuity Trust	
Single Life	6.20
Term Certain	6.28-6.29
Charitable Remainder Unitrust	
Single Life	6.30-6.31
Two Lives	6.34-6.35
Term Certain	6.32-6.33
Remainder Gift of Residence or Farm	6.20

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III. SINGLE LIFE REMAINDER FACTORS (TABLE S)

§6.15 A. Overview of Single Life Remainder Factors

Table S, based on Life Table 2000CM, provides factors for determining the present value of a remainder interest based on a single life for transfers after April 30, 1999. The table is set forth in Temp Treas Reg §20.2031-7T(d)(7), for interest rates between 4.2 and 14 percent, and IRS Pub 1457. For transfers after April 30, 1999, and before May 1, 2009, Table S, based on Life Table 90CM, is used. Treas Reg §20.2031-7A(f)(4). See §6.13A. For transfers after April 30, 1989, and before May 1, 1999, Table S, based on Life Table 80CNSMT, is used. Treas Reg §20.2031-7A(e)(4). See §6.13. For transfers after November 30, 1983, and before May 1, 1989, Table A is used rather than Table S. Treas Reg §20.2031-7A(d)(6). See §6.12.

Any remainder factor contained in Table S may be converted to a factor for determining the present value of an income interest (*e.g.*, a life estate) or an annuity interest. The income factor is 1 less the remainder factor. The annuity factor is the income factor divided by the interest rate. Temp Treas Reg §20.2031-7T(d)(2)(iii)-(iv).

The remainder factors in Table S also apply in calculating the present value of the remainder interest in property transferred to a pooled income fund. Temp Treas Reg §1.642(c)-6T(e)(5).

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§6.16 B. Example of Computation of Present Value of Single Life Annuity, Income, and Remainder Interests

The computation of the present value of a single life annuity or income interest and a remainder interest is illustrated below.

EXAMPLE: In March 2010, *D* transfers in trust to *B* a gift of income (or an annuity) for life. *B* is 65 years and 4 months old at the time of the gift. For purposes of computation, age 65 (*B*'s age on her nearest birthday) is used. To compute the present value of a single life annuity, income, or remainder interest, the practitioner must first determine the applicable IRC §7520 interest rate, as described in §6.9. The interest rate to be used for a transfer in March 2010 is 3.2 percent. If, however, an income, an estate, or a gift tax charitable contribution deduction is allowed for any part of the property transferred, *D* may use the applicable §7520 interest rates for either of the 2 preceding months. The following values are then computed based on Table S in Temp Treas Reg §20.2031-7T(d)(7):

Single Life Remainder Factors Based on IRS Table S					
Month	*Interest Rate*	(1) *Age*	(2) *Annuity*	(3) *Life Interest*	(4) *Remainder*
Jan. 2010	3.0%	65	12.9433	0.38830	0.61170
Feb. 2010	3.4%	65	12.4597	0.42363	0.57637
Mar. 2010	3.2%	65	12.6978	0.40633	0.59367

(1) The age of the individual used as the measuring life.

(2) The annuity factor equals the life interest factor divided by the interest rate.

(3) The life interest factor equals 1 less the remainder factor.

(4) The remainder factor is found in Table S for the appropriate interest rate and age.

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§6.17 C. Annuities

To calculate the value of an annuity payable at the end of each year during the life of an individual (*e.g.*, the first payment is due 1 year after a decedent's death or transfer to trust), the amount payable is multiplied by the annuity factor for the age of the individual whose life measures the duration of the annuity at the applicable IRC §7520 interest rate. Temp Treas Reg §20.2031-7T(d)(2)(iv).

EXAMPLE: *D* creates a GRAT and retains an annuity of $100,000 payable beginning 1 year from the creation of the trust during his lifetime. *D*'s age is 64 years and 8 months. If the date of the transfer to the trust is March 1, 2010, the interest rate is 3.2 percent. Referring to the chart in §6.16, the annuity factor for age 65 at 3.2 percent is 12.6978. Therefore, the value of the retained interest is $1,269,780 ($100,000 × 12.6978), and the value of the gift is the fair market value of the assets transferred less $1,269,780.

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§6.18 D. Life Interests

To calculate the value of an interest that consists of the right of a person, either for his or her life or for the life of another person, to receive the income of specific property or to use non-income-producing property, the value of the property is multiplied by the life interest factor for the age of the measuring life at the applicable IRC §7520 interest rate. Temp Treas Reg §20.2031-7T(d)(2)(iii).

EXAMPLE: Under the terms of a trust, *D* is entitled to receive for life the income from trust property with a current fair market value of $1 million. At age 65, *D* makes a gift of the interest on March 15, 2010. The applicable interest rate is 3.2 percent. In the chart in §6.16, the life interest factor for age 65 at 3.2 percent is 0.40633. The value of the income interest gift is $406,330 ($1 million × 0.40633).

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§6.19 E. Remainders or Reversionary Interests

The value of a remainder or reversionary interest subject to a life estate is determined by multiplying the value of the property on the date of its transfer to the trust by the remainder factor for the age of the life tenant at the applicable interest rate. Temp Treas Reg §20.2031-7T(d)(2)(ii).

EXAMPLE 1: *D* transfers by gift a remainder interest in property worth $500,000, subject to *E*'s right to receive the income for life. The date of the gift was March 10, 2010. The applicable interest rate is 3.2 percent. *E* is age 65 on the date of the gift. In the chart in §6.16, the remainder factor for age 65 at 3.2 percent is 0.59367. Therefore, the value of the gift is $269,835 ($500,000 × 0.59367).

The value of the remainder following an annuity interest is the value of the property transferred less the value of the annuity interest. Temp Treas Reg §20.2031-7T(d)(2)(iv).

EXAMPLE 2: *D* transfers $500,000 to a trust in March 2010 to pay a 5-percent annuity ($25,000) to *B* annually for life, with the remainder to be distributed to *R*. *B* is age 65 at the time of the transfer. The first payment is due at the end of the first trust year. The applicable interest rate is 3.2 percent. In the chart in §6.16, the annuity factor for age 65 at 3.2 percent is 12.6978. The value of the gift to *B* is $317,445 ($25,000 × 12.6978). Therefore, the value of the remainder interest given to *R* is $182,555 ($500,000 – $317,445).

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§6.20 F. Charitable Gifts

Table S in IRS Pub 1457 is also used to value gifts of interests in property to charity. A donor has the option, however, to use the Table S factors determined with respect to the interest rate at the time of the gift or for the 2 preceding months. IRC §7520(a). Three examples illustrate the use of the optional interest rate to maximize the charitable gift tax deduction:

EXAMPLE 1: *D* is age 65 on March 1, 2010, when $1 million is transferred to a CRAT. *D* is to receive an annuity of $50,000 for life, payable annually at the end of each year for life. *D* will have the option of using an interest rate of 3.0, 3.2, or 3.4 percent for purposes of computing the charitable contribution deduction:

- Using the 3.0-percent interest rate, the value of the annuity interest is $647,165 ($50,000 × 12.9433 (see chart in §6.16)), and the charitable remainder gift is $352,835 ($1 million – $647,165).
- Using the 3.2-percent interest rate, the value of the annuity interest is $634,890 ($50,000 × 12.6978 (see chart in §6.16)), and the charitable remainder gift is $365,110 ($1 million – $634,890).
- Using the 3.4-percent interest rate, the value of the annuity interest is $622,985 ($50,000 × 12.4597 (see chart in §6.16)), and the charitable remainder gift is $377,015 ($1 million – $622,985).

To obtain the largest charitable contribution deduction for the gift of the remainder interest to charity, the 3.4-percent interest rate should be used.

EXAMPLE 2: Assume that the facts of Example 1 remain the same except that the interest rates are 5 and 10 percent:

- With an interest rate of 5 percent, the remainder factor is 0.46037, the life interest factor is 0.53963 (1 – 0.46037), and the annuity factor is 10.7926 (0.53963 ¸ 0.05). Thus, the value of the annuity interest is $539,630 ($50,000 × 10.7926), and the charitable remainder gift is $460,370 ($1 million – $539,630).
- With an interest rate of 10 percent, the remainder factor is 0.25777, the life interest factor is 0.74223 (1 – 0.25777), and the annuity factor is 7.4223 (0.74223 ¸ 0.10). Thus, the value of the annuity interest is $371,115 ($50,000 × 7.4223), and the charitable remainder gift is $628,885 ($1 million – $371,115).

EXAMPLE 3: If a 65-year-old donor gave the remainder interest in a residence, with a current fair market value of $800,000, to charity in March 2010, the donor would have a choice of interest rates of 3.0, 3.2, or 3.4 percent to determine the value of the remainder interest for charitable gift tax purposes. See chart in §6.16. If the 3.0-percent interest rate is chosen, the value of the remainder interest is $489,360 ($800,000 × 0.61170). If the 3.2-percent interest rate is chosen, the value of the remainder interest is $474,936 ($800,000 × 0.59367). If the 3.4-percent interest rate is chosen, the value of the gift is $461,096 ($800,000 × 0.57637). To obtain the largest charitable contribution deduction, the 3.0-percent interest rate should be used.

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IV. TERM CERTAIN REMAINDER FACTORS (TABLE B)

§6.21 A. Overview of Term Certain Remainder Factors

Table B in Treas Reg §20.2031-7(d)(6), for interest rates between 4.2 and 14 percent, and IRS Pub 1457 applies to transfers made after April 30, 1989, and to the estates of decedents who die after that date. This table provides factors for determining the present value of a remainder interest following a term certain. A remainder factor may be converted to factors for determining the present value of both an income interest and an annuity interest postponed for a term of years. The factor for a term certain is equal to 1 less the remainder factor. The annuity factor is equal to the term certain factor divided by the applicable interest rate. See Treas Reg §20.2031-7(d)(2)(iii)-(iv).

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Source: Estate Planning/Drafting California Irrevocable Trusts/6 Valuing Interests in Property/§6.22 B. Example of Computation of Present Value of Annuity, Income, and Remainder Interests for Term Certain

§6.22 B. Example of Computation of Present Value of Annuity, Income, and Remainder Interests for Term Certain

The following examples illustrate the computation of the present value of an annuity, an income, and a remainder interest for a term certain:

EXAMPLE: *D* makes a gift in trust to *B* and *B*'s descendants for 10 years in March 2010. To compute the present value of an annuity, an income, or a remainder interest for a term certain, the practitioner must first determine the applicable IRC §7520 interest rate. Temp Treas Reg §20.2031-7T(d)(1). The interest rate to be used for a transfer in March 2010 is 3.2 percent. If an income, estate, or gift tax charitable contribution deduction is allowed for any part of the property transferred, *D* may use the applicable §7520 interest rates for the month of the transfer or the 2 preceding months. See chart in §6.9. The following values are then computed, based on Table B in IRS Pub 1457:

Term Certain Remainder Factors Based on IRS Table B					
Month	*Interest Rate*	(1) *Term of Years*	(2) *Annuity Factor*	(3) *Term Interest Factor*	(4) *Remainder Factor*
Jan. 2010	3.0%	10	8.5302	0.255906	0.744094
Feb. 2010	3.4%	10	8.3587	0.284195	0.715805
Mar. 2010	3.2%	10	8.4438	0.270201	0.729799

(1) The number of years of the term certain.

(2) The annuity factor equals the term interest factor divided by the interest rate.

(3) The term interest factor equals 1 less the remainder factor.

(4) The remainder factor is found in Table B for the appropriate interest rate and number of years.

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§6.23 C. Annuities

To compute the value of an annuity payable annually at the end of each year for a definite number of years, the amount payable annually is multiplied by the annuity factor and the applicable interest rate. Temp Treas Reg §20.2031-7T(d)(2)(iii).

EXAMPLE: On March 15, 2010, corporation *A* is given an annuity in the amount of $100,000 a year, payable annually for a term of 10 years. The interest rate for March 2010 is 3.2 percent. In the chart in §6.22, the annuity factor for a term certain of 10 years at 3.2 percent is 8.4438. The present value of the annuity interest is $844,380 ($100,000 × 8.4438).

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§6.24 D. Income for Term Certain

If the interest to be valued is the right to receive income from property or to use non-income-producing property for a term of years, the value of the interest is calculated by locating the applicable interest rate (see §6.9) and then referring to Table B in IRS Pub 1457.

EXAMPLE: Corporation *B* is to receive the income from a fund of $500,000 for 10 years, beginning in March 2010. The interest rate to be used for a gift in March 2010 is 3.2 percent. In the chart in §6.22, the term interest factor for a term certain of 10 years at 3.2 percent is 0.270201. The present value of the income interest given to *B* is $135,101 ($500,000 × 0.270201).

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§6.25 E. Remainders or Reversionary Interests

To determine the value of a remainder or reversion that is to take effect at the end of a term of years, the value of the property is multiplied by the remainder factor for the term and the applicable interest rate. See Temp Treas Reg §20.2031-7T(d)(2)(ii).

EXAMPLE: Corporation *A* transfers $1 million to a GRIT for 10 years in March 2010. At the end of the 10-year period, the property is to be distributed to *B*. The applicable interest rate for a gift in March 2010 is 3.2 percent. In the chart in §6.22, the remainder factor for a term certain of 10 years at 3.2 percent is 0.729799. The present value of the remainder interest in the property is $729,799 ($1 million × 0.729799).

Internal Revenue Code §2702 contains special valuation rules for transfers in trust with an interest retained by a "member of the family" unless specific exceptions apply. A "member of the family" includes the grantor's spouse, any ancestor or lineal descendant of the grantor or the grantor's spouse, a sibling of the grantor, or the spouse of any of those persons. IRC §§2701(e)(2), 2704(c)(2). Generally, unless a specific exception applies, the value of the retained interest in an intra-family transaction is zero (the "zero-value rate"). IRC §2702(a)(2). See §§2.30-2.31, 6.3.

The special valuation rules do not apply, however, when the grantor transfers a personal residence to a GRIT known as a qualified personal residence trust (QPRT) having as remainder beneficiaries lineal descendants or other members of the grantor's family. See chap 17 on QPRTs. The special valuation rules of IRC §2702 also do not apply if the grantor retains a qualified unitrust interest or guaranteed annuity interest in a GRUT (see chap 16) or GRAT (see chap 15) meeting the requirements of three specific exceptions under §2702. See IRC §2702(a)(2)(B), (a)(3), (b). If, however, the remainder beneficiary is the grantor's child and the grantor transfers cash or property other than a personal residence, the value of the gift under IRC §2702 is equal to the value of the cash or property because the interest retained by the grantor would not be a unitrust interest or a guaranteed annuity interest, and its value would therefore be zero. IRC §2702(a)(2)(A). See chap 14 on GRITs.

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§6.26 F. Contingent Remainder Interests

In some cases, the remainder interest may be contingent on the survival of the grantor for the duration of the term interest. This is true, for instance, for statutory qualified personal residence trusts (QPRTs) under IRC §2702. See chap 17. In such cases, the value of the remainder interest is reduced by the possibility of reversion to the grantor before the end of the term.

EXAMPLE 1: On March 10, 2010, *A*, age 50, transfers $1 million to a trust, retaining the right to receive all trust income. The trust is to terminate on the expiration of 5 years or on *A*'s earlier death. If *A* survives, the corpus is payable to *A*'s child, *C,* on termination of the trust. If *A* does not survive, the corpus is payable to *A*'s estate. Based on Table 2000CM, the probability of survival to age 50 is 0.93591 and the probability of survival to age 55 is 0.91211. Thus, the probability of the grantor's surviving the term of the trust is 0.97457 (0.91211 ¸ 0.93591). The remainder factor for a term certain of 5 years at 3.2 percent (the interest rate for March 2010) is 0.854283. Thus, the remainder factor contingent on the survival of the grantor is 0.832559 (0.854283 × 0.97457). The value of the remainder interest in the trust is $832,559 ($1 million × 0.832559).

If the interest to be valued is the remainder following an annuity for a term certain, the value of the remainder is the value of the property transferred less the value of the annuity interest. See Temp Treas Reg §20.2031-7T(d)(2)(iv). Because the interest valued in the calculation below is a term certain remainder, the result is unaffected by the change to Table 2000CM from Table 90CM applicable to transfers before May 1, 2009. See §6.13A.

EXAMPLE 2: *D* places $1 million in a 5-percent annuity trust for the benefit of *B* for 10 years on March 15, 2010. The remainder is to be paid to *R*. The amount of the annuity is $50,000 (5 percent × $1 million). The interest rate for a gift in March 2010 is 3.2 percent. The annuity factor for a term certain of 10 years at 3.2 percent is 8.4438. See chart in §6.22. The value of the annuity interest is $422,190 ($50,000 × 8.4438). Thus, the present value of the gift to *R* is $577,810 ($1 million – $422,190).

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§6.27 G. Charitable Contribution Deductions

If any interest in the property transferred for a term certain qualifies for a charitable contribution deduction for tax purposes, the interest rate chosen to value the gift may be the applicable interest rate for the month of the gift or either of the 2 months preceding the gift. IRC §7520(a).

This rule is illustrated in two examples involving a CLAT:

EXAMPLE 1: *D* transfers property valued at $1 million to a 10-percent CLAT on March 1, 2010. Under the terms of the trust, $100,000 per year (10 percent of $1 million) is to be paid annually, at the end of each year, to charity *B,* for 10 years. After that time, the property is to be distributed to *R*. Because a charitable contribution deduction will be taken for the charitable gift, *D* may use either the interest rate applicable to March 2010 gifts or the rates applicable to the 2 previous months, January or February 2010. Thus, *D* may choose an interest rate of 3.0, 3.2, or 3.4 percent. Table B in IRS Pub 1457 is used to determine the remainder factor (see chart in §6.22):

- If *D* chooses the January interest rate of 3.0 percent, the annuity factor is 8.5302, and the present value of the deduction is $853,020 ($100,000 × 8.5302). The value of the gift of the remainder to *R* is $146,980 ($1 million – $853,020).
- If *D* chooses the February interest rate of 3.4 percent, the annuity factor is 8.3587, and the value of the charitable annuity interest is $835,870 ($100,000 × 8.3587). The value of the gift of the remainder to *R* is $164,130 ($1 million – $835,870).
- If *D* chooses the March interest rate of 3.2 percent, the annuity factor is 8.4438, and the value of the annuity gift to charity is $844,380 ($100,000 × 8.4438). The value of the gift of the remainder to *R* is $155,620 ($1 million – $844,380).

To minimize the value of the gift to *R*, *D* should use the lowest interest rate available in this case: 3.0 percent. *D* makes a taxable gift of only $146,980 even though *R* will receive $1 million after 10 years if the property in fact produces $100,000 per year.

EXAMPLE 2: Assume that the facts of Example 1 remain the same except that the interest rates are 5 and 10 percent:

- With an interest rate of 5 percent, the remainder factor is 0.613913, the term certain factor is 0.386087 (1 – 0.613913), and the annuity factor is 7.72174 (0.386087 ¸ 0.05). The value of the charitable annuity is $772,174 ($100,000 × 7.72174). The value of the remainder is $227,826 ($1 million – $772,174).
- With an interest rate of 10 percent, the remainder factor is 0.385543, the term certain factor is 0.614457 (1 – 0.385543), and the annuity factor is 6.14457 (0.614457 ¸ 0.10). The value of the charitable annuity is $614,457 ($100,000 × 6.14457). The value of the remainder is $385,543 ($1 million – $614,457).

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V. ADJUSTMENT FACTORS FOR ANNUITIES (TABLE K)

§6.28 A. Overview of Annuity Adjustment Factors

The present value of an annuity will vary, depending on the frequency of the payments during the year. The later the payments are made during the year, the larger will be the value of the remainder interest. The difference is usually insignificant, however, and the payments during the year should be structured primarily for the recipient's needs or convenience rather than to merely increase the amount of the charitable deduction for the remainder interest.

Table K in Treas Reg §20.2031-7(d)(6), for interest rates between 4.2 and 14 percent, and IRS Pub 1457 contains adjustment factors to be used with Table S (see §6.15) and Table B (see §6.21). Adjustment factors are based on the frequency of annuity payments (*i.e.,* annually, semiannually, quarterly, monthly, or weekly), and assume payments made at the end of the relevant period.

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§6.29 B. Examples of Computations Using Table K Factors

If an annuity is payable at the end of semiannual, quarterly, monthly, or weekly periods, either during the life of an individual or for a definite number of years, the present value of the annuity interest must be adjusted by applying the appropriate adjustment factor from Table K. The use of adjustment factors is illustrated by the following examples of gifts to individuals and a gift to a charity. All the gifts involve annuities payable at intervals other than annually:

EXAMPLE 1: In March 2010, *D* gives corporation *B* an annuity of $100,000 per year, payable in equal amounts at the end of semiannual periods, for a term of 10 years. The interest rate for that month is 3.2 percent. The annuity factor is 8.4438. See chart in §6.22. In Table K, the adjustment factor for the interest rate of 3.2 percent, paid semiannually at the end of each interval, is 1.0079. The present value of the annuity at the date of the gift is $851,050 ($100,000 × 8.4438, × 1.0079).

EXAMPLE 2: In March 2010, *D* gives *B* a $50,000 annuity, payable over *B*'s lifetime in equal quarterly payments beginning 3 months after the gift is made. *B* was age 65 at the time of the gift. The interest rate used to compute the value of the gift is 3.2 percent. The annuity factor is 12.6978. See chart in §6.16. The Table K factor for the 3.2 percent interest rate, paid quarterly at the end of each interval, is 1.0119. The value of the annuity at the time of the gift is $642,445 ($50,000 × 12.6978 × 1.0119).

EXAMPLE 3: On March 1, 2010, *D* establishes a 5-percent CRAT for a period of 10 years. *D* transfers $1 million to the trust. The annuity of $50,000 is payable at the end of each trust year. Because the trust was established on March 1, 2010, the interest rates available are 3.0, 3.2, and 3.4 percent. The value of the annuity interest is computed as described in the chart in §6.22:

- If the interest rate chosen is 3.0 percent, the value of the annuity is $426,510 ($50,000 × 8.5302).
- If the interest rate chosen is 3.2 percent, the value of the annuity is $422,190 ($50,000 × 8.4438).
- If the interest rate chosen is 3.4 percent, the value of the annuity is $417,935 ($50,000 × 8.3587).

To achieve the largest charitable contribution deduction, the 3.4-percent interest rate should be used so that the charitable remainder interest is $582,065 ($1 million – $417,935). (In this example, the Table K factor is 1 because the payments are made at the end of each year.) *D* receives a deduction of only $582,065 even though the charitable remainder beneficiaries will receive $1 million after 10 years if the property in fact produces $50,000 per year.

If the annuity is payable at the end of semiannual, quarterly, monthly, or weekly periods, the Table K adjustment factors must be used. For example, if the annuity is paid at the end of semiannual periods and the interest rate is 3.4 percent, the Table K factor is 1.0084. Thus, the present value of the annuity is $421,445 ($50,000 × 8.3587 × 1.0084). The present value of the remainder interest is $578,555 ($1 million – $421,445).

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VI. CHARITABLE REMAINDER UNITRUST SINGLE LIFE REMAINDER FACTORS—ADJUSTED PAYOUT RATES (TABLES U(1), F)

§6.30 A. Overview of CRUT for Single Life

Table U(1) in Temp Treas Reg §1.664-4T(e)(7), for interest rates between 4.2 and 14 percent, and IRS Pub 1458 contains factors for determining the present value of a remainder interest in property following a single life unitrust interest with an adjusted payout rate ranging from 4.2 percent to 14 percent. This table supersedes former Table U(1) in Treas Reg §1.664-4A(f)(6), which remains applicable only for transfers made after April 30, 1999, and before May 1, 2009 (see §6.13A), former Table U(1) in Treas Reg §1.664-4A(e)(6), which remains applicable only for transfers made after April 30, 1989, and before May 1, 1999 (see §6.13), and Table E, which remains applicable only for transfers made after November 30, 1983, and before May 1, 1989 (see §6.12). Table E is set forth in Treas Reg §1.664-4A(d)(6).

Tables F (4.2-14.0) in Treas Reg §1.664-4(e)(6) contain factors for computing the adjusted payout rate of a unitrust when the unitrust payment is payable at the end of semiannual, quarterly, or monthly periods or when there is more than 1 month from the first valuation date of the unitrust to the annual payment, based on interest rates ranging from 4.2 percent to 14 percent. Tables F for interest rates below 4.2 percent may be found in IRS Pub 1458. Tables F are not based on mortality experience and are not changed by the adoption of Table 2000CM, which is based on the 2000 census. See §6.10.

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Source: Estate Planning/Drafting California Irrevocable Trusts/6 Valuing Interests in Property/§6.31 B. Example of Computation of Charitable Remainder Unitrust Interest--Single Life, Adjusted Payout

§6.31 B. Example of Computation of Charitable Remainder Unitrust Interest—Single Life, Adjusted Payout

The following example illustrates the computation of a charitable contribution deduction for a remainder interest in a unitrust under Tables U(1) and F:

EXAMPLE: *D*, age 50, establishes a CRUT with assets having a fair market value on the date of transfer (March 30, 2010) of $1 million. *D* is to receive annually, for life, a unitrust amount equal to 5 percent of the fair market value of the trust assets, determined at the beginning of each taxable year of the trust. The initial payment to *D* will be $50,000. The payments to *D* are to be made at the end of each taxable year of the trust. Seven steps are necessary to compute the charitable contribution deduction for the remainder interest in this trust. The first three steps are as follows:

Computation Steps (1)-(3)		
(1) *Interest*	(2) *Table F Value*	(3) *Adjusted Payout Rate*
3.0%	0.982905	4.915%
3.2%	0.981794	4.909%
3.4%	0.980685	4.903%

(1) Determine the applicable interest rates. The gift is made in March 2010, and a charitable contribution deduction is available. Thus, the interest rates for January, February, or March 2010 may be used. See chart in §6.9.

(2) Determine the Table F value. If a 3.0-percent interest rate is chosen, the Table F (3.0) value for a first payment 7 months after the valuation date is 0.982905. If a 3.2-percent interest rate is chosen, the Table F (3.2) value for a first payment 7 months after the valuation date is 0.981794. If a 3.4-percent interest rate is chosen, the Table F (3.4) value for a first payment 7 months after the valuation date is 0.980685. The Table F value is found on the last line of the Annual Period column in Tables F (3.0-3.4).

(3) Determine the adjusted payout rate by multiplying the adjustment factor from Table F by the unitrust's stated payout rate (in this example, 5 percent). The adjusted payout rate equals the unitrust rate (5 percent) multiplied by the Table F factor.

Steps (4), (5), and (6) each involve a three-part calculation of the unitrust single life remainder factor for the available adjusted payout rates by interpolation from the factors provided for the nearest available interest rates (4.8 and 5.0 percent).

(4) Determine the unitrust single life remainder factor for a 3.0-percent interest rate (January 2010) by interpolation, using Table U(1):

- (a) Based on the available adjusted payout rates determined in Step (3), find the nearest Table U(1) values for age 50 corresponding to the adjusted payout rate for a 3.0-percent interest rate:

Table U(1) Factor for Adjusted Payout Rate of 4.915% (3.0% Interest)

Computation Step (4)(a)			
Age	*Adjusted Payout Rate*	*Table U(1) Factor*	
50	4.8%	0.27214	
50	4.915%	(Y)	X
50	5.0%	0.25943	

- (b) Compute the remainder factor (Y) as shown in the following equations:

$$\frac{X}{(0.27214 - 0.25943)} = \frac{(4.915 - 4.8)}{(5.0 - 4.8)}$$

$$\frac{X}{0.01271} = \frac{0.115}{0.2}$$

$$X = 0.00734$$

$$(Y) = 0.27214 - X$$

$$(Y) = 0.26483$$

- (c) Compute the value of the charitable remainder interest by multiplying the remainder factor by the value of the property transferred to the trust. The value of the charitable remainder interest is $264,830 ($1 million × 0.26483).

(5) Determine the unitrust single life remainder factor for a 3.2-percent interest rate (March 2010) by interpolation, using Table U(1):

- (a) Based on the available adjusted payout rates determined in Step (3), find the nearest Table U(1) values for age 50 corresponding to the adjusted payout rate for a 3.2-percent interest rate:

Table U(1) Factor for Adjusted Payout Rate of 4.909% (3.2% Interest)

Computation Step (5)(a)			
Age	*Adjusted Payout Rate*	*Table U(1) Factor*	
50	4.8%	0.27214	X
50	4.909%	(Y)	
50	5.0%	0.25943	

- (b) Compute the missing remainder factor (Y) as shown in the following equations:

$$\frac{X}{(0.27214 - 0.25943)} = \frac{(4.909 - 4.8)}{(5.0 - 4.8)}$$

$$\frac{X}{0.01271} = \frac{0.109}{0.2}$$

$$X = 0.00693$$

$$(Y) = 0.27214 - X$$

$$(Y) = 0.26521$$

- (c) Compute the value of the charitable remainder interest by multiplying the remainder factor by the value of the property transferred to the trust. The value of the charitable remainder interest is $265,210 ($1 million × 0.26521).

(6) Determine the unitrust single life remainder factor for a 3.4-percent interest rate (February 2010) by interpolation, using Table U(1):

- (a) Based on the available adjusted payout rates determined in Step (3), find the nearest Table U(1) values for age 50 corresponding to the adjusted payout rate for a 3.4-percent interest rate:

Table U(1) Factor for Adjusted Payout Rate of 4.903% (3.4% Interest)

Computation Step (6)(a)			
Age	*Adjusted Payout Rate*	*Table U(1) Factor*	
50	4.8%	0.27214	X

50	4.903%	(Y)
50	5.0%	0.25943

- (b) Compute the missing remainder factor (Y) as shown in the following equations:

$$\frac{X}{(0.27214 - 0.25943)} = \frac{(4.903 - 4.8)}{(5.0 - 4.8)}$$

$$\frac{X}{0.01271} = \frac{0.103}{0.2}$$

$$X = 0.00656$$

$$(Y) = 0.27214 - X$$

$$(Y) = 0.26559$$

- (c) Compute the value of the charitable remainder interest by multiplying the remainder factor by the value of the property transferred to the trust. The value of the charitable remainder interest is $265,590 ($1 million × 0.26559).

(7) Compare the charitable remainder interests determined from Steps (4), (5), and (6), and select the interest rate that yields the largest charitable contribution deduction. In this case, using the 3.4-percent interest rate for February 2010 provides the largest charitable deduction.

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VII. CHARITABLE REMAINDER UNITRUST; TERM OF YEARS (TABLES D, F)

§6.32 A. Overview of CRUT Remainder Factors for Term of Years

Table D is contained in Treas Reg §1.664-4(e)(6) and IRS Pub 1458. Table D may be used to determine the present value of a remainder interest that is postponed for a term of years in a CRUT for transfers made either before or after April 30, 1989. The adjusted payout rate for Table D, however, is computed under Tables F.

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Source: Estate Planning/Drafting California Irrevocable Trusts/6 Valuing Interests in Property/§6.33 B. Example of Computation of Charitable Remainder Unitrust Interest Postponed for Term of Years; Adjusted Payout Rate

§6.33 B. Example of Computation of Charitable Remainder Unitrust Interest Postponed for Term of Years; Adjusted Payout Rate

The following example illustrates the computation of a charitable contribution deduction for a remainder interest that is postponed for a term of years in a unitrust under Tables D and F:

EXAMPLE: The donor, *D,* transfers $1 million to a CRUT on March 3, 2010. The trust instrument requires that the trust pay to *D* semiannually (on June 30 and December 31) 5 percent of the fair market value of the trust assets as of the previous December 31 for a term of 15 years. Seven steps are necessary to compute the charitable contribution deduction for the remainder interest in this trust. The first three steps are as follows:

Computation Steps (1)-(3)		
(1) *Interest*	(2) *Table F Value*	(3) *Adjusted Payout Rate*
3.0%	0.978102	4.891%
3.2%	0.976683	4.883%
3.4%	0.975270	4.876%

(1) Determine the applicable interest rates. The gift is made in March 2010, and a charitable contribution deduction is available. Thus, the interest rates for January, February, or March 2010 may be used. See chart in §6.9.

(2) Determine the Table F value. If a 3.0-percent interest rate is chosen, the Table F (3.0) value for a first payment at least 6 months but less than 7 months after the valuation date is 0.978102. If a 3.2-percent interest rate is chosen, the Table F (3.2) value for a first payment at least 6 months but less than 7 months after the valuation date is 0.976683. If a 3.4-percent interest rate is chosen, the Table F (3.4) value for a first payment at least 6 months but less than 7 months after the valuation date is 0.975270. The Table F value is found on the seventh line of the Semiannual Period column in Tables F (3.0-3.4).

(3) Determine the adjusted payout rate by multiplying the adjustment factor from Table F by the unitrust rate (in this example, 5 percent). The adjusted payout rate equals the unitrust rate (5 percent) multiplied by the Table F factor.

Steps (4), (5), and (6) each involve a three-part calculation of the unitrust remainder factor for the available adjusted payout rates by interpolation from the factors for the nearest available interest rates provided in Table D (4.8 and 5.0 percent). See §6.31 for an example of deriving factors by interpolation.

(4) Determine the unitrust remainder factor for a 3.0-percent interest rate (January 2010) by interpolation, using Table D values for 15 years corresponding to the adjusted payout rate (4.891), and compute the value of the charitable remainder interest by multiplying the remainder factor by the value of the property transferred to the trust. The value of the charitable remainder interest is $471,383 ($1 million × 0.471383).

(5) Determine the charitable remainder factor for a 3.2-percent interest rate (March 2010) by interpolation, using Table D values for 15 years corresponding to the adjusted payout rate (4.883), and compute the value of the charitable remainder interest by multiplying the remainder factor by the value of the property transferred to the trust. The value of the charitable remainder interest is $471,977 ($1 million × 0.471977).

(6) Determine the charitable remainder factor for a 3.4-percent interest rate (February 2010) by interpolation, using Table D values for 15 years corresponding to the adjusted payout rate (4.876), and compute the value of the charitable remainder interest by multiplying the remainder factor by the value of the property transferred to the trust. The value of the charitable remainder interest is $472,497 ($1 million × 0.472497).

Computation Steps (4)-(6)	
Interest Rate	*Value of Charitable Remainder Interest*
3.0%	$471,383
3.2%	$471,977
3.4%	$472,497

(7) Compare the charitable remainder interests determined from Steps (4), (5), and (6) and select the interest rate that yields the largest charitable contribution deduction. In this case, using the 3.4-percent interest rate for February 2010 provides the

largest charitable deduction.

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VIII. CHARITABLE REMAINDER UNITRUST; TWO MEASURING LIVES (TABLES U(2), F)

§6.34 A. Overview of CRUT Remainder Factors for Two Measuring Lives

A slightly different methodology is used when the remainder follows two measuring lives. The present value of the remainder interest in a two-life CRUT is determined by computing an adjusted payout rate and then selecting a valuation factor from the appropriate IRS valuation tables.

In a CRUT with two measuring lives, the valuation factor is determined from Table U(2). The adjusted payout rate for transfers made after April 30, 1989, is determined by multiplying the unitrust amount (the fixed percentage provided in the CRUT) by a payout factor for the period of the payment contained in Tables F. See IRS Pub 1458. An adjusted payout rate is used so that the valuation will more accurately reflect the rate of interest prevailing on the date of transfer to the CRUT. When the creation of a two-life unitrust includes the transfer of an interest to charity, the taxpayer may elect to use the IRC §7520 interest rate of the month of transfer or the two preceding months in calculating the adjusted payout rate.

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§6.35 B. Example of Computation of Charitable Remainder Unitrust With Two Measuring Lives

The following example illustrates the computation of a CRUT with two measuring lives under Tables F and U(2):

EXAMPLE: A husband and wife jointly create a CRUT. They make an initial transfer of $250,000 to the CRUT on March 18, 2010. On the date of the transfer, the ages of the husband and wife are 68 and 59. Under the terms of the CRUT, the unitrust amount is 6 percent of the fair market value of the trust's assets as of the last day of the preceding calendar year, payable quarterly for the joint lives of the husband and wife. On the death of the second spouse to die, the trust corpus (*i.e.*, the remainder) passes to a qualified charity. Seven steps are necessary to determine the present value of the charitable remainder interest:

Computation Steps (1)-(3)		
(1) *Interest*	(2) *Table F Value*	(3) *Adjusted Payout Rate*
3.0%	0.981729	5.890%
3.2%	0.980544	5.883%
3.4%	0.979363	5.876%

(1) Determine the applicable interest rates. For a March 2010 transfer, the interest rates that may be used are 3.0 percent (January 2010), 3.2 percent (March 2010), and 3.4 percent (February 2010).

(2) Determine the Table F value. The Table F value for a first payment at least 3 months but less than 4 months after the valuation date is found on the third line of the Quarterly Period column in Tables F (3.0-3.4).

(3) Determine the adjusted payout rate by multiplying the adjustment factor from Table F by the unitrust's stated payout rate (in this example, 6 percent). The adjusted payout rate equals the unitrust rate (6 percent) multiplied by the Table F value.

(4) Determine the Table U(2) factors for each of the available adjusted payout rates by interpolation from the Table U(2) factors provided for ages 68 and 59 for the nearest available interest rates (5.8 and 6.0 percent). See §6.31 for an example of deriving factors by interpolation.

(5) Match the ages of the measuring lives (68, 59) to the adjusted payout rates (5.890, 5.883, and 5.876 percent).

Computation Steps (4)-(6)	
Interest Rate	*Value of Charitable Remainder Interest*
3.0%	$62,180
3.2%	$62,275
3.4%	$62,372

(6) Determine the present value of the charitable remainder interest by multiplying the value of the transferred property by the appropriate valuation factor for each of the three interest rates. For a 3.4-percent interest rate, multiply $250,000 by 0.24949 (the factor for an adjusted payout rate of 5.876 percent). For a 3.2-percent interest rate, multiply $250,000 by 0.24910 (the factor for an adjusted payout rate of 5.883 percent). For a 3.0-percent interest rate, multiply $250,000 by 0.24872 (the factor for an adjusted payout rate of 5.890 percent).

(7) Compare the charitable remainder interests determined from Step (6) and select the interest rate that yields the largest charitable contribution deduction. In this case, using the 3.4-percent interest rate for February 2010 provides the largest charitable contribution deduction. The present value of the charitable remainder interest, based on the February 2010 interest rate, is $62,372.

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IX. LIMITATIONS ON APPLICATION OF STANDARD VALUATION FACTORS

§6.36 A. Limitations on Valuing High Yield Annuities, Unproductive Property, Inadequately Preserved Property, and Transfers to Trust in Cases of Terminal Illness

Regulations limit the use of the standard actuarial valuation factors in situations involving certain "restricted beneficial interests." For further discussion of these limitations, see Hayes & Krzanowski, *When IRS Actuarial Tables Don't Apply in Valuing Interests*, 32 Est Plan 21 (Feb. 2005). The regulations provide exceptions to the use of the standard valuation tables in the following circumstances:

- *High yield annuities*. High yield annuities are transfers to a trust with a high percentage annuity payout (relative to the IRC §7520 interest rate) when the annuitant has the right to receive the annuity until death or until the fund is exhausted and the annuity is expected to exhaust the fund before the last prescribed annual payment is made in full. For this purpose, the regulations require an assumption that any individual whose life is a measuring life will survive to age 110. If the annuity will exhaust the fund using these assumptions, a special IRC §7520 annuity factor must be calculated that takes into account exhaustion of the trust fund. Treas Reg §1.7520-3(b)(2)(i). See Rev Rul 77-454, 1977-2 Cum Bull 351. However, the special valuation factor is no longer used to value a transfer to a grantor retained annuity trust (GRAT) paying an annuity for a period of years, so long as the annuity will be paid to the annuitant's estate in the event that the annuitant dies before the end of the trust term. See chap 15.

- *Unproductive property*. Transfers to a trust providing for an ordinary income interest but funded with unproductive or underproductive assets that threaten the expected beneficial enjoyment by the income beneficiary may not be valued actuarially under IRC §7520. The tables do not apply unless the transferring instrument provides the beneficiary with that "degree of beneficial enjoyment" of the property consistent with the type of property interest that the standard valuation tables are designed to measure. Treas Reg §1.7520-3(b)(2)(ii).

- *Inadequately preserved property*. Transfers to a trust providing for a remainder or reversionary interest but containing provisions that threaten the expected beneficial enjoyment by the remainder or reversionary beneficiary may not be valued actuarially under IRC §7520. The tables do not apply unless, consistent with the preservation and protection that the law of trusts would provide for a person unqualifiedly designated as the remainder beneficiary of a trust for a similar duration, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected (*e.g.,* from erosion, invasion, depletion, or damage) until the remainder or reversionary interest takes effect in possession and enjoyment. Treas Reg §1.7520-3(b)(2)(iii).

- *Mortality component (terminal illness)*. The terminal illness mortality component refers to transfers to a trust when the individual whose life is the measuring life is terminally ill. In that situation, a special valuation factor must be computed that is based on the IRC §7520 interest rate and that incorporates a projection of the individual's actual life expectancy. An individual who is known to have an incurable illness or other deteriorating physical condition is considered to be terminally ill if there is at least a 50-percent probability that he or she will die within 1 year. Should the individual survive for at least 18 months after the transaction date, he or she is presumed to have not been terminally ill at the time of the transaction unless established otherwise by clear and convincing evidence. Treas Reg §1.7520-3(b)(3).

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§6.37 B. Example of Computation Involving Application of Limitations to Valuation of High Yield Annuity

Application of the regulatory limitation to the standard valuation factors for a high yield annuity and an eroding corpus is illustrated in the following example involving a CLAT (Temp Treas Reg §25.7520-3T(b)(2)(v), Example 5):

EXAMPLE: The donor, *D,* who is 60 and in normal health, transfers property worth $1 million to a trust on or after May 1, 2009. The trust will pay a 10-percent ($100,000 per year) annuity annually to a charity for the life of *D.* The remainder will be distributed to *D*'s child on *D*'s death. The IRC §7520 rate for the month of the transfer is 6.8 percent.

Because any individual whose life is a measuring life is assumed to survive until age 110, the life annuity must be determined until the measuring life reaches age 110. Based on an IRC §7520 interest rate of 6.8 percent, the practitioner must determine whether the annuity may exhaust the corpus before all annuity payments are made. This determination should be made by subtracting the age of the measuring life on the date of transfer (60) from the age to which the life annuity may continue under the assumption (110). In this example, the annuity must be calculated as if it would continue for 50 years. The practitioner should then multiply the annual annuity payment ($100,000) by the Table B annuity factor for 50 years (14.1577) to reach the present value of the term certain annuity ($1,415,770).

Because the present value of a $100,000 annuity for a term of 50 years exceeds the value of the trust principal ($1 million), the annuity will exhaust the trust before all payments are made. The value of the remainder interest is not, however, zero. Instead, the annuity must be valued as an annuity payable for a term of years or until the prior death of the annuitant, with the term of years determined by when the fund will be exhausted by the annuity payments. By using factors based on Table 2000CM (see §6.10) at 6.8 percent, the practitioner may determine that the fund will be sufficient to make 17 annual payments but not the entire 18th payment. Specifically, the initial corpus will be able to make payments of $67,287.28 per year for 17 years plus payments of $32,712.72 per year for 18 years. The practitioner then values the annuity by adding the value of the two separate temporary annuities.

In Table H (see IRS Pub 1457), the present value of an annuity of $67,287.28 per year, payable for 17 years or until the prior death of a person aged 60, is $597,013.12 ($67,287.28 × 8.8726). The present value of an annuity of $32,712.72 per year, payable for 18 years or until the prior death of a person aged 60, is $296,887.56 ($32,712.72 × 9.0756). Thus, the present value of the charitable annuity interest is $893,900.68 ($597,013.12 + $296,887.56).

The calculated value of the charitable annuity interest in the above example is substantially less than the present value of a $100,000 annuity for the life of *D* ($1,030,680) determined under the general rule using Table S, which would result in a $1 million charitable deduction for the transfer to the trust. In a contemporary example using a lower interest rate, the present value of a charitable lead annuity of $75,000 to be paid from a trust funded with $1 million worth of property on or after May 1, 2009, for the life of a donor age 60 assuming an IRC §7520 interest rate of 3.2 percent for the month of transfer would be $1,095,637 determined under the general rule using Table S but would be limited to $875,736 using Table H factors.

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§6.38 X. SELECTING COMPUTER SOFTWARE PROGRAMS

Despite the examples of valuation calculations set forth in this chapter, estate planners commonly use estate tax-planning computer software to make these calculations as well as to calculate taxes and other related information. Such software reduces the effort involved in performing the calculations and thereby enables a practitioner to deliver high quality work to clients, reduce the costs of legal services, and increase profitability.

Several commercial estate planning software products are available. Because the features of these products are constantly changing, however, this chapter contains a general discussion of product features and options rather than recommendations of particular programs. The discussion is based on suggestions in Evans, Wills, Trusts, and Technology: An Estate Lawyer's Guide to Automation (2d ed 2004). Attorneys choosing an estate planning software product may wish to consult that book.

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§6.39 A. Desirable Features of Estate Planning Software

In selecting estate planning software to aid in valuations of partial property interests, the attorney should consider the following features:

- *Dual capacity.* The practitioner should ascertain whether the program can perform calculations involving both charitable split interests and grantor retained interests. In fact, because the required calculations are so similar, most programs can handle both types of interests.

- *Present-value calculations*. A software program must be able to take the value of partial interests to be paid or benefits to be received in the future and reduce them to present value. To do so, the program must be able to:

- Calculate the probable duration of measuring lives if the remainder interest or income interest is based on one or more lives;

- Incorporate the requirements of IRC §7520 in a way that conforms with IRS regulations. Present-value calculations are based on the assumed interest rate under §7520 (see §§6.4, 6.9);

- Calculate an interest for a term of years, with the remainder being left at the conclusion of the term;

- Compute actuarial factors for one life in the case of payments to be made for the life of a beneficiary, with the remainder being left at the death of the beneficiary; and

- Compute depreciable interests in the case of a remainder interest in a residence or farm.

- *Complex present-value calculations.* In making present-value calculations, the practitioner may wish to select a program that includes the ability to calculate actuarial factors for (1) two or more lives and (2) interests determined by both a life and a term of years. Because computations of this nature are unusual and quite complicated, many programs cannot accommodate them.

- *Income tax deductions.* The ability to calculate charitable income tax deductions for inter vivos charitable gifts is a desirable feature. Some software programs can determine the amount and after-tax value of the deduction.

- *Future consequences.* The practitioner may wish to compare the future value of different types of gifts, including both the future rate of income and the appreciation of assets. Some programs are able make these kinds of projections.

Aside from features specifically designed for valuation of partial property interests, a practitioner selecting estate planning software may want to look for several general features. Some features are essential to any estate practice; others may or may not be useful in a particular practice:

- *Tax calculations.* A software program should be able to handle the following types of calculations:

- Estate tax calculations;

- Marital deduction formula;

- State death tax calculations;

- Gift calculations;

- Charitable deduction calculations; and

- Other federal taxes (*e.g.*, generation-skipping taxes, income taxes on retirement distributions, tax on excess retirement accumulations).

- *Reports.* A software program should have the ability to print a report showing the assumptions used in the calculations and the results of the calculations. The most effective reports are in the form of either side-by-side comparisons that show different groups of calculations in separate columns or charts that show the results of calculations in a graphic manner.

- *Lists of assets.* The attorney may desire a program that lists, describes, and inventories each asset in the estate. Several programs include this type of feature. Because detailed information on each particular asset may not be available, however, a program should also permit only the total for the estate to be entered or the total for different sets of assets.

- *Specific and general bequests.* Some estate planning programs can take into account assets that will be disposed of specifically or cash gifts to particular beneficiaries. This feature may be desirable—particularly for use in complicated estate plans.

- *Distributive shares.* The attorney may want to be able to ascertain the value of each individual share of the estate as well as the net estate to be distributed to the beneficiaries after taxes. Some programs have this capability. Some programs also allow the practitioner to apportion death taxes in various ways.

- *Order of death.* It is usually important for an estate planning program to have the ability to calculate all the taxes due after the death of each spouse and to show how the distributions and taxes will change if the order of death is reversed.

- *Future estate growth.* Some attorneys may desire a program that is able to (1) calculate future growth in the value of estate assets and (2) recalculate taxes and distributive shares based on the growth. A few programs permit such calculations.

- *Liquidity of estate.* It is often necessary to be able to determine whether the estate will have to sell any assets to meet its cash needs. Many programs can calculate an estate's cash requirements, the assets available to meet those requirements, and the amount of any shortfall.

- *Ability to perform quick, simple calculations.* A program with too many features or options may reduce the ability to generate simple examples or to perform rapid calculations. In selecting estate planning software, the attorney should balance the need for flexibility in handling complicated fact situations against the need for fast, straightforward calculations.

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§6.40 B. Use of Electronic Spreadsheets

Estate planning software usually performs most of the calculations necessary for valuing partial property interests. If a standard program does not accommodate a particular type of valuation, however, commercial electronic spreadsheets may be used to perform actuarial calculations.

Tax programs usually calculate estate taxes based on various sets of facts, but it may be useful to use a spreadsheet program to compute the taxes as well as to show the effects of different estate plans.

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§6.41 XI. SELECTED IRS VALUATION TABLES

The following are selections from the complete valuation tables published in IRS Pub 1457 (see §§6.4-6.5):

- Table B (Term Certain Remainder Factors) for interest rates from 2.2 percent to 7.0 percent;
- Table K (Adjustment Factors for Annuities Payable at the End of Each Interval) for interest rates from 2.2 percent to 14.0 percent;
- Table S (Based on Life Table 2000CM Single Life Remainder Factors Applicable After April 30, 2009) for interest rates from 2.2 percent to 7.0 percent; and
- Table 2000CM (Applicable After April 30, 2009).

TABLE B

TERM CERTAIN REMAINDER FACTORS
APPLICABLE AFTER APRIL 30, 1989

Interest Rate

YEARS	*2.2%*	*2.4%*	*2.6%*	*2.8%*	*3.0%*
1	.978474	.976563	.974659	.972763	.970874
2	.957411	.953674	.949960	.946267	.942596
3	.936801	.931323	.925887	.920493	.915142
4	.916635	.909495	.902424	.895422	.888487
5	.896903	.888178	.879555	.871033	.862609
6	.877596	.867362	.857266	.847308	.837484
7	.858704	.847033	.835542	.824230	.813092
8	.840220	.827181	.814369	.801780	.789409
9	.822133	.807794	.793732	.779941	.766417
10	.804435	.788861	.773618	.758698	.744094
11	.787119	.770372	.754013	.738033	.722421
12	.770175	.752316	.734906	.717931	.701380
13	.753596	.734684	.716282	.698376	.680951
14	.737373	.717465	.698131	.679354	.661118
15	.721500	.700649	.680440	.660851	.641862
16	.705969	.684228	.663197	.642851	.623167
17	.690772	.668191	.646390	.625341	.605016
18	.675902	.652530	.630010	.608309	.587395
19	.661352	.637237	.614045	.591740	.570286
20	.647116	.622302	.598484	.575622	.553676
21	.633186	.607716	.583318	.559944	.537549
22	.619556	.593473	.568536	.544693	.521893
23	.606219	.579563	.554129	.529857	.506692
24	.593169	.565980	.540087	.515425	.491394
25	.580400	.552715	.526400	.501386	.477606
26	.567906	.539761	.513061	.487729	.463695
27	.555681	.527110	.500059	.474445	.450189
28	.543720	.514756	.487387	.461522	.437077
29	.532015	.502691	.475036	.448952	.424346
30	.520563	.490909	.462998	.436723	.411987

31	.509357	.479404	.451265	.424828	.399987
32	.498392	.468168	.439830	.413257	.388837
33	.487664	.457195	.428684	.402001	.377026
34	.477166	.446479	.417820	.391052	.366045
35	.466894	.436015	.407232	.380400	.355383
36	.456844	.425796	.396913	.370039	.345032
37	.447010	.415816	.386854	.359960	.334983
38	.437387	.406071	.377051	.350156	.325556
39	.427972	.396553	.367496	.340619	.315754
40	.418759	.387259	.358183	.331341	.306557
41	.409745	.378183	.349107	.322316	.297628
42	.400924	.369319	.340260	.313537	.288959
43	.392294	.360663	.331637	.304997	.280543
44	.383849	.352210	.323233	.296690	.272372
45	.375586	.343995	.315042	.288609	.264439
46	.367501	.335894	.307059	.280748	.256737
47	.359950	.328021	.299277	.273101	.249259
48	.351850	.320333	.291693	.265663	.241999
49	.344275	.312825	.284302	.258427	.234950
50	.336864	.305494	.277097	.251388	.228107
51	.329613	.298334	.270075	.244541	.221463
52	.322518	.291341	.263321	.237880	.215013
53	.315575	.284513	.256561	.231401	.208750
54	.308782	.277845	.250059	.225098	.202670
55	.302135	.271333	.243722	.218967	.196767
56	.295631	.264973	.237546	.213003	.191036
57	.289267	.258763	.231526	.207201	.185472
58	.283040	.252698	.225659	.201558	.180070
59	.276947	.246776	.219941	.196068	.174825
60	.270986	.240992	.214367	.190727	.169733

YEARS	*3.2%*	*3.4%*	*3.6%*	*3.8%*	*4.0%*
1	.968992	.967118	.965251	.963391	.961538
2	.938946	.935317	.931709	.928122	.924556
3	.909831	.904562	.899333	.894145	.888996
4	.881620	.874818	.868082	.861411	.854804
5	.854283	.846052	.837917	.829876	.821927
6	.827793	.818233	.808801	.799495	.790315
7	.802125	.791327	.780696	.770227	.759918
8	.777253	.765307	.753567	.742030	.730690
9	.753152	.740142	.727381	.714865	.702587
10	.729799	.715805	.702106	.688694	.675564
11	.707169	.692268	.677708	.663482	.649581
12	.685241	.669505	.654158	.639193	.624597
13	.663994	.647490	.631427	.615793	.600574
14	.643405	.626199	.609486	.593249	.577475
15	.623454	.605608	.588307	.571531	.555265
16	.604122	.585695	.567863	.550608	.533908
17	.585390	.566436	.548131	.530451	.513373
18	.567238	.547810	.529084	.511031	.493628

19	.549649	.529797	.510699	.492323	.474642
20	.532606	.512377	.492952	.474300	.456387
21	.516091	.495529	.475823	.456936	.438834
22	.500088	.479235	.459288	.440208	.421955
23	.484582	.463476	.443328	.424093	.405726
24	.469556	.448236	.427923	.408567	.390121
25	.454996	.433497	.413053	.393610	.375117
26	.440888	.419243	.398700	.379200	.360689
27	.427217	.405458	.384846	.365318	.346817
28	.413970	.392125	.371473	.351944	.333477
29	.401133	.379231	.358564	.339060	.320651
30	.388695	.366762	.346105	.326648	.308319
31	.376643	.354702	.334078	.314689	.296460
32	.364964	.343038	.322469	.303169	.285058
33	.353647	.331759	.311263	.292070	.274094
34	.342681	.320850	.300447	.281378	.263552
35	.332055	.310300	.290007	.271077	.253415
36	.321759	.300096	.279930	.261153	.243669
37	.311782	.290229	.270202	.251593	.234927
38	.302114	.280685	.260813	.242383	.225285
39	.292747	.271456	.251750	.233509	.216621
40	.283669	.262530	.243002	.224960	.208289
41	.274873	.253897	.234558	.216725	.200278
42	.266350	.245549	.226407	208791	.192575
43	.258091	.237474	.218540	.201147	.185168
44	.250088	.229666	.210946	.193783	.178046
45	.242334	.222114	.203616	.186689	.171198
46	.234819	.214810	.196540	.179855	.164614
47	.227538	.207747	.189711	.173270	.158283
48	.220483	.200916	.183118	.166927	.152195
49	.213646	.194309	.176755	.160816	.146341
50	.207021	.187920	.170613	.154929	.140713
51	.200602	.181741	.164684	.149257	.135301
52	.194382	.175765	.158962	.143793	.130097
53	.188355	.169985	.153438	.138529	.125093
54	.182514	.164396	.148106	.133457	.120282
55	.176855	.158990	.142960	.128572	.115656
56	.171371	.153762	.137992	.123865	.111207
57	.166057	.148706	.133197	.119330	.106930
58	.160908	.143817	.128568	.114962	.102817
59	.155919	.139088	.124101	.110753	.098863
60	.151084	.134514	.119788	.106699	.095060

YEARS	*4.2%*	*4.4%*	*4.6%*	*4.8%*	*5.0%*
1	.959693	.957854	.956023	.954198	.952381
2	.921010	.917485	.913980	.910495	.907029
3	.883887	.878817	.873786	.868793	.863838
4	.848260	.841779	.835359	.829001	.822702
5	.814069	.806302	.798623	.791031	.783526
6	.781257	.772320	.763501	.754801	.746215

7	.749766	.739770	.729925	.720230	.710681
8	.719545	.708592	.697825	.687242	.676839
9	.690543	.678728	.667137	.655765	.644609
10	.662709	.650122	.637798	.625730	.613913
11	.635997	.622722	.609750	.597071	.584679
12	.510362	.596477	.582935	.569724	.556837
13	.585760	.571339	.557299	.543630	.530321
14	.562150	.547259	.532790	.518731	.505068
15	.539491	.524195	.509360	.494972	.481017
16	.517746	.502102	.486960	.472302	.458112
17	.496877	.480941	.465545	.450670	.436297
18	.476849	.460671	.445071	.430028	.415521
19	.457629	.441256	.425498	.410332	.395734
20	.439183	.422659	.406786	.391538	.376889
21	.421481	.404846	.388897	.373605	.358942
22	.404492	.387783	.371794	.356494	.341850
23	.388188	.371440	.355444	.340166	.325571
24	.372542	.355785	.339813	.324586	.310068
25	.357526	.340791	.324869	.309719	.295303
26	.343115	.326428	.310582	.295533	.281241
27	.329825	.312670	.296923	.281998	.267848
28	.316012	.299493	.283866	.269082	.255094
29	.303275	.286870	.271382	.256757	.242946
30	.291051	.274780	.259447	.244997	.231377
31	.279319	.263199	.248038	.233776	.220359
32	.268061	.252106	.237130	.223069	.209866
33	.257256	.241481	.226702	.212852	.199873
34	.246887	.231304	.216732	.203103	.190355
35	.236935	.221556	.207201	.193801	.181290
36	.227385	.212218	.198089	.184924	.172657
37	.218220	.203274	.189377	.176454	.164436
38	.209424	.194707	.181049	.168373	.156605
39	.200983	.186501	.173087	.160661	.149148
40	.192882	.178641	.165475	.153302	.142046
41	.185107	.171112	.158198	.146281	.135282
42	.177646	.163900	.152141	.139581	.128840
43	.170486	.156992	.144590	.133188	.122704
44	.163614	.150376	.138231	.127088	.116861
45	.157019	.144038	.132152	.121267	.111297
46	.150690	.137968	.126340	.115713	.105997
47	.144616	.132153	.120784	.110413	.100949
48	.138787	.126583	.115473	.105356	.096142
49	.133193	.121248	.110395	.100530	.091564
50	.128724	.116138	.105540	.095926	.087204
51	.122672	.111243	.100898	.091532	.083051
52	.117728	.106555	.096461	.087340	.079096
53	.112982	.102064	.092219	.083340	.075330
54	.108428	.097763	.088164	.079523	.071743
55	.104058	.093642	.084286	.075880	.068326
56	.099864	.089696	.080580	.072405	.065073
57	.095839	.085916	.077036	.069089	.061974

58	.091976	.082295	.073648	.065924	.059023
59	.088268	.078826	.070409	.062905	.056212
60	.084710	.075504	.067313	.060024	.053536

YEARS	*5.2%*	*5.4%*	*5.6%*	*5.8%*	*6.0%*
1	.950570	.948767	.946970	.945180	.943396
2	.903584	.900158	.896752	.893364	.889996
3	.858920	.854040	.849197	.844390	.839619
4	.816464	.810285	.804163	.798100	.792094
5	.776106	.768771	.761518	.754348	.747258
6	.737744	.729384	.721135	.712994	.704961
7	.701277	.692015	.682893	.673908	.665057
8	.666613	.656561	.646679	.636964	.627412
9	.633663	.622923	.612835	.602045	.591898
10	.602341	.591009	.579910	.569041	.558395
11	.572568	.560729	.549157	.537846	.526788
12	.544266	.532001	.520035	.508361	.496969
13	.517363	.504745	.492458	.480492	.468839
14	.491790	.478885	.466343	.454151	.442301
15	.467481	.454350	.441612	.429255	.417265
16	.444374	.431072	.418194	.405723	.393646
17	.422408	.408987	.396017	.383481	.371364
18	.401529	.388033	.375016	.326458	.350344
19	.381681	.368153	.355129	.342588	.330513
20	.326815	.349291	.336296	.323807	.311805
21	.344881	.331396	.318462	.306056	.294155
22	.327834	.314417	.301574	.289278	.277505
23	.311629	.298309	.285581	..273420	.261797
24	.296225	.283025	.270437	.258431	.246979
25	.281583	.268525	.256096	.244263	.232999
26	.267664	.254768	.242515	.230873	.219810
27	.254434	.241715	.229654	.318216	.207368
28	.241857	.229331	.217475	.206253	.195630
29	.229902	.217582	.205943	.194497	.184557
30	.218538	.206434	.195021	.184260	.174110
31	.207736	.195858	.184679	.174158	.164255
32	.197468	.185823	.174886	.164611	.154957
33	.187707	.176303	.165612	.155587	.146186
34	.178429	.167270	.156829	.147058	.137912
35	.169609	.158701	.148512	.138996	.130105
36	.161225	.150570	.140637	.131376	.122741
37	.153256	.142856	.133179	.124174	.115793
38	.145681	.135537	.126116	.117367	.109239
39	.138480	.128593	.119428	.110933	.103056
40	.131635	.122004	.113095	.104851	.097222
41	.125128	.115754	.107098	.099103	.091719
42	.118943	.109823	.101418	.093670	.086527
43	.113064	.104197	.096040	.088535	.081630
44	.107475	.098858	.090947	.083682	.077009
45	.102163	.093793	.086124	.079094	.072650

46	.097113	.088988	.081557	.074758	.068538
47	.092312	.084429	.077232	.070660	.064658
48	.087749	.080103	.073136	.066786	.060998
49	.083412	.075999	.069258	.063125	.057546
50	.079289	.072106	.065585	.059665	.054288
51	.075370	.068411	.062107	.056394	.051215
52	.071644	.064907	.058813	.053302	.048316
53	.068103	.061581	.055695	.050380	.045582
54	.064737	.058426	.052741	.047618	.043001
55	.061537	.055433	.049944	.045008	.040567
56	.058495	.052593	.047296	.042541	.038271
57	.055604	.049898	.044787	.040208	.036105
58	.052855	.047342	.042412	.038004	.034061
59	.050243	.044916	.040163	.035921	.032133
60	.047759	.042615	.038033	.033952	.030314

YEARS	*6.2%*	*6.4%*	*6.6%*	*6.8%*	*7.0%*
1	.941620	.939850	.938086	.936330	.934579
2	.886647	.883317	.880006	.876713	.873439
3	.834885	.830185	.825521	.820892	.816298
4	.786144	.780249	.774410	.768626	.762895
5	.740248	.733317	.726464	.719687	.712986
6	.697032	.689208	.681486	.673864	.666342
7	.656339	.647752	.639292	.630959	.622750
8	.618022	.608789	.599711	.590786	.582009
9	.581942	.572170	.562581	.553170	.543934
10	.547968	.537754	.527750	.517950	.508349
11	.515977	.505408	.495075	.484972	.475093
12	.485854	.475007	.464423	.454093	.444012
13	.457490	.446436	.435669	.425181	.414964
14	.430781	.419582	.408695	.398109	.387817
15	.405632	.394344	.383391	.372762	.362446
16	.381951	.370624	.359654	.349028	.338735
17	.359653	.348331	.337386	.326805	.316574
18	.338656	.327379	.316498	.305997	.295864
19	.318885	.307687	.296902	.286514	.276508
20	.300268	.289179	.278520	.268272	.258419
21	.282739	.271785	.261276	.251191	.241513
22	.266232	.255437	.245099	.235197	.225713
23	.250689	.240073	.229924	.220222	.210947
24	.236054	.225632	.215689	.206201	.197147
25	.222273	.212060	.202334	.193072	.184249
26	.209297	.199305	.189807	.180779	.172195
27	.197078	.187317	.178056	.169269	.160930
28	.185572	.176049	.167031	.158491	.150402
29	.174739	.165460	.156690	.148400	.140563
30	.164537	.155507	.146989	.138951	.131367
31	.154932	.146154	.137888	.130104	.122773
32	.145887	.137362	.129351	.121820	.114741
33	.137370	.129100	.121342	.114064	.107235
34	.129350	.121335	.113830	.106802	.100219

35	.121798	.114036	.106782	.100001	.093663
36	.114688	.107177	.100171	.093634	.087535
37	.107992	.100730	.093969	.087673	.081809
38	.101688	.094671	.088151	.082090	.076457
39	.095751	.088977	.082693	.076864	.071455
40	.090161	.083625	.077573	.071970	.066780
41	.084897	.078595	.072770	.067387	.062412
42	.079941	.073867	.068265	.063097	.058329
43	.075274	.069424	.064038	.059079	.054513
44	.070880	.065248	.060074	.055318	.050946
45	.066742	.061323	.056354	.051796	.047613
46	.062845	.057635	.052865	.048498	.044499
47	.059176	.054168	.049592	.045410	.041587
48	.055722	.050910	.046522	.042519	.038867
49	.052469	.047848	.043641	.039812	.036324
50	.049405	.044970	.040939	.037277	.033948
51	.046521	.042265	.038405	.034903	.031727
52	.043805	.039722	.036027	.032681	.029651
53	.041248	.037333	.033796	.030600	.027711
54	.038840	.035087	.031704	.028652	.025899
55	.036572	.032977	.029741	.026828	.024204
56	.034437	.030993	.027900	.025119	.022621
57	.032427	.029129	.026172	.023520	.021141
58	.030534	.027377	.024552	.022023	.019758
59	.028751	.025730	.023032	.020620	.018465
60	.027073	.024183	.021606	.019307	.017257

TABLE K

ADJUSTMENT FACTORS FOR ANNUITIES PAYABLE AT THE BEGINNING OF EACH INTERVAL

APPLICABLE AFTER APRIL 30, 1989

Frequency of Payments

Interest Rate	*Annually*	*Semi-Annually*	*Quarterly*	*Monthly*	*Weekly*
2.2	1.0000	1.0055	1.0082	1.0100	1.0107
2.4	1.0000	1.0060	1.0090	1.0110	1.0117
2.6	1.0000	1.0065	1.0097	1.0119	1.0127
2.8	1.0000	1.0070	1.0104	1.0128	1.0137
3.0	1.0000	1.0074	1.0112	1.0137	1.0146
3.2	1.0000	1.0079	1.0119	1.0146	1.0156
3.4	1.0000	1.0084	1.0127	1.0155	1.0166
3.6	1.0000	1.0089	1.0134	1.0164	1.0175
3.8	1.0000	1.0094	1.0141	1.0173	1.0185
4.0	1.0000	1.0099	1.0149	1.0182	1.0195
4.2	1.0000	1.0104	1.0156	1.0191	1.0205
4.4	1.0000	1.0109	1.0164	1.0200	1.0214
4.6	1.0000	1.0114	1.0171	1.0209	1.0224

4.8	1.0000	1.0119	1.0178	1.0218	1.0234
5.0	1.0000	1.0123	1.0186	1.0227	1.0243
5.2	1.0000	1.0128	1.0193	1.0236	1.0253
5.4	1.0000	1.0133	1.0200	1.0245	1.0262
5.6	1.0000	1.0138	1.0208	1.0254	1.0272
5.8	1.0000	1.0143	1.0215	1.0263	1.0282
6.0	1.0000	1.0148	1.0222	1.0272	1.0291
6.2	1.0000	1.0153	1.0230	1.0281	1.0301
6.4	1.0000	1.0158	1.0237	1.0290	1.0311
6.6	1.0000	1.0162	1.0244	1.0299	1.0320
6.8	1.0000	1.0167	1.0252	1.0308	1.0330
7.0	1.0000	1.0172	1.0259	1.0317	1.0339
7.2	1.0000	1.0177	1.0266	1.0326	1.0349
7.4	1.0000	1.0182	1.0273	1.0335	1.0358
7.6	1.0000	1.0187	1.0281	1.0344	1.0368
7.8	1.0000	1.0191	1.0288	1.0353	1.0378
8.0	1.0000	1.0196	1.0295	1.0362	1.0387
8.2	1.0000	1.0201	1.0302	1.0370	1.0397
8.4	1.0000	1.0206	1.0310	1.0379	1.0406
8.6	1.0000	1.0211	1.0317	1.0388	1.0416
8.8	1.0000	1.0215	1.0324	1.0397	1.0425
9.0	1.0000	1.0220	1.0331	1.0406	1.0435
9.2	1.0000	1.0225	1.0339	1.0415	1.0444
9.4	1.0000	1.0230	1.0346	1.0424	1.0454
9.6	1.0000	1.0235	1.0353	1.0433	1.0463
9.8	1.0000	1.0239	1.0360	1.0442	1.0473
10.0	1.0000	1.0244	1.0368	1.0450	1.0482
10.2	1.0000	1.0249	1.0375	1.0459	1.0492
10.4	1.0000	1.0254	1.0382	1.0468	1.0501
10.6	1.0000	1.0258	1.0389	1.0477	1.0511
10.8	1.0000	1.0263	1.0396	1.0486	1.0520
11.0	1.0000	1.0268	1.0404	1.0495	1.0530
11.2	1.0000	1.0273	1.0411	1.0503	1.0539
11.4	1.0000	1.0277	1.0418	1.0512	1.0549
11.6	1.0000	1.0282	1.0425	1.0521	1.0558
11.8	1.0000	1.0287	1.0432	1.0530	1.0568
12.0	1.0000	1.0292	1.0439	1.0539	1.0577
12.2	1.0000	1.0296	1.0447	1.0548	1.0587
12.4	1.0000	1.0301	1.0454	1.0556	1.0596
12.6	1.0000	1.0306	1.0461	1.0565	1.0605
12.8	1.0000	1.0310	1.0468	1.0574	1.0615
13.0	1.0000	1.0315	1.0475	1.0583	1.0624
13.2	1.0000	1.0320	1.0482	1.0591	1.0634
13.4	1.0000	1.0324	1.0489	1.0600	1.0643
13.6	1.0000	1.0329	1.0496	1.0609	1.0652
13.8	1.0000	1.0334	1.0504	1.0618	1.0662
14.0	1.0000	1.0339	1.0511	1.0626	1.0671

TABLE S

BASED ON LIFE TABLE 2000CM SINGLE
LIFE REMAINDER FACTORS

APPLICABLE AFTER APRIL 30, 2009

Interest Rate

AGE	*2.2%*	*2.4%*	*2.6%*	*2.8%*	*3.0%*
0	.20365	.17830	.15648	.13767	.12144
1	.20251	.17677	.15458	.13542	.11885
2	.20656	.18060	.15817	.13877	.12197
3	.21084	.18466	.16200	.14236	.12533
4	.21527	.18888	.16600	.14613	.12887
5	.21984	.19324	.17013	.15004	.13255
6	.22454	.19773	.17440	.15408	.13636
7	.22933	.20233	.17879	.15824	.14030
8	.23425	.20705	.18330	.16254	.14436
9	.23930	.21191	.18795	.16697	.14857
10	.24446	.21689	.19273	.17153	.15292
11	.24975	.22200	.19764	.17623	.15740
12	.25515	.22724	.20268	.18107	.16202
13	.26064	.23256	.20782	.18600	.16674
14	.26620	.23796	.21303	.19101	.17154
15	.27179	.24340	.21289	.19607	.17369
16	.27742	.24887	.22358	.20117	.18128
17	.28309	.25439	.22893	.20632	.18622
18	.28881	.25997	.23434	.21154	.19123
19	.29461	.26563	.23983	.21684	.19633
20	.30050	.27139	.24543	.22226	.20156
21	.30649	.27726	.25114	.22799	.20689
22	.31259	.28323	.25697	.23344	.21235
23	.31879	.28934	.26293	.23923	.21795
24	.32515	.29559	.26904	.24519	.22372
25	.33166	.30201	.27534	.25133	.22969
26	.33833	.30861	.28182	.25767	.23586
27	.34517	.31538	.28849	.26420	.24224
28	.35217	.32233	.29535	.27093	.24882
29	.35932	.32944	.30327	.27784	.25558
30	.36661	.33670	.30956	.28492	.26253
31	.37403	.34411	.31691	.29217	.26965
32	.38160	.35167	.32442	.29960	.27697
33	.38930	.35939	.33211	.30721	.28447
34	.39713	.36724	.33993	.31497	.29213
35	.40509	.37523	.34792	.32290	.29998
36	.41318	.38337	.35606	.33100	.30800
37	.42139	.39165	.36435	.33927	.31621
38	.42974	.40008	.37281	.34771	.32460
39	.43821	.40864	.38141	.35631	.33316
40	.44679	.41734	.39016	.36507	.34189
41	.45549	.42616	.39906	.37399	.35080
42	.46430	.43511	.40809	.38307	.35987
43	.47324	.44421	.41729	.39232	.36913
44	.48229	.45343	.42663	.40172	.37857
45	.49144	.46277	.43611	.41128	.38817

46	.50072	.47225	.44574	.42101	.39796
47	.51009	.48185	.45550	.43089	.40791
48	.51958	.49158	.46540	.44093	.41803
49	.52917	.50143	.47545	.45113	.42833
50	.53888	.51141	.48566	.46150	.43883
51	.54871	.52153	.49602	.47204	.44951
52	.55865	.53179	.50653	.48276	.46038
53	.56869	.54217	.51718	.49363	.47143
54	.57882	.55265	.52796	.50465	.48265
55	.58902	.56322	.53884	.51579	.49400
56	.59926	.57383	.54978	.52701	.50544
57	.60951	.58449	.56078	.53830	.51698
58	.61978	.59517	.57182	.54964	.52858
59	.63007	.60589	.58290	.56105	.54027
60	.64039	.61665	.59405	.57254	.55205
61	.65072	.62743	.60524	.58409	.56390
62	.66104	.63822	.61645	.59566	.57581
63	.67133	.64900	.62776	.60726	.58774
64	.68161	.65977	.63887	.61887	.59970
65	.69186	.67053	.65009	.63049	.61170
66	.70216	.68136	.66140	.64223	.62383
67	.71250	.69224	.67277	.65405	.63605
68	.72283	.70312	.68416	.66590	.64833
69	.73312	.71398	.69553	.67776	.66062
70	.74335	.72479	.70688	.68959	.67291
71	.75353	.73556	.71819	.70141	.68519
72	.76364	.74626	.72945	.71318	.69744
73	.77365	.75686	.74061	.72487	.70962
74	.78350	.76733	.75164	.73643	.72167
75	.79318	.77761	.76249	.74781	.73355
76	.80266	.78769	.77314	.75899	.74524
77	.81194	.79756	.78358	.76997	.75672
78	.82100	.80722	.79380	.78072	.76978
79	.82984	.81664	.80378	.79214	.77900
80	.83483	.82582	.81351	.80149	.78976
81	.84678	.83474	.82298	.81148	.80025
82	.85487	.84339	.83217	.82119	.81045
83	.86269	.85177	.84107	.83060	.82035
84	.87024	.85986	.84968	.83970	.82993
85	.87751	.86765	.85798	.84849	.83919
86	.88450	.87515	.86597	.85696	.84811
87	.89119	.88234	.87363	.86508	.85668
88	.89760	.88922	.88099	.87289	.86492
89	.90372	.89580	.88801	.88034	.87280
90	.90954	.90207	.89471	.88746	.88032
91	.91508	.90803	.90109	.89424	.88750
92	.92033	.91369	.90714	.90068	.89432
93	.92530	.91904	.91287	.90678	.90078
94	.92999	.92411	.91830	.91256	.90690
95	.93442	.92889	.92342	.91802	.91269
96	.93858	.93338	.92824	.92316	.91813

97	.94248	.93759	.93276	.92798	.92325
98	.94614	.94155	.93701	.93252	.92807
99	.94959	.94528	.94101	.93769	.93260
100	.95278	.94874	.94473	.94075	.93682
101	.95581	.95201	.94824	.94451	.94081
102	.95860	.95503	.95149	.94798	.94450
103	.96136	.95802	.95470	.95142	.94816
104	.96390	.96077	.95766	.95458	.95152
105	.96640	.96347	.96057	.95769	.95483
106	.96950	.96684	.96420	.96157	.95896
107	.97301	.97064	.96829	.96595	.96362
108	.97859	.97670	.97482	.97295	.97109
109	.98924	.98828	.98733	.98638	.98544

AGE	*3.2%*	*3.4%*	*3.6%*	*3.8%*	*4.0%*
0	.10741	.09528	.08476	.07564	.06772
1	.10451	.09209	.08131	.07194	.06379
2	.10740	.09476	.08376	.07420	.06586
3	.11054	.09767	.08647	.07670	.06817
4	.11385	.10076	.08935	.07938	.07066
5	.11730	.10399	.09237	.08220	.07329
6	.12089	.10736	.09553	.08515	.07605
7	.12460	.11085	.09880	.08822	.07892
8	.12844	.11477	.10221	.09142	.08193
9	.13243	.11824	.10576	.09476	.08507
10	.13655	.12214	.10945	.09824	.08835
11	.14081	.12619	.11328	.10187	.09177
12	.14521	.13037	.11724	.10563	.09533
13	.14972	.13466	.12132	.10949	.09900
14	.15430	.13903	.12547	.11344	.10273
15	.15894	.14344	.12968	.11743	.10652
16	.16361	.14790	.13391	.12145	.11034
17	.16834	.15241	.13821	.12554	.11421
18	.17314	.15699	.14258	.12969	.11815
19	.17803	.16167	.14703	.13393	.12218
20	.18304	.16646	.15161	.13289	.12633
21	.18817	.17138	.15631	.14277	.13060
22	.19342	.17642	.16114	.14739	.13500
23	.19882	.18161	.16612	.15215	.13955
24	.20440	.18699	.17128	.15710	.14429
25	.21018	.19256	.17655	.16226	.14924
26	.21616	.19835	.18224	.16764	.15440
27	.22236	.20436	.18804	.17324	.15980
28	.22877	.21058	.19407	.17907	.16542
29	.23537	.21701	.20031	.18511	.17126
30	.24216	.22362	.20674	.19135	.17730
31	.24914	.23044	.21338	.19779	.18355
32	.25631	.23745	.22022	.20455	.19002
33	.26368	.24467	.22727	.21133	.19671
34	.27123	.25207	.23451	.21839	.20360

35	.27896	.25967	.24195	.22567	.21070
36	.28688	.26746	.24961	.23317	.21803
37	.29499	.27546	.25746	.24087	.22557
38	.30330	.28366	.26554	.24880	.23334
39	.31179	.29205	.27381	.25694	.24133
40	.32046	.30064	.28229	.26529	.24954
41	.32932	.30942	.29097	.27386	.25797
42	.33836	.31840	.29986	.28264	.26662
43	.34760	.32758	.30897	.29165	.27552
44	.35702	.33697	.31829	.30088	.28465
45	.36663	.34655	.32782	.31033	.29400
46	.37644	.35634	.33757	.32002	.30360
47	.38642	.36633	.34753	.32992	.31343
48	.39660	.37652	.35770	.34006	.32351
49	.40696	.38691	.36810	.35043	.33383
50	.41754	.39754	.37874	.36106	.34442
51	.42832	.40838	.38961	.37194	.35528
52	.43931	.41945	.40073	.38307	.36641
53	.45050	.43074	.41208	.39446	.37781
54	.46186	.44222	.42364	.40607	.38945
55	.47338	.45387	.43540	.41789	.40131
56	.48501	.46565	.44729	.42987	.41335
57	.49675	.47755	.45932	.44201	.42555
58	.50858	.48956	.47147	.45427	.43790
59	.52050	.50167	.48375	.46668	.45041
60	.53253	.51392	.49617	.47925	.46310
61	.54465	.52627	.50872	.49196	.47595
62	.55683	.53870	.52136	.50478	.48892
63	.56907	.55120	.53409	.51770	.50200
64	.58134	.56375	.54688	.53071	.51519
65	.59367	.57637	.55976	.54381	.52849
66	.60615	.58916	.57283	.55713	.54203
67	.61874	.60208	.58605	.57062	.55575
68	.63140	.61509	.59938	.58423	.56963
69	.64409	.62815	.61277	.57973	.58360
70	.65680	.64124	.62621	.61168	.59764
71	.66951	.65434	.63968	.62549	.61776
72	.68220	.66745	.65317	.63933	.62593
73	.69484	.68051	.66662	.65315	.64009
74	.70735	.69346	.67997	.66688	.65417
75	.71971	.70625	.69318	.68048	.66813
76	.73187	.71886	.70621	.69390	.68192
77	.74382	.73127	.71904	.70713	.69553
78	.75556	.74346	.73166	.72016	.70894
79	.76706	.75542	.74405	.73296	.72213
80	.77830	.76711	.75618	.74550	.73507
81	.78927	.77853	.76803	.75777	.74773
82	.79994	.78966	.77959	.76974	.76009
83	.81030	.80047	.79083	.78139	.77214
84	.82035	.81095	.80174	.79271	.78385
85	.83005	.82110	.81230	.80368	.79521

86	.83942	.83089	.82251	.81428	.80619
87	.84843	.84031	.83234	.82450	.81679
88	.85708	.84938	.84180	.83434	.82700
89	.86537	.85806	.85087	.84378	.83681
90	.87329	.86637	.85954	.85282	.84620
91	.88085	.87429	.86783	.86146	.85518
92	.88803	.88184	.87572	.86969	.86374
93	.89484	.88899	.88321	.87751	.87188
94	.90130	.89578	.89032	.88493	.87961
95	.90741	.90220	.89706	.89197	.88694
96	.91316	.90825	.90340	.89859	.89385
97	.91857	.91395	.90937	.90484	.90036
98	.92367	.91931	.91500	.91073	.90650
99	.92846	.92346	.92030	.91628	.91299
100	.93292	.92906	.92523	.92144	.91769
101	.93715	.93352	.92992	.92635	.92281
102	.94105	.93763	.93424	.93088	.92754
103	.94492	.94171	.93853	.93528	.93224
104	.94848	.94547	.94248	.93951	.93657
105	.95199	.94917	.94637	.94359	.94083
106	.95636	.95379	.95123	.94868	.94616
107	.96131	.95901	.95672	.95455	.95219
108	.96923	.96739	.96555	.96373	.96191
109	.98450	.98356	.98623	.98170	.98077

AGE	*4.2%*	*4.4%*	*4.6%*	*4.8%*	*5.0%*
0	.06083	.05483	.04959	.04501	.04101
1	.05668	.05049	.04507	.04034	.03618
2	.05858	.05222	.04665	.04178	.03750
3	.06072	.05420	.04848	.04346	.03904
4	.06303	.05634	.05046	.04530	.04075
5	.06547	.05861	.05258	.04726	.04258
6	.06805	.06102	.05458	.04935	.04453
7	.07074	.06353	.05717	.05155	.04658
8	.07356	.06617	.05964	.05386	.04875
9	.07651	.06895	.06225	.05631	.05105
10	.07960	.07185	.06499	.05889	.05347
11	.08283	.07490	.06786	.06160	.05603
12	.08620	.07808	.07087	.06444	.05871
13	.08967	.08137	.07397	.06738	.06149
14	.09321	.08472	.07715	.07038	.06433
15	.09680	.08812	.08036	.07342	.06721
16	.10041	.09154	.08360	.07649	.07011
17	.10409	.09502	.08689	.07960	.07305
18	.10782	.09855	.09024	.08276	.07604
19	.11164	.10217	.09366	.08600	.07910
20	.11559	.10592	.09721	.08937	.08228
21	.11965	.10977	.10087	.09283	.08557
22	.12383	.11376	.10465	.09642	.08897
23	.12817	.11789	.10859	.10016	.09252
24	.13270	.12221	.11270	.10408	.09625

25	.13744	.12674	.11703	.10821	.10019
26	.14239	.13419	.12158	.11256	.10435
27	.14758	.13647	.12636	.11714	.10873
28	.15300	.14169	.13137	.12195	.11335
29	.15864	.14712	.13660	.12698	.11819
30	.16448	.15275	.14203	.13222	.12323
31	.17053	.15861	.14769	.13768	.12849
32	.17680	.16468	.15357	.14336	.13398
33	.18330	.17099	.15968	.14927	.13970
34	.19000	.17750	.16599	.15539	.14562
35	.19692	.18423	.17253	.16174	.15178
36	.20407	.19119	.17931	.16833	.15818
37	.21144	.19838	.18361	.17515	.16481
38	.21904	.20582	.19357	.18222	.17170
39	.22687	.21348	.20105	.18952	.17882
40	.23493	.22137	.21805	.19707	.18619
41	.24322	.22950	.21674	.20487	.19381
42	.25173	.23786	.22494	.21290	.20168
43	.26049	.24648	.23342	.22122	.20982
44	.26950	.25535	.24214	.22979	.21824
45	.27874	.26447	.25112	.23862	.22692
46	.28824	.27385	.26038	.24774	.23589
47	.29798	.28349	.26989	.25712	.24513
48	.30797	.29338	.27967	.26678	.25466
49	.31822	.30355	.28974	.27674	.26449
50	.32876	.31401	.30011	.28701	.27465
51	.33958	.32477	.31079	.29759	.28513
52	.35068	.33582	.32178	.30851	.29595
53	.36206	.34717	.33308	.31974	.30710
54	.37371	.35880	.34467	.33127	.31857
55	.38559	.37067	.35652	.34308	.33032
56	.39765	.38275	.36859	.35512	.34232
57	.40990	.39502	.38086	.37639	.35455
58	.42231	.40747	.39333	.37985	.36700
59	.43490	.42011	.40600	.39253	.37968
60	.44768	.43296	.41890	.40546	.39261
61	.46064	.44600	.43200	.41860	.40578
62	.47373	.45920	.44527	.43194	.41915
63	.48696	.47253	.45870	.44544	.43271
64	.50030	.48601	.47229	.45911	.44645
65	.51377	.49963	.48603	.47295	.46037
66	.52750	.51352	.50007	.48711	.47464
67	.54144	.52765	.51436	.50154	.48919
68	.55554	.54196	.52885	.51619	.50398
69	.56976	.55640	.54349	.53102	.51896
70	.58407	.57095	.55826	.54598	.53410
71	.59848	.58561	.57316	.56109	.54940
72	.61924	.60035	.58815	.57632	.56484
73	.62741	.61512	.60318	.59160	.58035
74	.64183	.62983	.61818	.60686	.59856

75	.65612	.64444	.63309	.62204	.61129
76	.67026	.65891	.64786	.63710	.62661
77	.68423	.67321	.66248	.65201	.64181
78	.69800	.68733	.67692	.66676	.65684
79	.71156	.70124	.69116	.68132	.67170
80	.72487	.71490	.70516	.69563	.68632
81	.73791	.72830	.71890	.70970	.70069
82	.75065	.74140	.73235	.72348	.71479
83	.76308	.75419	.74548	.73695	.72858
84	.77516	.76664	.75828	.75008	.74203
85	.78689	.77873	.77072	.76285	.75512
86	.79825	.79044	.78278	.77524	.76783
87	.80921	.80176	.79443	.78722	.78014
88	.81978	.81268	.80569	.79880	.79203
89	.82994	.82317	.81651	.80995	.80349
90	.83967	.83324	.82690	.82065	.81450
91	.84898	.84288	.83685	.83091	.82505
92	.85787	.85208	.84636	.84072	.83515
93	.86632	.86083	.85541	.85006	.84477
94	.87435	.86915	.86402	.85894	.85393
95	.88197	.87705	.87219	.86739	.86265
96	.88915	.88451	.87991	.87537	.87088
97	.89593	.89154	.88720	.88290	.87865
98	.90232	.89818	.89408	.89002	.88600
99	.90835	.90444	.90057	.89674	.89294
100	.91397	.91028	.90663	.90301	.89942
101	.91930	.91583	.91238	.90897	.90558
102	.92424	.92096	.91771	.91448	.91128
103	.92914	.92065	.92300	.91996	.91695
104	.93364	.93074	.92786	.92501	.92217
105	.93809	.93537	.93266	.92998	.92731
106	.94365	.94115	.93867	.93621	.93376
107	.94994	.94771	.94549	.94328	.94108
108	.96010	.95830	.95651	.95472	.95295
109	.97895	.97893	.97801	.97710	.97619

AGE	*5.2%*	*5.4%*	*5.6%*	*5.8%*	*6.0%*
0	.03749	.03441	.03170	.02931	.02721
1	.03254	.02934	.02652	.02403	.02183
2	.03373	.03042	.02750	.02492	.02264
3	.03516	.03173	.02871	.02603	.02366
4	.03674	.03319	.03006	.02729	.02483
5	.03844	.03478	.03153	.02866	.02610
6	.04026	.03647	.03312	.03014	.02749
7	.04217	.03826	.03479	.03171	.02895
8	.04421	.04017	.03658	.03338	.03053
9	.04637	.04220	.03849	.03518	.03222
10	.04865	.04435	.04052	.03709	.03402
11	.05106	.04663	.04267	.03912	.03594
12	.05360	.04903	.04494	.04127	.03798
13	.05623	.05152	.04729	.04816	.04010

14	.05892	.05406	.04971	.04579	.04227
15	.06164	.05664	.05214	.04810	.04445
16	.06438	.05923	.05459	.05041	.04664
17	.06716	.06185	.05707	.05276	.04886
18	.06998	.06452	.05959	.05514	.05111
19	.07288	.06726	.06218	.05758	.05341
20	.07589	.07010	.06487	.06012	.05582
21	.07900	.07305	.06765	.06276	.05831
22	.08223	.07610	.07055	.06550	.06090
23	.08559	.07930	.07358	.06837	.06363
24	.08914	.08267	.07678	.07141	.06651
25	.09289	.08625	.08018	.07465	.06960
26	.09686	.09003	.08380	.07810	.07288
27	.10106	.09405	.08764	.08177	.07639
28	.10549	.09829	.09171	.08567	.08012
29	.11013	.10275	.09598	.08977	.08406
30	.11498	.10742	.10047	.09408	.08820
31	.12006	.11230	.10517	.09860	.09255
32	.12535	.11741	.11009	.10335	.09712
33	.13088	.12275	.11525	.10832	.10192
34	.13661	.12829	.12061	.11350	.10693
35	.14258	.13408	.12621	.11892	.11217
36	.14879	.14009	.13204	.12457	.11764
37	.15523	.14635	.13811	.13046	.12335
38	.16193	.15287	.14444	.13661	.12932
39	.16887	.15962	.15102	.14300	.13544
40	.17606	.16663	.15784	.14965	.14201
41	.18350	.17390	.16493	.15656	.14873
42	.19120	.18141	.17227	.16372	.15572
43	.19918	.18922	.17990	.17118	.16301
44	.20742	.19370	.18781	.17892	.17057
45	.21595	.20566	.19600	.18694	.17843
46	.22476	.21431	.20450	.19527	.18659
47	.23386	.22326	.21328	.20390	.19505
48	.24325	.23250	.22238	.21283	.20383
49	.25294	.24206	.23179	.22210	.21294
50	.26298	.25196	.24156	.23172	.22242
51	.27335	.26221	.25168	.24170	.23226
52	.28407	.27282	.26216	.25206	.24249
53	.29513	.28378	.27301	.26279	.25309
54	.30651	.29507	.28420	.27388	.26406
55	.31820	.30668	.29572	.28529	.27537
56	.33014	.31855	.30751	.29699	.28697
57	.34233	.33068	.21957	.30898	.29887
58	.35474	.34304	.33188	.32121	.31103
59	.36740	.35567	.34446	.33374	.32348
60	.38033	.36858	.35733	.34656	.33625
61	.39351	.38175	.37048	.35968	.34933
62	.40690	.39514	.38387	.37305	.36367
63	.42049	.40876	.39749	.38666	.37625
64	.43428	.42258	.41133	.40051	.39010

65	.44827	.43662	.54540	.41460	.40420
66	.46262	.45103	.43987	.42911	.41872
67	.47727	.46578	.45468	.44397	.43363
68	.49218	.48079	.46978	.45915	.44887
69	.50731	.49603	.48513	.47458	.46438
70	.52260	.51147	.50069	.49025	.48013
71	.53808	.52710	.51646	.50615	.49614
72	.55371	.54291	.53243	.52225	.51237
73	.56943	.55882	.54851	.53849	.52876
74	.58516	.57476	.56464	.55480	.54523
75	.60083	.59065	.58074	.57109	.56169
76	.61640	.60646	.59676	.58731	.57810
77	.63186	.62215	.61269	.60345	.59444
78	.64717	.63772	.62849	.61948	.61068
79	.66230	.65312	.64414	.63537	.62680
80	.67721	.66830	.65959	.65106	.64272
81	.69188	.68235	.67481	.77754	.65844
82	.70628	.69674	.68977	.68176	.67391
83	.72037	.71232	.70443	.69669	.68909
84	.73413	.72638	.71877	.71130	.70396
85	.74753	.74008	.73275	.72556	.71849
86	.76055	.75340	.74636	.73944	.73264
87	.77316	.76630	.75956	.75292	.74638
88	.78536	.77880	.77234	.76598	.75971
89	.79712	.79085	.78467	.77859	.77259
90	.80843	.80244	.79655	.79073	.78500
91	.81298	.81358	.80795	.80241	.79693
92	.82966	.82423	.81888	.81360	.80838
93	.83955	.83440	.82931	.82428	.81931
94	.84898	.84409	.83925	.83447	.82975
95	.85795	.85331	.84872	.84419	.83970
96	.86643	.86203	.85768	.85338	.84912
97	.87444	.87028	.86616	.86208	.85804
98	.88202	.87808	.87418	.87031	.86649
99	.88918	.88546	.88177	.87811	.87449
100	.89587	.89234	.88885	.88539	.88196
101	.90223	.89890	.89560	.89233	.88908
102	.90811	.90496	.90184	.89875	.89568
103	.91397	.91100	.90806	.90514	.90225
104	.91935	.91656	.91379	.91103	.90830
105	.92467	.92204	.91943	.91683	.91426
106	.93133	.92892	.92651	.92413	.92176
107	.93890	.93673	.93457	.93242	.93028
108	.95118	.94942	.94767	.94593	.94420
109	.97529	.97438	.97348	.97259	.97170

AGE	*6.2%*	*6.4%*	*6.6%*	*6.8%*	*7.0%*
0	.02534	.02370	.02223	.02093	.01978
1	.01989	.01817	.01664	.01528	.01406
2	.02061	.01882	.01722	.01580	.01454

3	.02156	.01969	.01802	.01654	.01521
4	.02264	.02069	.01896	.01741	.01602
5	.02383	.02180	.01999	.01838	.01693
6	.02512	.02301	.02113	.01944	.01793
7	.02650	.02430	.02234	.02058	.01900
8	.02798	.02570	.02365	.02182	.02017
9	.02957	.02720	.02507	.02316	.02143
10	.03128	.02881	.02659	.02460	.02280
11	.03309	.03053	.02823	.02615	.02428
12	.03503	.03237	.02997	.02781	.02585
13	.03704	.03428	.03179	.02954	.02750
14	.03909	.03623	.03364	.03130	.02918
15	.04117	.03820	.03551	.03308	.03087
16	.04324	.04016	.03737	.03484	.03254
17	.04533	.04214	.03924	.03661	.03422
18	.04746	.04415	.04114	.03841	.03592
19	.04963	.04620	.04309	.04025	.03766
20	.05191	.04835	.04512	.04217	.03948
21	.05427	.05058	.04723	.04416	.04137
22	.05672	.05291	.04943	.04625	.04334
23	.05930	.05535	.05174	.04844	.04542
24	.06204	.05795	.05421	.05078	.04764
25	.06497	.06074	.05687	.05331	.05005
26	.06811	.06373	.05972	.05603	.05264
27	.07146	.06694	.06278	.05895	.05543
28	.07503	.07036	.06605	.06209	.05844
29	.07881	.07398	.06953	.06542	.06163
30	.08279	.07780	.07319	.06894	.06502
31	.08697	.08182	.07707	.07267	.06860
32	.09137	.08606	.08115	.07660	.07239
33	.09601	.09053	.08546	.08075	.07639
34	.10084	.09520	.08996	.08511	.08059
35	.10590	.10009	.09470	.08968	.08501
36	.11120	.10522	.09966	.09448	.08966
37	.11674	.11059	.10486	.09952	.09454
38	.12254	.11621	.11032	.10481	.09968
39	.12857	.12208	.11601	.11035	.10505
40	.13487	.12820	.12196	.11613	.11067
41	.14142	.13458	.12817	.12217	.11655
42	.14823	.14122	.13464	.12848	.12269
43	.15535	.14816	.14141	.13508	.12913
44	.16274	.15538	.14847	.14196	.13585
45	.17042	.16290	.15581	.14914	.14286
46	.17842	.17073	.16348	.15664	.15020
47	.18672	.17886	.17145	.16445	.15784
48	.19534	.18732	.17974	.17258	.16581
49	.20429	.19612	.18838	.18106	.17413
50	.21362	.20529	.19740	.18993	.18284
51	.22332	.21484	.20680	.19917	.19194
52	.23341	.22479	.21660	.20883	.20144
53	.24388	.23513	.22681	.21889	.21136

54	.25473	.24585	.23739	.22935	.22168
55	.26593	.25693	.24835	.24017	.23238
56	.27742	.26831	.25962	.25132	.24340
57	.28922	.28001	.27121	.26280	.25476
58	.30129	.29199	.28309	.27457	.26642
59	.31367	.30428	.29529	.28667	.27842
60	.32638	.31691	.30784	.29914	.29079
61	.33940	.32987	.32073	.31195	.30352
62	.35269	.34311	.33391	.32506	.31656
63	.36625	.35663	.34738	.33847	.32990
64	.38007	.37043	.36113	.35218	.34356
65	.39417	.38451	.37519	.36620	.35753
66	.40871	.39905	.38972	.38071	.37201
67	.42365	.41400	.40468	.39567	.38696
68	.43892	.42931	.42001	.41101	.40230
69	.45450	.44493	.43567	.42670	.41800
70	.47033	.46083	.45162	.44269	.43403
71	.48644	.47702	.46788	.45901	.45040
72	.50278	.49347	.48441	.47562	.46707
73	.51930	.51010	.50115	.49245	.48399
74	.53591	.52684	.51802	.50943	.50106
75	.55253	.54361	.53492	.52645	.51820
76	.56912	.56036	.55182	.54349	.53536
77	.58565	.57706	.56868	.56050	.55251
78	.60209	.59369	.58549	.57747	.56963
79	.61841	.61021	.60219	.59435	.58668
80	.63456	.62657	.61875	.61109	.60359
81	.65050	.64273	.63512	.62766	.62034
82	.66621	.65867	.65127	.64401	.63690
83	.68164	.67433	.66716	.66012	.65321
84	.69676	.68969	.68275	.67593	.66923
85	.71154	.70472	.69801	.69141	.68493
86	.72595	.71937	.71290	.70654	.70028
87	.73995	.73362	.72740	.72127	.71523
88	.75354	.74746	.74148	.73558	.72978
89	.76668	.76085	.75511	.74945	.74387
90	.77934	.77377	.76827	.76284	.75749
91	.79153	.78620	.78094	.77575	.77063
92	.80323	.79814	.79312	.78816	.78326
93	.81440	.80956	.80477	.80004	.79536
94	.82508	.82047	.81591	.81140	.80694
95	.83526	.83088	.82654	.82225	.81800
96	.84491	.84074	.83662	.83254	.82850
97	.85405	.85009	.84617	.84230	.83846
98	.86270	.85895	.85523	.85155	.84791
99	.87090	.86735	.86382	.86033	.85687
100	.87856	.87519	.87185	.86854	.86526
101	.88587	.88268	.87952	.87638	.87327
102	.89263	.88961	.88662	.88364	.88069
103	.89938	.89653	.89370	.89089	.88810
104	.90558	.90289	.90021	.89756	.89492

105	.91170	.90916	.90664	.90413	.90164
106	.91940	.91706	.91474	.91242	.91013
107	.92816	.92605	.92395	.92186	.91987
108	.94247	.94075	.93904	.93734	.93565
109	.97081	.96992	.96904	.96816	.96729

TABLE 2000CM

Age x	*l(x)*	*Age x*	*l(x)*	*Age x*	*l(x)*
(1)	(2)	(1)	(2)	(1)	(2)
0	100000	37	96921	74	66882
1	99305	38	96767	75	64561
2	99255	39	96600	76	62091
3	99222	40	96419	77	59476
4	99197	41	96223	78	56721
5	99176	42	96010	79	53833
6	99158	43	95782	80	50819
7	99140	44	95535	81	47694
8	99124	45	95268	82	44475
9	99110	46	94981	83	41181
10	99097	47	94670	84	37837
11	99085	48	94335	85	34471
12	99073	49	93975	86	31114
13	99057	50	93591	87	27799
14	99033	51	93180	88	24564
15	98998	52	92741	89	21443
16	98950	53	92270	90	18472
17	98891	54	91762	91	15685
18	98822	55	91211	92	13111
19	98745	56	90607	93	10773
20	98664	57	89947	94	8690
21	98577	58	89225	95	6871
22	98485	59	88441	96	5315
23	98390	60	87595	97	4016
24	98295	61	86681	98	2959
25	98202	62	85691	99	2122
26	98111	63	84620	100	1477
27	98022	64	83465	101	997
28	97934	65	82224	102	650
29	97844	66	80916	103	410
30	97750	67	79530	104	248
31	97652	68	78054	105	144
32	97549	69	76478	106	81
33	97441	70	74794	107	43
34	97324	71	73001	108	22
35	97199	72	71092	109	11
36	97065	73	69056	110	0

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7

Structuring the Trust Instrument

Jeffrey A. Dennis-Strathmeyer

I. RECOMMENDED TRUST DESIGN §7.1

II. DRAFTING CONSIDERATIONS

A. The Audience §7.2

B. Required Formalities §7.3

C. Clauses Mandated by Tax Laws §7.4

D. Narrow Focus—Comparison With Revocable Trusts §7.5

E. Tax-Sensitive Powers §7.6

F. California Trust Law §7.7

III. PROPOSED ORGANIZATION §7.80

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§7.1 I. RECOMMENDED TRUST DESIGN

This chapter addresses basic questions users may have concerning the general overall organization of irrevocable trust instruments. It is appropriate to begin that discussion by emphasizing that there is no single "right" way to draft these documents. There are few statutory requirements for a valid trust, and drafting practices vary considerably by locality, practitioner taste and philosophy, demands of the practitioner's drafting system, and the demands of the practitioner's firm. Nevertheless, it is appropriate that a drafting book make some general recommendations concerning trust design in order to provide guidance to less experienced practitioners.

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II. DRAFTING CONSIDERATIONS

§7.2 A. The Audience

At the risk of stating the obvious, it is helpful to remember that the purpose of a trust instrument is to convey information to the various members of an intended audience. That audience potentially includes the settlor, the trustee, the beneficiaries, the family CPA, the Internal Revenue Service, the local Superior Court judge, and various third parties who may conduct business with the trustee. This is typically a very disparate group in terms of education in general, and knowledge of trusts and taxes in particular. Writing a document that can be understood by all of these persons can be a challenging task. Indeed, it is not rare to encounter an experienced practitioner who claims to have abandoned much of the task in favor of simply making sure the document will not be misinterpreted by the IRS or the courts, reasoning that other interested parties can be educated by use of separately stated explanations.

For those not yet willing to abandon the effort of drafting an understandable document, the following suggestions may be helpful:

- Keep the document short. This not only helps the reader, but it helps the drafter.
- Organize the document by logical topics.
- Put the most important information near the beginning of the document.
- Use informative headings (and do not nullify them with a boilerplate provision that says to ignore them).
- Separate less substantive boilerplate from the more substantive clauses. Remember that the user of an automobile should be able to find out how to turn the headlights on and off without having to read wiring diagrams. The same applies to a trust.
- Include one or more clauses near the beginning of the document that state the purpose of the trust and any special intended tax consequences. See, *e.g.,* the "Statement of Intent" clause for the qualified personal residence trust at §17.64.
- Avoid overly subtle cross-references with respect to provisions determining rights to receive distributions. For example, if a trust will contain a definition of "issue," the definition usually should be placed in the portion of the trust containing distribution provisions, and the references to "issue" should alert the reader that the term has a definition within the document. Particularly in the case of more lengthy documents, the often-encountered drafting technique of putting all definitions in one place, usually amidst boilerplate at the end of the document, is burdensome for the reader and creates uncertainty as to whether the settlor (or even the drafter) was fully aware of the definition each time the word was used.
- Do not hide important provisions in the boilerplate. For example, a distribution power should not be located in the middle of a list of routine administration powers.

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§7.3 B. Required Formalities

Assuming the use of a written instrument, a trust may take the form of a conveyance signed by the settlor or the settlor's authorized agent, or a declaration signed by the trustee. Prob C §§15200, 15206. In the case of an irrevocable trust, it is imperative that the trust state that it cannot be amended or revoked. Prob C §15400. No other formality is required, although acknowledgment before a notary is customary. Suitable clauses for satisfying the statute are found in chap 8.

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§7.4 C. Clauses Mandated by Tax Laws

In many cases a trust will not qualify for desired tax treatment unless it contains certain express provisions mandated by the Internal Revenue Code or Treasury Regulations. Trusts subject to such requirements include charitable trusts subject to IRC §664, qualified personal residence trusts (QPRTs), other trusts involving retained interests and therefore subject to the special valuation rules of IRC §2702, and qualified domestic trusts (QDOTs), which are used to obtain a marital deduction for a transfer to a surviving spouse who is not a citizen of the United States. IRC §§2056(d), 2056A.

In some cases, particularly those involving charitable trusts, the IRS has published prototype language, and even complete forms, that may be used to satisfy the regulatory requirements. In such situations, it may be desirable to include all mandatory language at a single location in the trust instrument, thereby making it easier to demonstrate compliance. This also makes it easier to update the form as regulations change, and can serve as a reminder that these particular provisions cannot be altered when using the same form for another client.

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§7.5 D. Narrow Focus—Comparison With Revocable Trusts

In one significant way, it is often much easier to draft an irrevocable trust than a revocable one. The typical revocable trust will often remain in effect for many years before the majority of its provisions have much significance; and the assets of the trust typically are not well-managed assets suitable for a trust, but rather the odd and ever-changing accumulations of persons going about daily life. Also, revocable trusts have multiple beneficiaries by their nature (a minimum of a settlor and someone else).

In contrast, many irrevocable trusts have very short terms, are funded with very specific assets, and may benefit only a single beneficiary. Further, the most significant tax event is often the gift that occurs on initial transfer.

As a result of these and similar comparisons, it is often possible to draft an irrevocable trust that is far shorter and more narrowly focused on a specific task than is the case with a revocable trust.

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§7.6 E. Tax-Sensitive Powers

One of the most challenging tasks involved in drafting an irrevocable trust is to be sure that the trust results in desired tax treatment for income tax and transfer tax purposes. If it is undesirable that a trust be deemed owned by the settlor for income tax purposes, considerable care must be exercised to avoid giving the settlor or specified other persons any powers that will trigger application of the grantor trust rules. IRC §§671-679. See §§3.22-3.44. See also Zaritsky, *Grantor Trusts: Sections 671-679*, Tax Management Portfolios 858-2d (2001). For estate tax purposes, it is generally important that the settlor not have a power that will result in trust property being included in the settlor's estate, or, in the case of retained interest trusts, that any such power terminate on expiration of the retained interest. See generally Lischer, *Incomplete Lifetime Transfers: Retained Powers Under Sections 2036(a)(2) and 2038*, Tax Management Portfolios 50-6th (2008). See also §2.48.

When generation-skipping transfer tax is a consideration, it is not only important that the trust not be includable in the estate of the settlor at the time of the settlor's death (except during the intentionally retained term of a retained interest trust), but it is also important to avoid periods before death during which the trust estate would have been included in the estate of the settlor or the spouse of the settlor if either had died at the time. See the discussions of the estate tax inclusion period (ETIP) rule at §§4.29, 4.41.

Finally, it is often the case that tax objectives will be defeated if a beneficiary or the settlor's spouse is given a general power of appointment under IRC §2041. This typically requires imposing limitations on the distribution powers of such persons. See §§9.54-9.57.

In each case, the risk that the drafter will inadvertently provide the settlor or some other person who will have an undesirable power can be reduced by using a short document with logical organization.

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§7.7 F. California Trust Law

Particularly in cases where there is little likelihood that the trust will be involved in out-of-state transactions, documents can be shortened considerably by simply relying on the California Trust Law (Prob C §§15000-19403), preferably with an express reference to the applicable provisions of the statute. This can be particularly helpful in reducing the list of trustee powers. See §10.57 for a form incorporating the statutory powers. See also Prob C §§18100-18100.5, which significantly minimize the need of third parties to inquire into the powers of a trustee.

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§7.8 III. PROPOSED ORGANIZATION

The following outline for a generic irrevocable trust can be adapted by practitioners to meet the needs of particular trust documents. The basic flow of the organization scheme is: (1) establish the entity, (2) state the distribution rights, and (3) provide the housekeeping rules.

Article One: Creation of the Trust

Conveyance or declaration creating the trust

Authorization to make additions to the trust

Statement of the name of the trust

Statement of purpose of the trust

Declaration that the trust is irrevocable

Article Two: Trustees

Naming of regular trustees and successors

Naming of independent "special trustee" and successors

Naming of persons prohibited from being a trustee

Article Three: Distribution of trust estate

Granting of *Crummey* withdrawal powers

Distributions to be made if all goes as planned

Distributions in the event of unexpected events

Distributions to persons under a specified age

Distributions to incompetent persons

Prohibitions against trustee making any discretionary distributions to or for self or any person the trustee has a legal obligation to support.

Statement of distribution duties of independent special trustee

Power to terminate small trust.

Article Four: Trustee Powers

Article Five: Tax Objectives and Savings Clauses.

General statement of tax objectives and prohibition of trustee taking any action that would prevent accomplishment

Prohibition against exercising any power for the benefit of the settlor

Limitations on powers of the settlor (if settlor is trustee or otherwise has any powers)

Article Six: Miscellaneous Administration Provisions

Trustee compensation

Accounting

Rule-Against-Perpetuities clause

Spendthrift clause

Choice-of-Law clause

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8

Introductory and Basic Clauses

Sandra J. Chan
Diana Hastings Temple

I. INTRODUCTORY CLAUSES
- A. Creation of Trust §8.1
  - 1. Form: Trust Agreement §8.2
  - 2. Form: Declaration of Trust §8.3
  - 3. Form: Transfer Document §8.4
- B. Form: Name of Trust §8.5

II. IRREVOCABILITY
- A. Statutory Presumption of Revocability §8.6
- B. Form: Irrevocability of Trust §8.7

III. CONCLUDING CLAUSES
- A. Signatures
  - 1. Form: Signature When Agreement of Trust Is Used §8.8
  - 2. Form: Signature When Declaration of Trust Is Used §8.9
- B. Form: Spouse's Consent to Transfer §8.10
- C. Acknowledgments
  - 1. Purpose of Acknowledgment §8.11
  - 2. Form: Acknowledgment §8.12

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I. INTRODUCTORY CLAUSES

§8.1 A. Creation of Trust

Either a declaration of trust or a trust agreement may be used to create a trust. Although some practitioners use declarations when the settlor is also the trustee and agreements when the settlor and trustee are different, no distinction is required in practice. The use of an agreement or a declaration is largely a matter of personal preference.

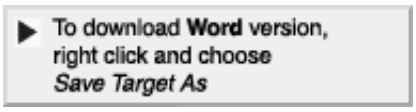
The forms in §§8.2-8.3 provide for optional use of schedules that list all assets transferred to the trust. When the settlor declares himself or herself to be the trustee of the property, a trust may be created in property listed in a written schedule of property intended to be in the trust, without a transfer of title to the trust. See *Estate of Heggstad* (1993) 16 CA4th 943, 20 CR2d 433 (written declaration of trust by owner of real property sufficient to create trust in that property; transfer of title to trust not necessary).

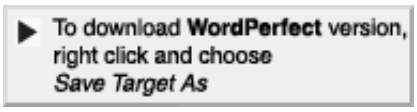
Some attorneys prefer to nominally fund the trust and add to the trust using a separate transfer document, instead of attaching schedules to the trust instrument. If the transfer must be recorded, only the transfer document must be recorded—not the entire trust instrument. For a separate transfer document, see §8.4.

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Source: Estate Planning/Drafting California Irrevocable Trusts/8 Introductory and Basic Clauses/§8.2 1. Form: Trust Agreement

§8.2 1. Form: Trust Agreement





8.2-1 Trust agreement

This agreement is made between _ _[*name of settlor*]_ _ (called the "settlor") and _ _[*name of trustee*]_ _, as trustee. The settlor hereby transfers and delivers to the trustee, without consideration, _ _[*ten dollars ($10) or more/the property described in Schedule A, attached to this trust*]_ _. All property subject to this trust from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.

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Source: Estate Planning/Drafting California Irrevocable Trusts/8 Introductory and Basic Clauses/§8.3 2. Form: Declaration of Trust

§8.3 2. Form: Declaration of Trust

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8.3-1 Declaration of trust

[*Use one of the following alternatives*]

[*Alternative 1: Settlor as trustee*]

***Declaration of Trust*. _ _**[*Name of settlor(s)*]**_ _ (called the settlor(s) or the trustee(s), depending on the context) declare(s) that _ _**[*he/she/they*]**_ _ _ _**[*has/have*]**_ _ set aside and hold(s) in trust _ _**[*ten dollars ($10) or more/the property described in Schedule A, attached to this trust*]**_ _. All property subject to this trust from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.**

[*Alternative 2: Nonsettlor as trustee*]

***Transfer to Trust*. _ _**[*I/We*]**_ _, _ _**[*name(s) of settlor(s)*]**_ _ (called the settlor(s)), hereby transfer and deliver to _ _**[*name of trustee*]**_ _ (called the trustee), without consideration, _ _**[*ten dollars ($10) or more/the property described in Schedule A, attached to this trust*]**_ _. All property subject to this trust from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.**

Comment: When the settlor and trustee are not the same person, the declaration of trust may take the form of a transfer to the trustee as provided in Alternative 2.

When a settlor is the trustee, the trustee's powers and discretion must be more limited than those of an independent trustee to avoid adverse tax effects. See §§10.3-10.6.

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§8.4 3. Form: Transfer Document

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8.4-1 Transfer of additional property to trust

Transfer of Additional Property to Trust

***Transfer to Trust*. _ _[*Name of settlor*]_ _ hereby transfers the following property to _ _[*name of trustee*]_ _, trustee under that certain irrevocable trust agreement dated _ _[*date*]_ _, by and between _ _[*name*]_ _, as settlor and _ _[*name*]_ _, as trustee. The settlor hereby appoints the trustee and the trustee's successors in office as the settlor's attorney-in-fact, with durable power of attorney unaffected by the settlor's subsequent incapacity, for the purpose of completing any additional documentation desirable in connection with the transfer of the following property to that trustee:** _ _[*List all property transferred, e.g., cash; securities and brokerage accounts; real property (including the APN); partnerships and closely held business interests; tangible personal property, including household or office furniture, furnishings, and equipment, works of art, clothing, jewelry, personal effects, boats, airplanes, automobiles, and other vehicles; and miscellaneous property, including other real, personal, or mixed tangible or intangible property of every kind and description now or at any time hereafter owned by or standing in the settlor's name or in which he or she has any interest*]_ _.

Executed at _ _[*city*]_ _**, California, on** _ _[*date*]_ _**.**

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

Acknowledgment of Receipt

The undersigned, trustee under the above trust, hereby acknowledges receipt of the above-described property.

Date: _ _ _ _ _ _

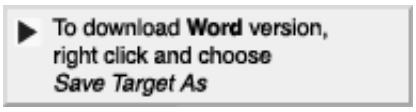
__[*Signature of trustee*]__
_ _[*Typed name*]_ _
Trustee

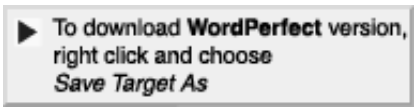
[*Acknowledgement; see §8.12*]

Comment: A separate transfer document may be used in lieu of the Schedule A method of funding. On acknowledgment, see §8.11.

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§8.5 B. Form: Name of Trust





8.5-1 Name of trust

***Name of Trust*. The trust(s) created by this instrument may be referred to collectively as the _ _[*full name(s) of settlor(s) and year established, e.g., John J. Smith _ _[and Mary L. Smith*]_ _ *1996 Trust*]_ _. Each separate trust created by this instrument may be referred to by adding the name of its beneficiary to that name.**

Comment: Although this clause is not essential, it is often useful in dealing with third parties—especially when the settlors have established several trusts in a single document.

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II. IRREVOCABILITY

§8.6 A. Statutory Presumption of Revocability

Unlike most jurisdictions, all voluntary trusts in California are revocable unless expressly made irrevocable by the terms of the governing instrument. Prob C §15400. Because any tax objectives (see §§1.4-1.5) cannot be achieved unless the instrument is irrevocable, a clause specifically prohibiting revocation must be included in any trust instrument designed to produce tax savings.

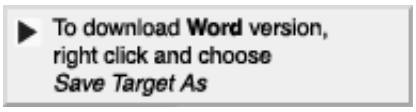
The drafter's inadvertent silence on this subject can lead to disaster. See, *e.g., Newman v Commissioner* (9th Cir 1955) 222 F2d 131; *Estate of Alvin Hill* (1975) 64 TC 867, acq 1976-2 Cum Bull 2, aff'd without published opinion (5th Cir 1978) 568 F2d 1365. The tax authorities generally will not recognize a retroactive reformation of the trust for tax purposes. *Newman v Commissioner, supra*; *Gaylord v Commissioner* (9th Cir 1946) 153 F2d 408. But see *Flitcroft v Commissioner* (9th Cir 1964) 328 F2d 449 (state court judgment of reformation given effect for federal estate tax purposes when there was convincing evidence of parties' intention and Internal Revenue Service was given notice of state court proceeding). See also *Bilafer v Bilafer* (2008) 161 CA4th 363, 73 CR3d 880 (settlor of irrevocable trust has standing to seek court reformation of trust to conform trust to settlor's intent).

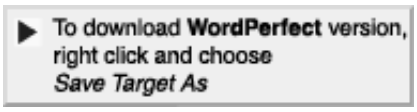
The attorney should carefully explain the effects of irrevocability and record the fact that the clients understood the consequences and still wished to proceed. The clients must be made aware that the trustee who accepts such a trust also accepts the duty to defend it from attack, including attack by the settlors. In discharging this duty, the trustee is entitled to allowance of reasonable attorney fees and costs. Thus, the clients, in effect, pay for both sides of the fight.

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Source: Estate Planning/Drafting California Irrevocable Trusts/8 Introductory and Basic Clauses/§8.7 B. Form: Irrevocability of Trust

§8.7 B. Form: Irrevocability of Trust





8.7-1 Irrevocability of trust

***Irrevocability of Trust*. This trust _ _[*agreement*]_ _ is irrevocable and the _ _[*settlor has/settlors have*]_ _ no powers of amendment.**

Comment: Powers that fall short of a power to revoke may nonetheless cause a settlor to lose the tax advantages intended to be realized from the trust. See §§2.58-2.62. On the relationship between revocation and amendment, see Drafting California Revocable Trusts, chap 20 (4th ed Cal CEB 2003).

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Source: Estate Planning/Drafting California Irrevocable Trusts/8 Introductory and Basic Clauses/ III. CONCLUDING CLAUSES/ A. Signatures/§8.8 1. Form: Signature When Agreement of Trust Is Used

III. CONCLUDING CLAUSES

A. Signatures

§8.8 1. Form: Signature When Agreement of Trust Is Used

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8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _**, California, on** _ _[*date*]_ _**.**

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor _ _[*and Trustee*]_ _

__[*Signature of individual trustee*]__
_ _[*Typed name*]_ _
Trustee

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

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Source: Estate Planning/Drafting California Irrevocable Trusts/8 Introductory and Basic Clauses/§8.9 2. Form: Signature When Declaration of Trust Is Used

§8.9 2. Form: Signature When Declaration of Trust Is Used

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8.9-1 Signature when declaration of trust is used

Executed at _ _[*city*]_ _**, California, on** _ _[*date*]_ _**.**

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor _ _[*and Trustee*]_ _

Acceptance by Trustee

I certify that I have read the foregoing trust instrument and that I accept the trust estate on the terms and conditions under which it is to be administered by the trustee.

Date: _ _ _ _ _ _

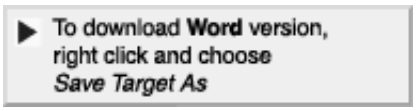
__[*Signature of individual trustee*]__
_ _[*Typed name*]_ _
Trustee

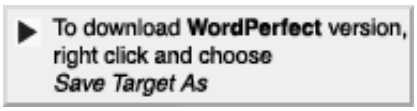
_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

Comment: Acceptance by the trustee is unnecessary if a settlor is serving as the sole trustee.

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§8.10 B. Form: Spouse's Consent to Transfer





8.10-1 Spouse's consent to transfer

I, _ _[*name*]_ _, the settlor's spouse, hereby consent to transfer of the property described in Schedule A, attached to this trust.

Comment: Even if the property being transferred to the trust is considered to be the settlor's separate property, it is advisable to have the nontransferring spouse or registered domestic partner (Fam C §297.5) sign a consent to the transfer in the event the property turns out to be quasi-community or community property. For a case in which failure to obtain a spouse's consent led to a professional malpractice case, see *Sindell v Gibson Dunn & Crutcher* (1997) 54 CA4th 1457, 63 CR2d 594.

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C. Acknowledgments

§8.11 1. Purpose of Acknowledgment

A single, all-purpose form of acknowledgment is provided in CC §1189(a). The statutory form should not be varied by the drafter. See form in §8.12. An acknowledgment of an instrument executed by an authorized person on behalf of an incorporated or unincorporated entity is prima facie evidence that the instrument was executed by the entity and conclusive evidence of its proper execution in favor of any good faith purchasers, lessees, and encumbrancers. CC §1190.

Neither acknowledgment nor recordation of the trust instrument is necessary for the trust to be valid. In fact, it may be preferable not to record the trust instrument, because lack of knowledge of trust terms permits third parties to deal freely with a trustee without further inquiry about restrictions contained in the instrument.

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Source: Estate Planning/Drafting California Irrevocable Trusts/8 Introductory and Basic Clauses/§8.12 2. Form: Acknowledgment

§8.12 2. Form: Acknowledgment

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8.12-1 Acknowledgment

State of California)
)
County of _ _[*name of county*]**_ _)**
)
_____)

On _ _[*date*]**_ _ before me, _ _**[*name and title of officer*]**_ _, personally appeared _ _**[*name(s)*]**_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

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9

Dispositive Clauses

John R. Cohan

I. DISTRIBUTION CLAUSES
- A. Outright Distribution of Trust Assets on Termination of Trust
  - 1. Termination and Distribution on Settlor's Death §9.1
    - a. Survivorship Period §9.2
    - b. Multiple Beneficiaries §9.3
    - c. Minor Beneficiaries §9.4
    - d. Form: Distribution on Settlor's or Surviving Settlor's Death §9.5
  - 2. Termination and Distribution When Trust Is Small
    - a. When Termination and Distribution Are Appropriate for Small Trust §9.6
    - b. Form: Distribution When Trust Is Small §9.7
- B. Sprinkling Trust
  - 1. Description of Sprinkling Trust §9.8
  - 2. Form: Sprinkling Trust §9.9
  - 3. Sprinkling Power Exercised by Special Trustee
    - a. Purpose of Sprinkling Power §9.10
    - b. Form: Sprinkling Power Exercised by Special Trustee §9.11
    - c. Form: Power Granted to Special Trustee to Add Beneficiaries of Named Class §9.11A
  - 4. Tax Considerations for Sprinkling Trust
    - a. Estate Tax on Sprinkling Trust §9.12
    - b. Gift Tax on Sprinkling Trust §9.13
    - c. Income Tax on Trust Income §9.14
    - d. Generation-Skipping Transfer Tax on Sprinkling Trust Distributions §9.14A
  - 5. Form: Substitution of Independent Trustee §9.15
- C. Sprinkling Trust (Income Only, Ascertainable Standard)
  - 1. Description of Income-Only Sprinkling Trust §9.16
  - 2. Form: Sprinkling Trust (Income Only, Ascertainable Standard) §9.17
  - 3. Tax Considerations for Income-Only Sprinkling Trust
    - a. Estate, Gift, and Generation-Skipping Transfer Tax on Sprinkling Trust §9.18
    - b. Income Tax on Trust Income §9.19
- D. Single Trust With Discretion to Distribute Principal
  - 1. Description of Discretionary Trust §9.20
  - 2. Form: Single Trust (Discretion to Distribute Principal) §9.21
  - 3. Form: Separate Shares (Discretion to Distribute Principal) §9.21A
  - 4. Tax Considerations for Discretionary Trust
    - a. Estate Tax on Discretionary Trust §9.22
    - b. Gift Tax on Discretionary Trust §9.23
    - c. Income Tax on Trust Income §9.24
    - d. Generation-Skipping Transfer Tax on Discretionary Trust §9.24A
- E. Separate Trust for Each Beneficiary
  - 1. Description of Separate Trust §9.25
  - 2. Forms for Separate Trusts
    - a. Form: Separate Trust for Each Beneficiary §9.26
    - b. Form: Distribution of Income and Principal or Accumulation of Income During Child's Minority §9.27
    - c. Form: Distribution After Child Reaches Age 21 §9.28
  - 3. Tax Considerations for Separate Trusts
    - a. Estate and Gift Tax on Trust §9.29
    - b. Income Tax on Trust Income §9.30
    - c. Generation-Skipping Transfer Tax on Trust Distributions §9.30A
- F. Accumulation Trust
  - 1. Description of Accumulation Trust §9.31
  - 2. Forms for Accumulation Trust
    - a. Form: Accumulation of Income §9.32
    - b. Form: Distribution if No Issue §9.33

3. Tax Considerations for Accumulation Trust
a. Estate and Gift Tax on Trust §9.34
b. Income Tax on Trust Income §9.35
4. Escape From Trust Rate Compaction
a. Desirability of Escape Hatch §9.36
b. Form: Special Power of Invasion §9.37
5. Less Significant Exceptions to IRC §674 §9.38
a. Power to Apply Income to Satisfy Support Obligation §9.38A
b. Power Affecting Beneficial Enjoyment Only After Occurrence of Event §9.38B
c. Testamentary Power of Appointment §9.38C
d. Power to Allocate Among Charitable Beneficiaries §9.38D
e. Power to Withhold Income During Disability of Beneficiary §9.38E
f. Power to Allocate Between Corpus and Income §9.38F
G. Hybrid Trusts
1. Income Tax Considerations for Hybrid Trust §9.39
2. Estate and Gift Tax Considerations for Hybrid Trust §9.40
H. Annuity Trusts and Unitrusts
1. Purpose of Annuity Trust and Unitrust §9.41
2. Forms for Annuity Trust and Unitrust
a. Form: Annuity Trust §9.42
b. Form: Unitrust §9.43
3. Tax Considerations for Annuity Trust and Unitrust
a. Estate and Gift Tax on Trust §9.44
b. Income Tax on Trust Income §9.45

II. OTHER CLAUSES FOR PERMANENT TRUSTS
A. Miscellaneous Trust Clauses §9.46
1. Form: Preventing Outright Distributions to Minors and Others §9.47
2. Form: Survivorship Clause §9.48
3. Form: Distribution of Remainder §9.49
4. Form: Distribution to CUTMA Custodian §9.49A
B. Beneficiary as Trustee
1. Problems of Nonsettlor Beneficiary §9.50
2. Form: Beneficiary as Trustee §9.51
3. Tax Considerations for Nonsettlor Beneficiary
a. Estate and Gift Tax on Trust §9.52
b. Income Tax on Trust Income §9.53
C. Additional Considerations
1. Powers of Appointment
a. Purpose of Powers of Appointment §9.54
b. Form: Power of Appointment Created §9.55
c. Tax Considerations in Creating and Exercising Power of Appointment
(1) Estate and Gift Tax on Trust §9.56
(2) Income Tax on Trust Income §9.57
2. Perpetuities Clause
a. Rule Against Perpetuities §9.58
b. Form: Perpetuities Savings Clause Trust Including Power of Appointment §9.59
3. Generation-Skipping Transfer Tax §9.60
4. Retention of Reversionary Interest §9.61
5. Marital Deduction §9.62
D. Guidelines for Exercising Discretion to Distribute §9.63
E. Protecting the Spendthrift
1. When Spendthrift Protection Necessary §9.64
2. Form: Spendthrift Settlor Clause §9.65
3. Tax Considerations in Spendthrift Trust
a. Estate and Gift Tax on Trust §9.66
b. Income Tax on Trust Income §9.67
F. When Disclaimers Effective §9.68

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I. DISTRIBUTION CLAUSES

A. Outright Distribution of Trust Assets on Termination of Trust

§9.1 1. Termination and Distribution on Settlor's Death

Most settlors, particularly those without minor beneficiaries or without sizable estates, do not wish their trusts to continue for any appreciable time beyond their lifetimes. For these settlors, the distribution clauses of the trust need only direct how the trust assets should be distributed on their deaths, although, as discussed in this chapter, a settlor may want to authorize predeath distributions to maintain flexibility. In the case of married settlors, final distribution clauses are often made effective on the death of the second spouse.

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§9.2 a. Survivorship Period

In drafting clauses to distribute trust assets outright, the attorney should consider (1) whether a beneficiary must survive the settlor to be entitled to a gift, and (2) the consequences of a beneficiary's failure to satisfy a survival requirement.

The trust should clearly specify the settlor's desires concerning a survival requirement. Absent an express survival clause, the successor trustee or the court will have to interpret the trust to ascertain whether there is an implied survival requirement. See 3 Scott & Ascher on Trusts §13.2.9 (5th ed 2007). If a survival requirement is implied and not met and no alternate disposition is provided, the gift usually will pass under the residuary clause of the trust. If no survival requirement is deemed implied and the beneficiary dies before distribution, distribution will be made to the beneficiary's estate or the persons entitled to that estate.

For further discussion of survivorship clauses, see Drafting California Revocable Trusts §8.20 (4th ed Cal CEB 2003). For a form of clause, see §9.48.

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§9.3 b. Multiple Beneficiaries

If there are multiple beneficiaries, the trust must describe what shares they will take and provide alternative distributive patterns if one or more beneficiaries do not survive to take their share. The trust could provide, for example, that the remaining beneficiaries would split the deceased beneficiary's gift equally.

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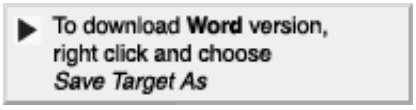
§9.4 c. Minor Beneficiaries

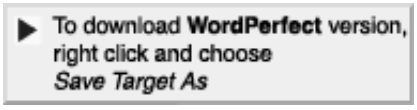
If distributions are to be made to "issue" or may otherwise result in distributions to minors, the drafter should include a clause providing either for a continuing trust for the minor's benefit or for distribution to a third party to hold or administer for the minor beneficiary. Particularly for small gifts, distribution to a custodian under the California Uniform Transfers to Minors Act (Prob C §§3900-3925) may be desirable because it allows the trust to be terminated. For a form, see §9.49A.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.5 d. Form: Distribution on Settlor's or Surviving Settlor's Death

§9.5 d. Form: Distribution on Settlor's or Surviving Settlor's Death





[*Use one of the following alternatives*]

[*Alternative 1: Outright distribution to one adult beneficiary*]

***Distribution on Settlor's Death*. After the death of the _ _[*settlor/surviving settlor*]_ _, the trustee shall distribute the balance of the trust estate to _ _[*name of beneficiary*]_ _ if _ _[*he/she*]_ _ survives the _ _[*settlor/surviving settlor*]_ _ by _ _[*number*]_ _ days. If _ _[*name of beneficiary*]_ _ fails to survive the _ _[*settlor/surviving settlor*]_ _, the trustee shall distribute the balance of the trust estate to _ _[*name of alternate beneficiary*]_ _ if _ _[*he/she*]_ _ so survives.**

[*Alternative 2: Outright distribution to multiple beneficiaries*]

After the death of the _ _[*settlor/surviving settlor*]_ _, the trustee shall distribute the balance of the trust estate as follows:

(1) _ _[*Number*]_ _ percent of the trust estate to _ _[*name of beneficiary*]_ _;

(2) _ _[*Number*]_ _ percent of the trust estate to _ _[*name of beneficiary*]_ _; and

(3) _ _[*Number*]_ _ percent of the trust estate to _ _[*name of beneficiary*]_ _.

The right of each beneficiary to receive a distribution is contingent upon the beneficiary surviving the _ _[*settlor/surviving settlor*]_ _ by _ _[*number*]_ _ days. If a beneficiary fails to so survive, the share which would otherwise be distributed to that beneficiary shall be added on a prorata basis to the gifts to the beneficiaries who so survive.

Comment: Alternatively, the share of a deceased beneficiary is often left to that beneficiary's issue who meet the survival requirement, by right of representation, per capita, or per capita at each generation. See Prob C §§245-247.

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2. Termination and Distribution When Trust Is Small

§9.6 a. When Termination and Distribution Are Appropriate for Small Trust

If the trust corpus for a particular beneficiary is small, administration may be cumbersome and time consuming. The beneficiary may be able to achieve substantially more with the corpus than with small income benefits. Prescribed periodic valuation dates eliminate questions and the need for continued review when the value is borderline.

Probate Code §15408 permits termination or modification of small trusts. The court may modify trust clauses, terminate the trust in whole or in part, or change the trustee if the trust principal is so low in relation to administration costs that continuance of the trust under its existing terms would defeat or impair its purposes. Prob C §15408(a). The laws apply to all trusts, regardless of when created and regardless of the existence of a spendthrift clause.

In addition to the court's power to modify or terminate small trusts, the trustee may terminate a trust without court approval and without an express provision in the trust instrument (see §9.7) if its principal does not exceed $20,000. Prob C §15408(b). If termination of the trust is ordered by the court, principal and undistributed income are distributed according to the settlor's intentions to the fullest extent possible. Prob C §15410(c). If the trust is terminated by the trustee, and the settlor's intent is not adequately expressed in the trust instrument, the trustee may distribute the trust property to the living beneficiaries on an actuarial basis. Prob C §15410(d).

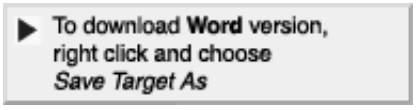
Some attorneys have found the courts reluctant to exercise their statutory power of termination. The power should not, however, be vested in the beneficiary-trustee. See *Maytag v U.S.* (10th Cir 1974) 493 F2d 995 (trust assets includable in beneficiary's estate under IRC §2041). See also *Estate of Richard C. Maxant*, TC Memo 1980-414, nonacq AOD 1981-97 (interest in trust property not includable under IRC §2041 because of Tax Court finding of substantial adverse interest by cotrustees).

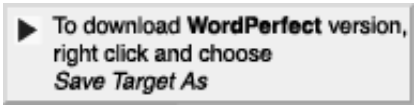
A settlor, whether or not acting as trustee, should not be given the power to terminate the trust. The termination will cause the trust to be included in his or her gross estate under IRC §2038.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.7 b. Form: Distribution When Trust Is Small

§9.7 b. Form: Distribution When Trust Is Small





***Termination of Trust*. If the trust share held for any beneficiary who is over age 18 will have a total value at the end of any calendar year of less than _ _[*dollar amount*]_ _, the _ _[*trustee/special trustee*]_ _ may, in the trustee's discretion, distribute the entire trust share as then constituted to that beneficiary and thereby terminate his or her trust.**

Comment: This clause permits the trustee to terminate a trust share without prior court approval for trust values less than any value chosen by the settlor.

In some circumstances it is appropriate to give the trustee a broad termination power without specifying a dollar amount.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/ B. Sprinkling Trust/§9.8 1. Description of Sprinkling Trust

B. Sprinkling Trust

§9.8 1. Description of Sprinkling Trust

A sprinkling trust is the most flexible trust for meeting the client's tax objectives, as discussed in chap 5. Unfortunately, the class of persons who may act as trustee of such a trust without adverse tax consequences is most restricted. A client choosing a sprinkling trust must pay the price of relinquishing control over the trust assets to truly independent trustees.

A trustee who is given complete discretion requires guidelines for exercising this discretion to enable the trustee to carry out the settlors' wishes and to avoid disputes. Some corporate fiduciaries will refuse to accept a trust giving them complete discretion without guidelines. On discretionary powers given to trustees, see chap 10.

The guidelines in §9.9 are only illustrative. For further discussion, see §9.63. The discretion to consider tax consequences is important in view of the generation-skipping transfer (GST) tax and the generally high income tax rates imposed on undistributed trust income. One beneficiary may be taxed at the same rate as the trust, whereas another beneficiary may be taxed at a lower rate. Obviously, the trustee should be able to compensate for this disparity.

If the settlor chooses the option of including beneficiaries' spouses among the group of permitted income beneficiaries, or as principal beneficiaries, the settlor may wish to define the word "spouse" and to further specify that the group includes (perhaps unremarried) surviving spouses.

PRACTICE TIP: The consulting editor considers it vital to empower the trustee to consider circumstances other than those enumerated in the trust document, to create flexibility and to recognize the settlors' inability to anticipate future circumstances. In adapting this form, the drafter must consider the settlors' particular situation and their intentions.

Exercise of the power to enable a child to enter a business or profession may cause an unfair preference. The consulting editor couples this power with a power to lend money to the beneficiary, so that the trustee can make all or a portion of the distribution an advance against the beneficiary's ultimate share. If made at a below-market rate of interest or without interest, these loans will be subject to the imputed-interest rules of IRC §7872. A purported loan to a beneficiary may result in a taxable distribution under the GST tax rules if the "loan" is economically unsound so that it is regarded as a distribution and is made to a beneficiary two or more generations younger than the settlor (*e.g.,* a grandchild instead of a child). See IRC §2612(b).

The final distribution clause should be combined with the clause directing the trustee to withhold distributions from minors. See §9.47. Current distributions for the benefit of minors are not an effective way to funnel taxable income to low-bracket taxpayers. For a child under age 19, even modest amounts of unearned income are taxed at the parents' rate under IRC §1(g). On the "kiddie" tax, see §§3.19-3.20. Distributions for the minor's account may be authorized to guardians, custodians, a trust for minors, or a relative other than the settlors. Although distributions to the settlors for the account of their minor child are probably permissible because a parent is prohibited by law from using the funds for the minor's support if the parent can provide these funds, this may create disputes with revenue agents. Use of the clause in §9.47 may limit these disputes. See *Upjohn v U.S.* (WD Mich 1972) 72-2 USTC ¶12,888, 30 AFTR2d 5918.

Generally, a sprinkling trust gives the trustee discretion to distribute income and principal to one or more of a specified group of persons. Neither settlor is included in the class of potential beneficiaries, the settlors may retain only limited investment control over trust assets, and the settlors retain no control over distributions.

NOTE: The IRS has ruled that identification of beneficiaries by class or status such as "children" or "spouse" is not a retention of a power to change beneficial interests. See Rev Rul 80-255, 1980-2 Cum Bull 272, specifically holding that the birth or adoption of children is an act of independent significance and that a provision for their inclusion in a trust is not the retention of a power over the trust. See also *Estate of Ethel H. Kurz* (1993) 101 TC 44, 60.

If a sprinkling trust may benefit grandchildren or other skip persons, consideration must be given to exempting the trust from the generation-skipping transfer tax. This may be desirable if grandchildren will receive a large share of the distributions, but will provide an inefficient use of the settlor's exemption if most of the distributions will be made to children. See chap 4.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.9 2. Form: Sprinkling Trust

§9.9 2. Form: Sprinkling Trust

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***Discretionary Distributions*. Until termination of this trust, the trustee _ _[*shall/may*]_ _ pay to or apply for the benefit of one or more of the settlors' children living _ _[*at the date of this instrument/from time to time including after-born children*]_ _, _ _[*their spouses*]_ _, _ _[*and*]_ _ the issue of the settlors' children living from time to time, _ _[*and their spouses*]_ _ as much of the net income and principal of the trust as the trustee, in the trustee's discretion, considers appropriate after taking into consideration to the extent the trustee considers advisable any of the several beneficiaries' other income or resources known to the trustee. In exercising its discretion, the trustee shall take into account:**

(1) The settlors' desire to consider their _ _[*children/grandchildren/great-grandchildren*]_ _ as primary beneficiaries and the other beneficiaries of secondary importance;

(2) The settlors' desire to afford all their issue the opportunity to pursue a trade school or college and graduate school education if it is productively pursued in the trustee's discretion;

(3) The settlors' desire to enable any beneficiary to obtain capital to enter any business or profession that the trustee determines is more likely to succeed than fail;

(4) The settlors' desire to enable any beneficiary to make a reasonable downpayment on a primary personal residence;

(5) The tax consequences of any distribution or failure to distribute; and

(6) Other factors that the trustee considers relevant.

Any net income not distributed shall be accumulated and added to principal. In exercising the discretion conferred by this clause, the trustee may pay more to or apply more for the benefit of some beneficiaries than others and may make payments to or application of benefits for one or more beneficiaries to the exclusion of others if the trustee considers this necessary or appropriate in light of the circumstances, the size of the trust estate, and the probable future needs of the beneficiaries. All payments or applications of benefits under this clause shall be charged against the trust estate as a whole, rather than against the ultimate distributive share of a beneficiary to whom or for whose benefit the payment is made.

At the earlier to occur of the date on which the settlors' youngest living child has attained age _ _[*18/25/30*]_ _ or when there are no living children, the entire trust as then constituted shall be divided in equal shares, one for each living child of the settlors who is then a beneficiary of this trust and one for each group of the living issue of a deceased child of the settlors who was a beneficiary of the trust at any time. Each share allocated for a living child shall be distributed to the child, and each share allocated for a group composed of the living issue of a deceased child shall be distributed to those issue by right of representation.

[*If appropriate, add the following option*]

[*Option: Distribution to spouse of deceased child*]

If a deceased child of the settlors who was a beneficiary of the trust leaves a spouse then living, _ _[*one-half/one-third*]_ _ of the portion of the trust the deceased child would have received if that child were living shall go to the deceased child's spouse if that spouse is then living.

Comment: If the word "shall" rather than "may" is used in the first sentence, the drafter must also include a clause relating to discharge of a legal obligation of support. See §9.27.

For a definition of "issue," see §10.134. The phrase "by right of representation" refers to the distribution plan under Prob C §246(a). Some practitioners believe that it is more fair to distribute to issue "per capita at each generation." See

Prob C §247.

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3. Sprinkling Power Exercised by Special Trustee

§9.10 a. Purpose of Sprinkling Power

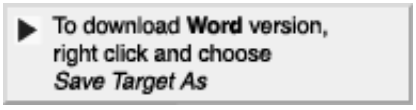
Giving a special trustee a sprinkling power is useful when the settlor wishes to use the experience and knowledge of a family friend or other individual who is acquainted with the beneficiaries' personal needs but who does not wish or is unable to assume the full range of duties and responsibilities of a trustee, including investment decisions. The sprinkling powers may include guidelines to assist the special trustee in making determinations. On guidelines generally, see §9.63. The settlor may also wish to name successor special trustees or to give the special trustee the power to designate successors (see §9.11) or add beneficiaries of a named class (see §9.11A).

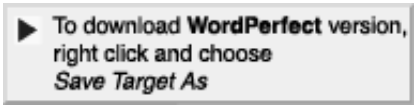
The special trustee should not be a settlor, nonadverse party, related or subordinate party, beneficiary to whom income or principal may be sprinkled, or the parent of a minor beneficiary who is still a dependent. Adverse federal estate tax consequences may result from such an appointment or could result in the trust income being taxed to the special trustee. See §9.12.

If a beneficiary, acting as the trustee or a cotrustee, has the power (either alone or in conjunction with other trustees or persons) to apply the principal of the trust for his or her own benefit and the power is not limited by an ascertainable standard (as defined in IRC §2041(b)(1)(A); Treas Reg §20.2041-1(c)(2)), the power is treated as a general power of appointment and the assets over which the power was exercisable are included in the beneficiary-trustee's estate. For further discussion, see §9.52.

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§9.11 b. Form: Sprinkling Power Exercised by Special Trustee





***Discretionary Distributions*. Income of the trust estate shall be added to and become principal, and the trustee shall pay to or apply for the benefit of _ _[*e.g., the settlor's children*]_ _ (called the primary beneficiaries) and _ _[*e.g., the lawful issue of such children living from time to time or any one or more of them*]_ _ (called the secondary beneficiaries) amounts that _ _[*name of special trustee*]_ _, in _ _[*his/her*]_ _ discretion, determines to be necessary or proper for their health, education (including study at an institution of higher education and vocational training), support, and maintenance, taking into account:**

(1) The other assets (excluding those that cannot be readily liquidated) and the income from other sources of the primary and secondary beneficiaries;

(2) The beneficiaries' relative ages, needs, and customary standards of living; and

(3) The income, estate, and generation-skipping transfer tax consequences of any distribution under this clause.

The settlor intends to provide, in order of preference, first for the primary beneficiaries and thereafter for the secondary beneficiaries. The rights and interests of remainder interests are subordinate to this purpose. The settlor intends not to limit distributions to amounts required for necessities of life; distributions shall also be made for luxuries, including but not limited to, _ _[*e.g., travel expenses; purchase of a home; and the purchase of jewelry, fur, and similar items appropriate to the station in life of the respective beneficiaries of this trust*]_ _.

Any distribution to a minor may be made for the minor's account to his or her parent, guardian, custodian, or other adult with whom he or she resides as long as such distribution may not be used to discharge any legal obligation of support the minor's parent has to the minor. No bond shall be required of the parent, guardian, custodian, or other adult. _ _[*Name of special trustee*]_ _ shall exercise this power from time to time in trust and by a written instrument delivered to the trustee. The trustee shall comply with all written directions received from _ _[*name of special trustee*]_ _ but shall incur no liability to any beneficiary of the trust or to any other person for following such written directions or for failure to act in the absence of a written direction.

On the death or inability of _ _[*name of special trustee*]_ _ to exercise this power, or on relinquishment of this power by _ _[*name of special trustee*]_ _ in a written instrument delivered to the trustee, the trustee shall thereafter exercise this power.

[*If appropriate, add the following option*]

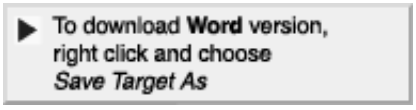
[*Option: Special trustee limited to sprinkling of income*]

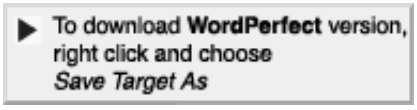
The special trustee's responsibilities shall be limited to the exercise of discretion under this clause, and the special trustee shall not be concerned with other aspects of trust administration.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.11A c. Form: Power Granted to Special Trustee to Add Beneficiaries of Named Class

§9.11A c. Form: Power Granted to Special Trustee to Add Beneficiaries of Named Class





***Special Trustee's Power to Add Beneficiaries*. The _ _**[*description and name of special trustee, e.g., husband's brother, James Doe*]**_ _, as special trustee, and his successors, have the power to add _ _**[*specify class, e.g., any niece or nephew of either settlor*]**_ _ as a beneficiary of this trust or any subtrust created under this instrument. An added beneficiary is entitled to receive distributions of income and principal in the discretion of the special trustee. The special trustee has the power to eliminate any or all added beneficiaries.**

***Designation of Successor Special Trustee*. _ _**[*Name of subordinate party, e.g., James Doe*]**_ _, as special trustee, has the power to designate one or more successor special trustees. If _ _**[*he/she*]**_ _ fails to do so, the person described in Article _ _**[*number, e.g., Two*]**_ _ shall act as special trustee.**

***Release of Power to Add Beneficiaries*. Any special trustee has the power to release the power to add beneficiaries by written instrument delivered to the principal trustee. Any release of a power shall be binding on any successor special trustee.**

Comment: This power may be added to achieve grantor trust status. See discussion in §5.10.

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4. Tax Considerations for Sprinkling Trust

§9.12 a. Estate Tax on Sprinkling Trust

Adverse estate tax consequences occur if either settlor is a trustee or a cotrustee of a sprinkling trust. A power to make discretionary distributions to one or more of a group of beneficiaries constitutes the power to designate the persons who will enjoy the property or its income within the meaning of IRC §2036(a)(2) and the power to amend the trust within the meaning of IRC §2038. See Treas Reg §20.2038-1(a). Conversely, for estate tax purposes, the vesting of sprinkling powers (no matter how broad) in third persons does not have adverse estate tax consequences except as follows:

- The settlors are considered to have retained the powers personally if they have retained the absolute power to substitute themselves as trustees or cotrustees. See Treas Reg §20.2038-1(a)(3). See also *U.S. v Byrum* (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382; *Estate of Farrell v U.S*. (Ct Cl 1977) 553 F2d 637. Neither settlor may retain the power to remove a trustee and appoint a successor unless the power is limited to designating successors who are not settlors and not related or subordinate parties within the meaning of IRC §672(c). Rev Rul 95-58, 1995-2 Cum Bull 191. See §9.14.
- With some exceptions that cannot be relied on, the settlors may not be among the class of potential beneficiaries. See §5.4.
- The settlors may not retain the right to have trust funds applied to discharge their legal obligation to support their minor children. The fact that a third person merely has the discretion to do so does not, however, result in adverse estate tax consequences. See §5.23.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.13 b. Gift Tax on Sprinkling Trust

§9.13 b. Gift Tax on Sprinkling Trust

A sprinkling trust results in a completed gift because the settlors have placed beyond their own control the determination of who will receive the trust property. Treas Reg §25.2511-2(a)-(b). The gift does not, however, qualify for the $13,000 (plus further inflation adjustments) per-donee annual exclusion under IRC §2503 for gifts other than gifts of future interests, because the beneficiaries' rights depend on the trustee's future actions. See §2.35. For the use of *Crummey* powers to create gifts of present interests, see §2.36.

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§9.14 c. Income Tax on Trust Income

The settlors are treated as owners of a sprinkling trust when they have retained, either themselves or through a nonadverse party, a power of disposition over the beneficial enjoyment of the trust property. See IRC §674. An exception to this rule exists that the settlors may employ if they designate only certain individuals as trustees. See IRC §674(c). The exception contains two requirements (Treas Reg §1.674(d)-2(b)):

- The appointment of independent trustees; and
- The absence of a power in any person to add beneficiaries other than after-born and after-adopted children to the class of eligible beneficiaries.

For discussion of creating a "defective" grantor trust by including trust clauses deliberately designed to fail the exception to IRC §674(c), see §§3.40, 5.9-5.10. For a form of power to add beneficiaries other than children of the settlors, see §9.11A.

Independent trustees under IRC §674(c) must be persons other than settlors, no more than half of whom are related or subordinate parties subservient to the settlors' wishes. Examples of independent trustees are:

- A corporate fiduciary;
- The settlors' accountant, attorney, or partner (otherwise unrelated);
- A friend with whom neither settlor has a prohibited employment relationship either directly or through a corporation (see IRC §672(c));
- A cousin or uncle;
- Two or more of the above;
- A bank and one subservient corporate employee; or
- An independent accountant and one sibling.

A settlor's power to remove a trustee and name a successor trustee must be carefully defined. Otherwise, the IRS may take the position that the settlor is the true holder of the trustee's power. Rev Rul 95-58, 1995-2 Cum Bull 191. In Rev Rul 95-58, the IRS adopted the position that a settlor may hold the power to substitute trustees as long as the settlors and any party related or subordinate to either settlor within the meaning of IRC §672(c) are excluded from the class of potential appointees. This is one of the few instances in which an income tax consequence has been introduced into the estate tax, and there is no statutory authority for it. Nevertheless, clients do not wish to invite a war by disregarding the ruling. The solution to the problem posed by Rev Rul 95-58 is as follows: Those settlors who can live with the limitation of potential appointees in the ruling may themselves hold the power to substitute trustees. See Alternative 1 in §9.15. Settlors who wish to include members of the prohibited class in the pool of potential appointees should vest the power to substitute trustees in a third person. See Alternative 2 in §9.15. This is another form of the battle between flexibility using others to hold powers and control in the settlors requiring more restrictions.

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§9.14A d. Generation-Skipping Transfer Tax on Sprinkling Trust Distributions

The trustee's power to consider the tax consequences of a distribution is particularly important because of the generation-skipping transfer (GST) tax. All distributions from the trust to grandchildren and more remote issue while children or other nonskip persons are still beneficiaries of the trust are "taxable distributions" subject to the GST tax to the extent that the trust assets are not completely shielded by the settlors' IRC §2631 GST exemption. See IRC §2612(b). On the death of the last beneficiary of the trust who is in the children's generation, a GST tax will be imposed on the entire trust ("taxable termination"). See IRC §2612(a). At that point, however, distributions to grandchildren are no longer subject to the GST tax, although distributions to more remote generations continue to be subject to the tax. See IRC §2653(a).

Another approach to a sprinkling trust is to allocate a sufficient GST exemption to the trust to fully protect it and then have it continue as a sprinkling trust for the full perpetuities period. In this way, it may continue free of transfer tax for about 100 years. Yet another approach is to continue the sprinkling trust, if not covered by any exemption, as a sprinkling trust until the death of the last surviving child, thereby postponing the tax consequences of the death of the first children to die until the death of the last child to die. See IRC §2612(a)(1)(A). For a general discussion of the GST tax, see chap 4.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.15 5. Form: Substitution of Independent Trustee

§9.15 5. Form: Substitution of Independent Trustee

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[*Use one of the following alternatives*]

[*Alternative 1: Settlor may substitute trustees*]

Substitution of Trustee. **_ _**[*The settlor/Both settlors acting jointly or the survivor of them*]**_ _ shall have the power exercisable at any time and from time to time to remove any trustee and to name a successor trustee. The successor may not be a related or subordinate party to _ _**[*the/either*]**_ _ settlor within the meaning of Internal Revenue Code §672(c) or any successor statute. This power may be exercised or relinquished by a written instrument delivered to the person acting as trustee and each person to whom payments may then be made in the trustee's discretion.**

[*Alternative 2: Trustee may resign and appoint substitute trustees*]

Substitution of Trustee. **Any trustee may resign as trustee at any time and appoint a successor trustee as long as no trustee acting from time to time is settlor _ _**[*or a spouse not legally separated from the settlor*]**_ _ and no more than half the number of trustees acting from time to time are related or subordinate parties to _ _**[*the/either*]**_ _ settlor within the meaning of Internal Revenue Code §672(c) or any successor statute. This power may be exercised or relinquished by a written instrument delivered to each acting trustee and to each person to whom payment may then be made in the trustee's discretion.**

Comment: Alternative 1 gives a settlor power to remove a trustee and name a successor. Alternative 2 does not vest such a power in a settlor as long as a third party is acting as trustee and the settlors are not eligible to become successors. The clause permitting a trustee to name a successor can be modified to limit the power to situations in which the trust would no longer have a trustee or a sufficient number of independent trustees.

The trust instrument should expressly permit the trustee to resign; otherwise, after acceptance, the trustee of an irrevocable trust cannot resign except by court permission or by the beneficiaries' consent. Prob C §15640.

On the importance of specifically prohibiting the settlors from appointing themselves as trustees on removal or resignation of the trustee, see §§9.12, 9.14.

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C. Sprinkling Trust (Income Only, Ascertainable Standard)

§9.16 1. Description of Income-Only Sprinkling Trust

The permissible class of trustees under the tax laws is considerably broader when only income may be distributed among a class of beneficiaries and the trustee's discretion to distribute income is limited by an ascertainable standard. IRC §674(d). See §9.19. Thus, it differs from the sprinkling trust in two respects:

- Only trust income may be shifted among beneficiaries; and
- The power to distribute income must be limited by an ascertainable standard.

Principal may not be distributed at all. Any person except a settlor or a spouse not legally separated from the settlor may be the trustee of an income-only sprinkling trust.

Treasury Regulation §1.674(b)-1(b)(5)(i) states:

> [A] power to distribute… for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort, or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard.

Treasury Regulation §20.2041-1(c)(2) lists the following as examples of limited standards:

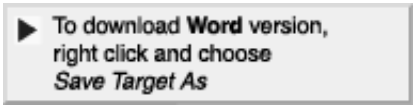
> "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism."

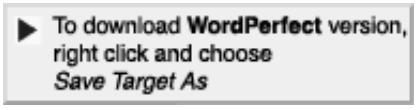
The wording of the regulations should be followed closely. See *Estate of Victor J. Strauss*, TC Memo 1995-248 (beneficiary's power to invade corpus for his "care and comfort" was not limited by ascertainable standard).

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.17 2. Form: Sprinkling Trust (Income Only, Ascertainable Standard)

§9.17 2. Form: Sprinkling Trust (Income Only, Ascertainable Standard)





***Discretionary Distributions*. Until termination of this trust, the trustee _ _[*shall/may*]_ _ pay to or apply for the benefit of one or more of the settlors' children living _ _[*at the date of this instrument/from time to time including after-born children*]_ _, _ _[*their spouses*]_ _, _ _[*and*]_ _ the issue of the settlors' children living from time to time, _ _[*and their spouses*]_ _ as much of the net income of the trust as the trustee, in the trustee's discretion, considers necessary for their proper support, health, maintenance, and education, after taking into consideration to the extent the trustee considers advisable any of the several beneficiaries' other income or resources known to the trustee. Any net income not distributed shall be added to principal. In exercising the discretion conferred by this clause, the trustee may pay more income to or apply more income for the benefit of some beneficiaries than others and may make payments to or applications of benefits for one or more beneficiaries to the exclusion of others if the trustee considers this necessary or appropriate in light of the circumstances, the size of the trust income, and the probable future needs of the beneficiaries. All payments or applications of benefits under this clause shall be charged against the trust estate as a whole, rather than against the ultimate distributive share of a beneficiary to whom or for whose benefit the payment is made.**

When all the settlors' children living _ _[*at the date of this instrument/from time to time including after-born children*]_ _ have attained age _ _[*18/25/30*]_ _ years or have died, the entire trust as then constituted shall be distributed in equal shares, one for each living child of the settlors who is then a beneficiary of this trust, and one for each group of the living issue of a deceased child of the settlors who was a beneficiary of the trust at any time.

[*If appropriate, add the following option*]

[*Option: Distribution to spouse of deceased child*]

If a deceased child of the settlors who was a beneficiary of the trust leaves a spouse then living, _ _[*one-half/one-third*]_ _ of the portion of the trust the deceased child would have received if that child were living shall go to the deceased child's spouse if that spouse is then living.

Comment: If the word "shall" rather than "may" is used in the first sentence, a clause relating to discharge of a legal obligation of support must be used. See §9.27. The form to substitute trustees in §9.15 may be used in conjunction with this trust and may be liberalized by precluding only appointment of either settlor, a spouse living with a settlor, or a person related or subordinate to either spouse. If the optional clause relating to a spouse is used, the drafter may wish to define the word "spouse." For discussion of including beneficiaries' spouses among trust beneficiaries, see §9.8.

For a definition of "issue," see §10.134. The phrase "by right of representation" refers to the distribution plan under Prob C §246(a).

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/ 3. Tax Considerations for Income-Only Sprinkling Trust/§9.18 a. Estate, Gift, and Generation-Skipping Transfer Tax on Sprinkling Trust

3. Tax Considerations for Income-Only Sprinkling Trust

§9.18 a. Estate, Gift, and Generation-Skipping Transfer Tax on Sprinkling Trust

The estate, gift, and generation-skipping transfer (GST) tax considerations for an income-only sprinkling trust are substantially the same as for a regular sprinkling trust. For discussion of estate and gift taxes, see §§9.12-9.13. For discussion of the GST tax, see §9.14A.

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§9.19 b. Income Tax on Trust Income

If neither a settlor nor a spouse acts as trustee or cotrustee or has the power to appoint himself or herself as such, and if no one may add to the class of eligible beneficiaries (other than the addition of after-born or after-adopted children as discussed in §9.8), the settlors are not treated as owners of an income-only sprinkling trust (limited by an ascertainable standard), referred to by tax practitioners as a "674(d) trust"). However, the slightest deviation from the statutory requirements (*e.g.,* a power to invade principal), as permitted in a true sprinkling trust, may have unplanned and unwanted income tax consequences. See discussion in §9.14.

Inability to reach trust principal makes this type of trust impractical for most clients. The IRS apparently limits the application of IRC §674(b)(5)(A) (see §9.21) to income beneficiaries or remainder beneficiaries of only those trusts that require distribution of income currently. See the parenthetical clause in the first sentence of Treas Reg §1.674(b)-1(b)(5)(i). This position is logical; otherwise, the exception of IRC §674(d) would have been extended to both income and principal.

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D. Single Trust With Discretion to Distribute Principal

§9.20 1. Description of Discretionary Trust

If the income of a single trust is required to be distributed currently to one or more beneficiaries or may be accumulated in strict conformity with IRC §674(b)(6) or (7), discretion to distribute principal may be given the trustee within limits. IRC §674(b)(5). For discussion of the limits of discretion and who may be trustees, see §§9.22-9.24. On how to accumulate income and still comply with the rules regarding distributions of principal, see §9.41.

The form in §9.21 is intended to qualify for the exception in IRC §674(b)(5)(A), which requires current distribution of trust income and also requires an ascertainable standard enforceable by a court for invasion of principal. Thus, if the determination of the trustee is "conclusive" with respect to the exercise or nonexercise of the power of invasion, the power is not considered to be limited by a reasonably definite standard. The fact that the governing instrument is phrased in discretionary terms, however, is not in itself an indication that no reasonably definite standard exists. See Treas Reg §1.674(b)-1(b)(5)(i). Regarding ascertainable standards, see §9.16. See also Prob C §16080. Out of an abundance of caution, the form refers to children and grandchildren of deceased children to ensure that principal distributions may be made only to persons who are clearly beneficiaries (remainder beneficiaries) of the trust at the time of payment. The statute requires payments to "beneficiaries."

The form in §9.21A is intended to qualify for the exception in IRC §674(b)(5)(B). The statute is clearer than the regulation in addressing itself to separate shares of a single trust. A proportionate charge to a single trust for several beneficiaries as contemplated by Treas Reg §1.674(b)-1(b)(5)(ii)-(iii), Example (3), is problematic because values of the single trust fluctuate. Moreover, support and other needs of grandchildren do not arise on the principle of representation. The consulting editor prefers to use separate trusts to avoid the problems of a single trust that are not solved by separate shares. In using the form, the drafter should consider providing the trustee with guidelines for the exercise of his or her discretion. See §§9.9, 9.63.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.21 2. Form: Single Trust (Discretion to Distribute Principal)

§9.21 2. Form: Single Trust (Discretion to Distribute Principal)

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***Mandatory Distribution of Income and Discretionary Distributions of Principal*. Until termination of this trust, the entire net income of the trust shall be paid to or applied for the benefit of the settlors' children living _ _**[*at the date of this instrument/from time to time including after-born children*]**_ _, in equal shares, or to the survivor of them. In addition, the trustee may pay to or apply for the benefit of one or more of the settlors' children living _ _**[*at the date of this instrument/from time to time including after-born children*]**_ _ and to the children and grandchildren of any deceased children living from time to time, as much of the principal of the trust as the trustee, in the trustee's discretion, considers necessary for their proper support, health, maintenance, or education, after taking into consideration to the extent the trustee considers advisable any of the several beneficiaries' other income or resources known to the trustee.**

On the death of the last of the settlors' children living at the date of this instrument, the entire trust as then constituted shall be distributed in equal shares, one for each group of the living issue of a deceased child of the settlors who was a beneficiary of the trust at any time.

[*If appropriate, add the following option*]

[*Option: Distribution to spouse of deceased child*]

If a deceased child of the settlors who was a beneficiary of the trust leaves a spouse then living, _ _[*one-half/one-third*]**_ _ of the portion of the trust the deceased child would have received if that child were living shall go to the deceased child's spouse if that spouse is then living.**

Comment: If the word "may" is changed to "shall" in the sentence dealing with the invasion power, or if either settlor acts as a cotrustee or sole trustee, the addition to Alternative 1 in §9.27 must be used.

See §10.134 for a definition of "issue." The phrase "by right of representation" refers to the distribution plan under Prob C §246(a).

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.21A 3. Form: Separate Shares (Discretion to Distribute Principal)

§9.21A 3. Form: Separate Shares (Discretion to Distribute Principal)

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***Mandatory Distribution of Income and Discretionary Distributions of Principal*. The trustee shall divide the trust into _ _[*e.g., two*]_ _ equal shares for the respective benefit of the following children of the settlors: _ _[*Names of children*]_ _. Until the termination of this trust, each share shall be retained and administered by the trustee as a separate trust, as follows: The entire net income of each trust shall be paid to or applied for the benefit of the child for whom each trust was set aside and to the issue living from time to time of a deceased child by right of representation.**

In addition, the trustee may pay to or apply for the benefit of the child for whom a trust is set aside and to the issue of any deceased child for whom a trust was set aside living from time to time by right of representation as much of the principal of the trust set aside for the child's or issue's benefit as the trustee, in the trustee's discretion, shall determine. When the settlors' youngest living child has attained age _ _[*18/25/30*]_ _, each respective share of this trust shall be distributed to the child for whom the share was set aside or, if he or she is not then living, to the share set aside for his or her then-living issue by right of representation.

[*If appropriate, add the following option*]

[*Option: Distribution to spouse of deceased child*]

If a deceased child of the settlors who was a beneficiary of a trust leaves a spouse then living, _ _[*one-half/one-third*]_ _ of the portion of the trust the deceased child would have received if that child were living shall go to the deceased child's spouse if that spouse is then living.

Comment: If the word "may" is changed to "shall" in the sentence dealing with the invasion power, or if either settlor acts as a cotrustee or sole trustee, the addition to Alternative 1 in §9.27 must be used.

See §10.134 for a definition of "issue." The phrase "by right of representation" refers to the distribution plan under Prob C §246(a).

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3. Tax Considerations for Discretionary Trust

§9.22 a. Estate Tax on Discretionary Trust

If the children are adults, assets held in trust using the form in §9.21 are not included in the settlors' estates, even if one of them acts as trustee, as long as the "tax-sensitive" trustee clauses described in §10.112 are used and excessive administrative powers prohibited by IRC §675 are avoided. A power to make distributions under an ascertainable standard is not a hidden device to designate beneficial enjoyment within IRC §2036(a)(2) or a power to amend within IRC §2038. See *Estate of Ralph Budd* (1968) 49 TC 468, acq 1973-2 Cum Bull 1.

If the children are minors and a settlor acts as a cotrustee or sole trustee, the addition to Alternative 1 in §9.27 must be used to keep the trust out of either settlor's estate. It is conservative practice to vest the power to invade for minors in a third party special trustee if either parent is active as trustee. In the editor's opinion, however, this is not required if the form in §9.27 is used.

Conversely, when assets are held in trust using the form in §9.21A, someone other than the settlors must act as trustee or cotrustee to avoid having the trust included in the settlors' gross estates, because the trustee's discretion is not subject to an ascertainable standard. See §9.12. See also Halbach, *Tax-Sensitive Trusteeships*, 63 Or L Rev 381 (1984).

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.23 b. Gift Tax on Discretionary Trust

§9.23 b. Gift Tax on Discretionary Trust

A completed gift occurs on the creation of either trust in §9.21 because the settlors have given up control over the choice of ultimate beneficiaries. See §9.13.

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§9.24 c. Income Tax on Trust Income

Assuming the absence of a power in any person to add beneficiaries other than after-born and after-adopted children to the class of eligible beneficiaries, anyone may act as trustee of these trusts from an income tax point of view by reason of the specific exceptions in IRC §674(b)(5). Great care must be taken when drafting any deviations from the forms in §9.21 to comply with IRC §674(b)(5) if the settlors do not want to be treated as owners of the trust for income tax purposes. See §3.14. (For estate tax purposes, the settlors may not act as trustees under the alternative form in §9.21A. See §9.22.)

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.24A d. Generation-Skipping Transfer Tax on Discretionary Trust

§9.24A d. Generation-Skipping Transfer Tax on Discretionary Trust

Because the trust in §9.21 is ultimately distributed to the children or other issue of the settlor's children, the termination of the trust will be treated as a taxable termination subject to generation-skipping transfer (GST) tax. For this reason, it is expected that the settlors' IRC §2631 GST exemptions will be allocated to the trust to the extent necessary to fully protect the trust from GST tax. Accordingly, payments of income or principal to the children or grandchildren of the settlor's deceased children during the term of the trust, which would otherwise be treated as taxable distributions, will be exempt from GST tax.

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E. Separate Trust for Each Beneficiary

§9.25 1. Description of Separate Trust

A separate trust for each child is a typical vehicle for substantial gifts; it permits invasion of principal to be charged to the payee, as opposed to the entire family. Separate trusts also enable income accumulated during minority to be taxed to separate trusts and use the lower brackets of more than one trust, although the tax benefits from accumulating income in a trust have been greatly reduced by the compaction of trust income tax rates. See §5.7. Regardless, an additional advantage of separate trusts lies in the ability to avoid shifting taxable income from one beneficiary to another and the need for disproportionate distributions to equalize the after-tax effects to the beneficiaries. The settlors may act as trustees of these trusts if proper administrative restrictions are laid down. See §9.29. The consulting editor, however, encourages clients to select a third party as trustee to avoid tax controversies.

The forms in §§9.26-9.28 provide a separate trust for each beneficiary, and give the trustee discretion to distribute income or principal during a child's minority. The trustee may be directed, however, to take the child's other resources into account to encourage accumulation in the trust. There may be other variations on ultimate distribution, *e.g.*, in more than two stages or at different ages.

The consulting editor does not use the optional language "to the extent the trustee considers advisable" when there is a tax-sensitive trustee. See generally Halbach, *Tax-Sensitive Trusteeships*, 63 Or L Rev 381 (1984).

If the settlors wish to qualify for the annual gift tax exclusion, the attorney may wish to use instead the clauses in §§12.58-12.62, which are designed specifically for that purpose.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/ 2. Forms for Separate Trusts/ §9.26 a. Form: Separate Trust for Each Beneficiary

2. Forms for Separate Trusts

§9.26 a. Form: Separate Trust for Each Beneficiary

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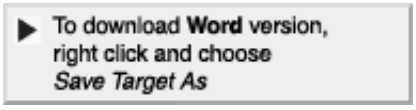
***Division of Trust*. The trustee shall divide the trust into _ _[*e.g., two*]_ _ equal shares for the benefit of the following children of the settlors: _ _[*Names of children*]_ _. Until the termination of this trust, each share shall be retained and administered by the trustee as a separate trust, as follows:**

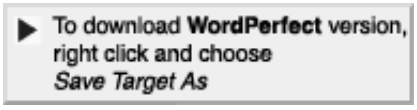
Comment: "Grandchildren" or another term for the relationship of the minors to the settlors should be substituted for "children," as appropriate.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.27 b. Form: Distribution of Income and Principal or Accumulation of Income During Child's Minority

§9.27 b. Form: Distribution of Income and Principal or Accumulation of Income During Child's Minority





[*Use one of the following alternatives*]

[*Alternative 1: Trustee has discretion to distribute income or principal during child's minority*]

***Discretionary Distributions*. As long as the child for whom the trust is set aside is under age 21, the trustee _ _[*shall/may*]_ _ pay to or apply for the child's benefit as much of the net income and principal of the child's trust as the trustee, in the trustee's discretion, considers necessary for the child's proper support, health, maintenance, and education, after taking into consideration _ _[*to the extent the trustee considers advisable*]_ _ any of the child's other income or resources known to the trustee. Any net income not distributed shall be accumulated and added to principal.**

[*Add if settlor is trustee*]

Income or principal of the child's trust shall not, however, be used to discharge in whole or in part the settlors' legal obligation, from time to time existing under the laws of the state of their domicile, to support the minor child, unless a court of competent jurisdiction determines that the distribution is necessary for the minor child's support, health, and education.

[*Alternative 2: Trustee to accumulate income during child's minority*]

As long as the child for whom the trust is set aside is under age 21, the trustee shall accumulate the income of his or her trust and add it to principal.

Comment: For discussion of the "shall" versus "may" option dealing with distributions during minority, see §5.24. A clause preventing outright distribution to minor issue should be added. See §9.47.

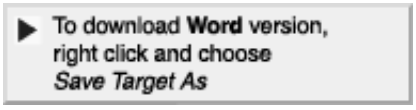
The addition to Alternative 1 should be used unless there is a discretionary power in a third party trustee to invade principal.

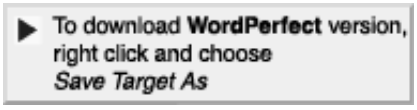
With respect to Alternative 2, the age of majority under California law is 18. Fam C §6501. Internal Revenue Code §674(b)(7) permits accumulation of income until the child attains age 21 without the settlors' being treated as owners of the trust for income tax purposes. See §3.34. However, a serious disadvantage to the use of this form is that income is trapped in the trust until a child attains age 21. Since the compaction of trust income tax rates, modest amounts of income can approach the top brackets. See §5.7.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.28 c. Form: Distribution After Child Reaches Age 21

§9.28 c. Form: Distribution After Child Reaches Age 21





***Mandatory Distribution of Income and Discretionary Distributions of Principal*. After a child has attained age 21, the trustee shall pay to or apply for the benefit of the child the entire net income of the child's trust, quarterly or at more frequent intervals. In addition, the trustee _ _[*shall/may*]_ _ pay to or apply for the benefit of the child as much of the principal of the child's trust as the trustee, in the trustee's discretion, considers necessary for the child's proper support, health, maintenance, and education, after taking into consideration _ _[*to the extent the trustee considers advisable*]_ _ any of the child's other income or resources known to the trustee.**

When the child attains age _ _[*18/25/30*]_ _, the trustee shall distribute to the child _ _[*e.g., one-half*]_ _ of the principal of the child's trust as then constituted. When the child attains age _ _[*25/35/40*]_ _, the trustee shall distribute to the child the undistributed balance of his or her trust.

If a child dies before becoming entitled to receive distribution of his or her entire trust, _ _[*any part of*]_ _ the undistributed balance of that child's trust _ _[*not disposed of under the child's power of appointment*]_ _ shall then be distributed, free of trust, to the child's then-living issue by right of representation. If there is no issue, the child's share shall be distributed to the settlors' then-living issue by right of representation. However, if any part of the balance to be distributed would otherwise be distributed to a person for whose benefit a trust is then being administered under this instrument, that part shall instead be added to that trust and shall thereafter be administered according to its terms, except that any addition to a partially distributed trust shall augment proportionally the distributed and undistributed portions of that trust.

Comment: The consulting editor does not use the optional language "to the extent the trustee considers advisable" when there is a tax-sensitive trustee. See generally Halbach, *Tax-Sensitive Trusteeships*, 63 Or L Rev 381 (1984).

The power of appointment referred to in the form is a limited power of appointment. See §9.54.

For a definition of "issue," see §10.134. The phrase "by right of representation" refers to the distribution plan under Prob C §246(a).

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3. Tax Considerations for Separate Trusts

§9.29 a. Estate and Gift Tax on Trust

A settlor should act as trustee under the form in §9.26 only if the addition to Alternative 1 in §9.27 is used. Payment of a settlor's legal support obligation, even under an ascertainable standard, may be a power of appointment. See §9.18. Under Alternative 2 in §9.27, however, a settlor may be trustee without adverse estate tax consequences as long as the excessive administrative powers described in IRC §675 are avoided.

To avoid any controversy with the IRS, the consulting editor prefers to use a third party when the settlors have substantial assets. Another possibility is to name a settlor as trustee and to vest any power to make discretionary distributions during a child's minority in an independent special trustee or independent trustee.

A completed gift has occurred in both alternatives. See §9.23.

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§9.30 b. Income Tax on Trust Income

Each trust is a separate taxpayer during a child's minority that may cause an increase in tax to the extent that income is not distributed. For discussion of the income tax effects of a trust as a separate taxpayer, see §5.7. See also the multiple trust rule of IRC §643(f), discussed in §5.31.

From an income tax point of view, the discretion to accumulate income during minority constitutes a specific exception to the general rule of IRC §674 if beneficiaries cannot be added to the trust (except for after-born or after-adopted children). IRC §674(b)(7); Treas Reg §1.674(b)-1(b)(7). If a settlor is acting as trustee, his or her discretion to make distributions should be limited by an ascertainable standard, and a clause prohibiting discharge of a settlor's legal obligations (such as the addition to Alternative 1 in §9.27) should be used. Treas Reg §1.674(b)-1(b)(5)(i). On ascertainable standards, see §9.16.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.30A c. Generation-Skipping Transfer Tax on Trust Distributions

§9.30A c. Generation-Skipping Transfer Tax on Trust Distributions

A generation-skipping transfer (GST) will occur at the time of the child's death, subject to the combined IRC §2631 exemptions, which the settlors may wish to preserve for other purposes. The GST tax is applied at a flat rate equal to the highest estate tax bracket in effect at the time of the transfer (so that any estate tax exemption and lower brackets available to the child may be lost). IRC §2641(b). To the extent that the child has a general power of appointment, the estate tax applies and the GST tax does not apply (IRC §2611(b)(2)), thereby making the child's estate tax exemption available for the trust assets. For a form of general power of appointment, see §9.55. For a general discussion of the GST tax, see chap 4.

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F. Accumulation Trust

§9.31 1. Description of Accumulation Trust

The trustee is given complete flexibility to accumulate or distribute income, so that income can be withheld from a beneficiary who acts unwisely. For a beneficiary with widely fluctuating income, the beneficiary's personal tax planning can be facilitated by distributing income in lean years. This is true to only a limited extent, however, because of trust rate compaction.

The child's testamentary power of appointment causes inclusion of the trust in the child's gross estate and prevents a generation-skipping transfer (GST) tax on the child's death. See §9.30A. Alternatively, the trust might provide that the undistributed balance is distributed to the settlor's other children. See discussion of hybrid trusts in §9.39.

Neither settlor may act as a trustee of this trust without adverse estate tax consequences. See §9.34. For the effect of income tax rate compaction on income accumulated in the trust, see §5.7.

For income tax purposes, a settlor or nonadverse party may be permitted to withhold income from a beneficiary temporarily if the effect of withholding does not shift the ultimate receipt of this income from one beneficiary to another. IRC §674(b)(6). Extremely technical and limited exceptions to this rule apply. See §9.35.

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2. Forms for Accumulation Trust

§9.32 a. Form: Accumulation of Income

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***Accumulation of Income and Distributions of Principal*. The trustee shall divide the trust estate into _ _[*e.g., two*]_ _ equal shares for the benefit of the following children of the settlors: _ _[*Names of children*]_ _. Until the termination of this trust, each share shall be retained and administered by the trustee as a separate trust, as follows:**

(1) The trustee shall accumulate the income of each trust in a separate account and may pay to or apply for the benefit of the child for whom the trust is set aside as much of the current or accumulated income as the trustee, in the trustee's discretion, considers necessary for the child's proper support, health, education, comfort, happiness, and well-being.

(2) When the child attains age _ _[*18/21/25/30*]_ _, the trustee shall distribute to the child the entire principal and accumulated income of the child's trust as then constituted.

(3) If a child dies before becoming entitled to receive distribution of his or her entire trust, the undistributed balance of that child's trust shall then be distributed, free of trust, to one or more persons and entities (including the child's estate, the child's creditors, or the creditors of the child's estate) appointed by the child in a written instrument filed with the trustee specifically referring to and exercising this power of appointment or, if this power is not exercised, to his or her then-living issue by right of representation.

[*If appropriate, add the following option*]

[*Option: Distribution to spouse of deceased child*]

If a deceased child of the settlors who was a beneficiary of the trust leaves a spouse then living, _ _[*one-half/one-third*]_ _ of the portion of the trust the deceased child would have received if that child were living shall go to the deceased child's spouse if that spouse is then living.

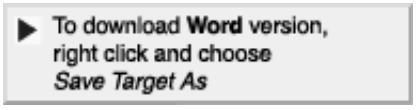
Comment: For a definition of "issue," see §10.134. The phrase "by right of representation" refers to the distribution plan under Prob C §246(a).

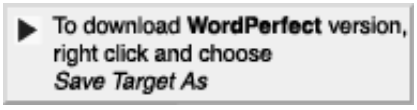
A clause preventing outright distribution to minor issue should be added. See §9.47.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.33 b. Form: Distribution if No Issue

§9.33 b. Form: Distribution if No Issue





***Distribution if No Issue*. If there is no issue, the child's trust shall be distributed to the settlors' then-living issue by right of representation. If, however, any part of the balance to be distributed would otherwise be distributed to a person for whose benefit a trust is then being administered under this instrument, that part shall instead be added to that trust and shall thereafter be administered according to its terms.**

[*If appropriate, add the following option*]

[*Option: Addition to partially distributed fund augments undistributed portions*]

Any addition to a partially distributed trust shall augment proportionally the distributed and undistributed portions of that trust.

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3. Tax Considerations for Accumulation Trust

§9.34 a. Estate and Gift Tax on Trust

A settlor who acts as trustee has retained the power to alter the trust and the power to designate who will enjoy the trust income because the trustee's power to accumulate or distribute income is not limited by an ascertainable standard. IRC §§2036(a)(2), 2038. The pertinent income tax provisions (see §9.35) do not require that the power be limited by an ascertainable standard. Thus, the settlors cannot act as trustees or cotrustees if estate tax savings are an objective of the trust.

If any other person acts as trustee, the trust will not be included in a settlor's estate. A completed gift will have occurred, but it will not qualify for the gift tax present-interest exclusion unless *Crummey* powers are used to satisfy the present interest requirement. See §2.35, chap 12.

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§9.35 b. Income Tax on Trust Income

Generally, settlors are not taxed on trust income if they or a nonadverse party have the power to accumulate income under the following circumstances (IRC §674(b)(6); see §3.33):

- The accumulated income must be distributed to the beneficiary from whom it was withheld or to his or her estate, or it must be subject to the broadest possible limited power of appointment; or
- The accumulated income must be distributed on termination of the trust to the current income beneficiaries in irrevocably specified shares.

The last unlettered paragraph of §674(b)(6), however, amplifies both exceptions and thus makes §674(b)(6) ambiguous. The drafter should note the requirement in the last paragraph of §674(b)(6) that the date of distribution of the trust must be one that "could reasonably have been expected to occur within the beneficiary's lifetime." For example, if a trust instrument directs that income be accumulated until a 21-year-old beneficiary reaches age 90, the last paragraph of §674(b)(6) probably does not afford the trust any protection.

The technical requirements of IRC §674(b)(6) are explained in Treas Reg §1.674(b)-1(b)(6). They differ from those imposed by IRC §674(d) because an ascertainable standard is not required for income tax purposes under IRC §674(b)(6). Internal Revenue Code §674(b)(6) is poorly drafted, and its requirements are extremely technical. Great care should be taken to understand the section before relying on it. For further discussion, see §3.33.

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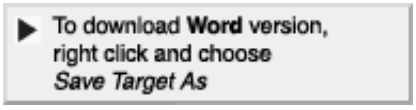
4. Escape From Trust Rate Compaction

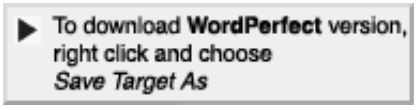
§9.36 a. Desirability of Escape Hatch

Due to the compaction of trust income tax rates under IRC §1(e), it is desirable to provide an escape hatch from high tax brackets with respect to a trust that will otherwise accumulate income at any time—by reason of a beneficiary's minority or otherwise. The escape hatch may consist of a clause vesting discretion in a special trustee to make distributions, as provided in §9.37. Giving a special trustee discretion to make such distributions will minimize income taxes. Such discretion cannot, however, be vested in a tax-sensitive trustee, and clients may not want to vest it in a corporate fiduciary.

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§9.37 b. Form: Special Power of Invasion





***Special Trustee's Power to Make Discretionary Distributions*. Whenever this instrument directs that income of a trust be added to principal, the special trustee may make distributions to or for the benefit of the beneficiary or beneficiaries of the trust in the amounts and proportions as the special trustee determines, to minimize the income taxes generated by the trust or the estate or generation-skipping transfer taxes allocable to the trust. Distributions may be made, however, only if the special trustee determines, in the special trustee's discretion, that a beneficiary will not be harmed by such distributions because of a reduced incentive to work or study, an apparent inability to manage property, or otherwise.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.38 5. Less Significant Exceptions to IRC §674

§9.38 5. Less Significant Exceptions to IRC §674

Potentially relevant not only to an accumulation trust described in §§9.31-9.37 but also to the other trusts described in §§9.8-9.19 (sprinkling trusts) and §§9.20-9.30A (discretionary trusts) are several less significant exceptions to the general rule of IRC §674, which cause trust income to be taxable to the settlors if beneficial enjoyment of the trust income or corpus may be affected by a power exercisable by a settlor or nonadverse party without the approval or consent of any adverse party. These remaining exceptions are discussed in §§9.38A-9.38F.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.38A a. Power to Apply Income to Satisfy Support Obligation

§9.38A a. Power to Apply Income to Satisfy Support Obligation

Under IRC §674(b)(1) and Treas Reg §1.674(b)-1(b)(1), income of a trust will not be taxable to a settlor simply because any person (including a settlor or a party nonadverse to a settlor acting as a trustee or cotrustee) may use such income to support a beneficiary whom a settlor is obligated to support. The income will be taxed to the settlor only to the extent that the income is actually used to satisfy this legal obligation. For discussion of support obligations, see §§5.19-5.23. The estate tax rule is entirely different. For estate tax purposes, the mere existence of a power vested in a settlor to use income or principal of a trust to satisfy the settlor's obligation of support, whether or not the power is exercised, will cause adverse estate tax consequences.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.38B b. Power Affecting Beneficial Enjoyment Only After Occurrence of Event

§9.38B b. Power Affecting Beneficial Enjoyment Only After Occurrence of Event

If the settlors retain a power to affect the beneficial enjoyment of trust property, the trust income will be taxed to the settlors unless the limited exception of IRC §674(b)(2) is met. The exception is that if the settlors do not have a reversionary interest under IRC §673 greater than 5 percent at the creation of the trust (except for a reversion on the death of a child under age 21), and the exercise of the power may not take effect until after the event causing the reversion has occurred, then the settlors will be taxable on trust income only after the event has occurred. If the power is relinquished before the occurrence of the event, the settlors will never be taxed on the trust income.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.38C c. Testamentary Power of Appointment

§9.38C c. Testamentary Power of Appointment

A testamentary power of appointment in any person other than a settlor to control beneficial enjoyment of income of a trust generally will not cause the trust income to be taxable to a settlor. IRC §674(b)(3); Treas Reg §1.674(b)-1(b)(3). A settlor will be taxed, however, if he or she retains the right to dispose of trust income accumulated in the discretion of a settlor or a nonadverse party without an adverse party's approval or consent. For example, if a trust provides that the net income for accounting purposes is payable to a beneficiary for life but a settlor retains a testamentary power of appointment over the remainder, that settlor will be taxed on the trust's gains and losses that have been allocated to corpus. Retention of this power by a settlor also will have adverse estate tax consequences. See §5.15. This exception, too, is of limited practical value.

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§9.38D d. Power to Allocate Among Charitable Beneficiaries

Under IRC §674(b)(4) and Treas Reg §1.674(b)-1(b)(4), a power in any person to determine the beneficial enjoyment of corpus or income that is irrevocably payable to charitable organizations or to an employee stock ownership plan (ESOP) in a qualified gratuitous transfer will not cause the trust income to be taxed to a settlor. For discussion of IRC §674(b)(5) pertaining to distributions of corpus, see §9.39.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.38E c. Power to Withhold Income During Disability of Beneficiary

§9.38E c. Power to Withhold Income During Disability of Beneficiary

On the power to withhold income during a beneficiary's minority (IRC §674(b)(7)), see §9.30. The principles described in that section also apply while an income beneficiary is under a legal disability.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.38F f. Power to Allocate Between Corpus and Income

§9.38F f. Power to Allocate Between Corpus and Income

A final exception in IRC §674(b)(8) and Treas Reg §1.674(b)-1(b)(8) provides that a settlor will not be taxed on trust income solely because someone holds the power, albeit expressed in broad terms, to allocate trust receipts and disbursements between corpus and income. Unless an independent trustee is appointed, however, any other power given the trustees must be in keeping with one of the other exceptions provided in IRC §674(b). For the definition of "independent trustee," see §9.14.

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G. Hybrid Trusts

§9.39 1. Income Tax Considerations for Hybrid Trust

Superficially, a combination of powers under IRC §§674(b)(5) and 674(b)(6) would seem to result in the creation of a typical sprinkling trust, for which an independent trustee is necessary. This may not be the case, however. In the consulting editor's opinion, it is possible to draft a hybrid trust (like the several trusts described below) that is not a true sprinkling trust, with a settlor or nonadverse party as the trustee.

For income tax purposes, a power to withhold income temporarily under §674(b)(6) may apparently be combined with a power to distribute principal under §674(b)(5) if the terms of the trust comply strictly with the requirements of both sections. For discussion of the requirements of §674(b)(6), see §9.35. To meet the §674(b)(5) requirements:

- A settlor's or nonadverse party's power as trustee to distribute corpus must be limited by an ascertainable standard; or
- Either all distributions of corpus to a beneficiary must be charged against that beneficiary's trust or, if each beneficiary does not have his or her own trust, against the beneficiary's proportionate share of corpus as though it constituted a separate trust.

As a practical matter, meeting the different requirements of both sections may be difficult to accomplish unless a trust's income account is segregated from its principal account.

A true sprinkling trust differs from such a hybrid trust in that it neither maintains separate accounts for income and principal nor usually limits to an ascertainable standard the purposes for which distributions may be made to members of its defined class of beneficiaries.

In IRS Letter Ruling 8204105, the trustees had complete discretion to accumulate the income of each child's trust or to distribute the income to each child. Any accumulated income, however, was to be retained in a separate account. The trustees also had the power to distribute principal to a child (from that child's trust) for that child's health and education and, perhaps, his use and benefit (the ruling is unclear on whether an ascertainable standard existed). Each child was to receive his entire trust (including principal and accumulated income) at age 35. If a child died before reaching age 35, his trust was to be distributed equally to the settlors' other children. These trusts combined features of the trusts in §9.21 (single trust with discretion to distribute principal) and §9.32 (accumulation trust).

The IRS ruled that the settlors would *not* be taxed on the trusts' income under IRC §674(a), because the settlors' power, as trustees, to accumulate income was within the exception in §674(b)(6)(B) and their power to distribute principal was within the exception in §674(b)(5).

Although the powers described in §674(b)(5)-(6) may be combined, a power under IRC §674(d) may not be combined with a power under any part of §674(b). If the settlors do not wish to accumulate income beyond a beneficiary's 21st birthday, a combination of §674(b)(5) (relating to powers to distribute principal) and 674(b)(7) (relating to accumulations of income while a beneficiary is under age 21) is easier to draft than a combination of §674(b)(5)-(6) because there need not be separate income and principal accounts when §674(b)(7) is relied on to accumulate income. Section 674(b)(7) does not require that accumulated income be distributed ultimately to one or more alternate takers in irrevocably specified shares, or to the beneficiary's appointees, as is required under §674(b)(6). With §674(b)(7), Congress has provided a small reprieve in recognition of the fact that one cannot distribute the income of a trust to a minor. However, a trust that accumulates income beyond a beneficiary's 21st birthday is treated more strictly. If §674(b)(7) is used, the drafter must comply strictly with the requirements of §674(b)(5) regarding distributions of principal.

No matter which type of hybrid trust described above is used, beneficiaries cannot be added to the trust (except after-born or after-adopted children as discussed in §9.8). Clients wishing to use a hybrid trust should be advised that there are no published IRS rulings and no case law (to date) interpreting the income tax consequences of this type of trust. Furthermore, use of a hybrid trust may result in adverse estate tax consequences. See §9.40.

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§9.40 2. Estate and Gift Tax Considerations for Hybrid Trust

For discussion of the federal estate and gift tax consequences of the retention of powers under IRC §674(b)(5)-(6) like the ones described in §9.39, see §§9.22-9.23, 9.34.

In particular, note that all the powers described in §9.39 (other than the power to invade principal for the benefit of someone other than a settlor under an ascertainable standard), if held by a settlor personally or in his or her fiduciary capacity as trustee, constitute powers to amend within the purview of IRC §2038, thereby causing inclusion of the trust's assets in a settlor's gross estate for federal estate tax purposes. The estate tax problem can be avoided by appointing someone else as trustee. Under Rev Rul 95-95, 1995-2 Cum Bull 191, however, the class of potential appointees may not include a related or subordinate party. See comment to forms in §9.15 for discussion of Rev Rul 95-58 and a potential solution to its limitation.

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H. Annuity Trusts and Unitrusts

§9.41 1. Purpose of Annuity Trust and Unitrust

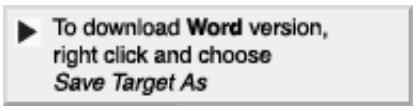
Trust law and tax law are both preoccupied with distinctions between principal and income, which may have been appropriate in the agricultural society of medieval England but have little relevance to, *e.g.,* an investor in securities. In the consulting editor's opinion, an accumulation of income and payment of either a fixed sum with an adjustment for cost-of-living changes or a specified percentage of the annual initial value of a trust gives the trustee greater freedom in investment decisions, eliminates many vexing administrative questions, and affords protection against inflation. See §10.110.

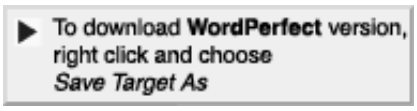
Although the unitrust has been associated with charitable remainder trusts, the concept of a specified payment, regardless of the trust's income, has been used for many years in other contexts. Under Prob C §16328, a trust may use a unitrust interest with a payout percentage of not less than 3 percent and not greater than 5 percent in place of an income interest that might otherwise be required. For example, a unitrust interest may be used to give the settlor's spouse a qualifying life income interest in a federal estate and gift tax marital deduction qualifying trust under Treas Reg §20.2056(b)-7(d)(1). See §2.39A. Under Prob C §§16336.4-16336.7, a trustee may convert an income interest into a unitrust interest with a payout percentage of not less than 3 percent and not greater than 5 percent with the consent of the beneficiaries or by court order. See §10.116A.

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2. Forms for Annuity Trust and Unitrust

§9.42 a. Form: Annuity Trust





***Payment of Annuity Amount*. The trustee shall pay to or apply for the benefit of _ _**[*name of beneficiary*]**_ _ the sum of _ _**[*dollar amount*]**_ _ per month from the net income and principal of the trust. Any net income not distributed shall be accumulated and added to principal.**

[*If appropriate, add the following option*]

[*Option 1: Distribution of principal (ascertainable standard)*]

In addition, the trustee may pay to or apply for benefit of _ _[*name of beneficiary*]**_ _ as much of the principal of the trust as the trustee, in the trustee's discretion, considers necessary for _ _**[*his/her*]**_ _ proper support, health, maintenance, and education, after taking into consideration to the extent the trustee considers advisable any of the beneficiary's other income or resources known to the trustee.**

[*Continue*]

[*If appropriate, add the following option*]

[*Option 2: Adjustment for inflation*]

If at any time during the life of this trust the cost-of-living index, consumer price index, or other appropriate index for _ _[*Southern/Northern*]**_ _ California, published by the Bureau of Labor Statistics of the Department of Labor (or any other comparable agency of the United States Government), shows that the cost of living, on December 31 of the preceding calendar year, is higher or lower than the cost of living on December 31, _ _**[*year*]**_ _, then and only then shall the sum of _ _**[*dollar amount*]**_ _ per month be increased or decreased for the current calendar year to an amount per month that bears the same ratio to that sum as the index, on December 31 of the preceding calendar year, bears to the cost-of-living index on December 31, _ _**[*year*]**_ _. The trustee shall have discretion to determine which price index, published by the Bureau of Labor Statistics (or other comparable agency of the United States Government), shall be used and to determine the amount of any increase or decrease in that sum under this clause. The trustee need not, however, make any adjustment for changes in the price index if the amount of the resulting increase or decrease would be less than 1 percent of the sum as adjusted in the prior year. On the death of _ _**[*name of beneficiary*]**_ _, the trustee shall distribute the trust as then constituted to _ _**[*e.g., the settlors' then-living issue/by right of representation/name of another beneficiary*]**_ _.**

Comment: A clause for a fixed payment for a long period without a clause that adjusts for inflation is not likely to provide peace of mind to the beneficiary. If the adjustment for inflation option is used, however, the trust may become exhausted during inflationary times if the trustee's investment policy does not produce growth of capital to cover the increased payout amount.

A settlor may be the trustee of an annuity trust. But see §9.29. For tax aspects of a settlor acting as trustee with the optional power of invasion, see §§9.39-9.40.

For a definition of "issue," see §10.134. The phrase "by right of representation" refers to the distribution plan under Prob C §246(a).

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§9.43 b. Form: Unitrust

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***Payment of Unitrust Amount*. The trustee shall pay to or apply for the benefit of _ _**[*name of beneficiary*]**_ _ each year during _ _**[*his/her*]**_ _ lifetime a unitrust amount equal to _ _**[*number*]**_ _ percent of the net fair market value of the trust assets, valued annually on the first day of the trust's taxable year for federal income tax purposes. This valuation shall be made in such reasonable manner as the trustee shall, in the trustee's discretion, determine._ _**[*The unitrust amount is intended to satisfy the definition of "income" in Treasury Regulation §1.643(b)-1.*]**_ _**

In a taxable year of the trust that is for less than 12 months and in the year of the death of _ _[*name of beneficiary*]**_ _, the amount to be paid by the trust shall be a fraction of _ _**[*number*]**_ _ percent. The numerator of that fraction shall be the number of days in the trust's first taxable year or the number of days in the trust's year preceding the day on which _ _**[*name of beneficiary*]**_ _ died, and the denominator shall be 365. On the death of _ _**[*name of beneficiary*]**_ _, the trustee shall distribute the trust as then constituted to the settlors' _ _**[*then-living issue/issue by right of representation*]**_ _.**

Comment: Under Treas Reg §1.643(b)-1, a unitrust interest may be treated as an income interest if the payout percentage is not less than 3 percent and not greater than 5 percent. The optional language in the first paragraph may be used to clarify that this use of the unitrust interest is intentional. Among other things, this may help to ensure that the full unitrust amount (including capital gains) will be included in distributable net income (DNI) under Treas Reg §1.643(a)-3(b), with the result that the gains will be taxed to the beneficiary rather than the trust. Ordinarily, capital gains are not included in DNI unless provided by the trust document.

The optional power of invasion in §9.42 may be added to a unitrust as well as to an annuity trust. Because the unitrust payout is based on a percentage of fair market value, it may tend to account for inflation. For additional requirements for a trust whose remainder is payable to a charitable organization for which a tax benefit is desired, see chap 19. A settlor may be the trustee of a unitrust. For tax aspects of a settlor acting as trustee with the optional power of invasion, see §§9.39-9.40.

Because trusts other than charitable trusts under IRC §§501(a) and 4947(a)(1) have a calendar taxable year (IRC §644), the language regarding the date of valuation in the form refers to a January 1 valuation date for most trusts.

For a definition of "issue," see §10.134. The phrase "by right of representation" refers to the distribution plan under Prob C §246(a).

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/ 3. Tax Considerations for Annuity Trust and Unitrust/§9.44 a. Estate and Gift Tax on Trust

3. Tax Considerations for Annuity Trust and Unitrust

§9.44 a. Estate and Gift Tax on Trust

The only distribution discretion given to the trustees in §9.42 is the power to invade principal, which is limited by an ascertainable standard. If the beneficiary is not the settlor, the settlor's spouse, or the settlor's minor child, the power will not cause inclusion in the settlor's estate even if the settlor is the trustee. IRC §2036(a)(2); *Estate of Ralph Budd* (1968) 49 TC 468, acq 1973-2 Cum Bull 1.

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§9.45 b. Income Tax on Trust Income

A settlor who acts as trustee of an annuity trust or unitrust is not treated as the owner of the trust for income tax purposes (see §9.39). Apparently, the power of invasion comes within the exception of IRC §674(b)(5). This section literally applies only to corpus, and in the annuity trust (see §9.42) and the unitrust (see §9.43) the power may apply to income as well. An invasion of income does not seem to come under IRC §674(b)(6). Nevertheless, the spirit of both of these exceptions should apply. When a settlor is the trustee, the consulting editor prefers to vest the power of invasion in a third party, special trustee.

A beneficiary is not taxed on distributable net income (DNI) accumulated while the beneficiary was under age 21, except for multiple trusts. Otherwise, the beneficiary will be subject to tax on distributions received by him or her to the extent of current and previously undistributed DNI. See §3.10. The trustee may be able to avoid these difficulties by creating less taxable income than the amount of each annual distribution through the purchase of tax-exempt bonds or growth securities.

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II. OTHER CLAUSES FOR PERMANENT TRUSTS

§9.46 A. Miscellaneous Trust Clauses

The trust clauses described in this chapter provide for distribution to the settlors' children and grandchildren. For a clause preventing outright distribution to minor issue, see §9.47. For an alternative clause, see §9.49A. Certain other clauses are required to complete the dispositive clauses of the trust, as discussed below.

Provision of a specified survivorship period eliminates successive transfers of the trust property from the settlor's estate to a beneficiary's estate if the beneficiary fails to survive for the designated time. The settlor, not the initial beneficiary, determines who ultimately receives the property. Such a survivorship clause also prevents the double estate taxation of property passing to a beneficiary who dies shortly after the settlor, even though IRC §2013 provides a credit to mitigate the effect of this double taxation. On the other hand, in the context of inter vivos irrevocable trusts, it would often be desirable to include trust property in the taxable estate of a beneficiary because the property would receive a new basis for income tax purposes under IRC §1014. In an era of increasing estate tax exemptions, income tax considerations may be more important.

It is important for the clause to clearly indicate the beginning of the survival period, as this clause does. See §9.48. A clause providing only that a beneficiary must survive for a certain time may invite litigation over its meaning. See *Burkett v Cappovilla* (2003) 112 CA4th 1444, 5 CR3d 817 (ambiguous trust survivorship clause required distributees to survive 60 days after settlor's death—not 60 days after execution of trust).

The consulting editor prefers to avoid a host of problems by excluding the settlors from the class of ultimate recipients, unless the clients feel strongly about including them. See §9.49. The purpose of this clause is to avoid nondisposition and therefore reversion of any property. The combinations and permutations for disposition are limited only by the ingenuity of the settlors and their attorney.

If the settlors are included in the clause, or no similar clause is inserted, and either settlor dies before distribution of the trust, the actuarial present value of a settlor's reversionary interest is included in his or her gross estate. IRC §2033. See §2.59. A settlor will be treated as owner of the trust for income tax purposes if his or her interest is not remote (*i.e.,* if his or her interest at the inception of the trust is greater than a mere 5 percent). IRC §673(a).

Distributions to remainder beneficiaries who are two or more generations younger than the settlors will be subject to the generation-skipping transfer tax if not covered by an exemption. See chap 4. Remainder distributions to charity are free from the tax. See IRC §2651(f)(3).

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§9.47 1. Form: Preventing Outright Distributions to Minors and Others

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***Power to Delay Distributions*. If any person entitled to outright distribution of a trust or of a portion of a trust is under age _ _**[*18/21/25*]**_ _ _ _**[*or if the trustee determines that there is a compelling reason (such as a serious disability, pending divorce, potential financial difficulty, serious tax disadvantage in making the distribution, or similar substantial cause) to postpone a distribution, in complete or partial termination of a trust*]**_ _, the trustee shall continue to hold and administer that beneficiary's trust (or portion of the trust) estate for his or her benefit. Income of the beneficiary's trust shall be added to principal, and the trustee shall pay to or apply for the benefit of the beneficiary as much of the beneficiary's trust as the trustee, in the trustee's discretion, considers necessary for the beneficiary's proper support, health, maintenance, and education, after taking into consideration to the extent the trustee considers advisable any of the beneficiary's other income or resources known to the trustee. When the beneficiary attains age _ _**[*18/21/25*]**_ _ _ _**[*or when, in the trustee's discretion, the compelling reason for postponement of a distribution ceases to exist*]**_ _, the trustee shall distribute to the beneficiary his or her entire trust.**

If the beneficiary dies before attaining age _ _[*18/21/25*]**_ _ _ _**[*or while distribution has been postponed*]**_ _, his or her trust shall be distributed to his or her then-living issue by right of representation.**

[*If appropriate, add the following option*]

[*Option: Distribution to spouse of deceased beneficiary*]

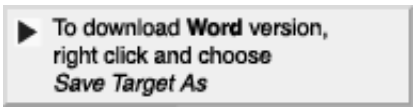
If a beneficiary of any trust leaves a spouse then living, _ _[*one-half/one-third*]**_ _ of the portion of the trust that beneficiary's issue would have received shall instead be distributed to the beneficiary's spouse if that spouse is then living.**

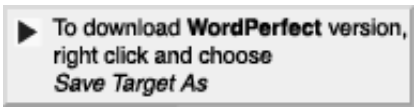
Comment: For an alternative clause providing for distribution to a CUTMA custodian, see §9.49A.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.48 2. Form: Survivorship Clause

§9.48 2. Form: Survivorship Clause





***30-Day Survival Requirement*. Except as otherwise provided in this document, if any person named or described in the trust fails to survive any event entitling that person to a distribution by 30 days, that person shall be considered to have predeceased that event.**

Comment: If the event described in this clause is the settlor's death, a 30-day survivorship period is provided. Other events, such as a child's or a spouse's death, are also covered.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.49 3. Form: Distribution of Remainder

§9.49 3. Form: Distribution of Remainder

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[*Use one of the following alternatives*]

[*Alternative 1: Distribution to contingent beneficiaries*]

***Distribution of Remainder*. If at any time before full distribution of the trust estate all the settlors' issue are deceased and no other disposition of the property is directed by this instrument, the remaining portion of the trust shall then be distributed in equal shares to _ _[*name(s) of contingent beneficiary(ies)*]_ _ who are living, on the occurrence of the event requiring distribution. If, however, any of them are not then living but leave issue then living, those issue shall take by right of representation the share that their ancestor would have taken had he or she been then living. If any of _ _[*name(s) of contingent beneficiary(ies)*]_ _ are not living on the happening of the event requiring distribution and leave no issue, that portion of the trust shall be distributed with one-half going to the husband's heirs and one-half to the wife's heirs, their identities and respective shares to be determined as if each settlor and his or her parents had died immediately before the occurrence of the event requiring distribution and according to the laws of the State of California then in effect relating to the succession of separate property not acquired from a parent, grandparent, or predeceased spouse.**

[*Alternative 2: Distribution to settlor's heirs*]

If at any time before full distribution of the trust estate all the settlors' issue are deceased and no other disposition of the property is directed by this instrument, the remaining portion of the trust shall then be distributed with one-half going to the husband's heirs and one-half to the wife's heirs, their identities and respective shares to be determined as if each settlor and his or her parents had died immediately before the occurrence of the event requiring distribution and according to the laws of the State of California then in effect relating to the succession of separate property not acquired from a parent, grandparent, or predeceased spouse.

[*Alternative 3: Distribution to charitable remainder beneficiary*]

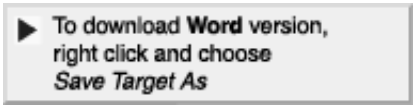
If at any time before full distribution of the trust estate all the settlors' issue are deceased and no other disposition of the property is directed by this instrument, the remaining portion of the trust shall then be distributed to _ _[*legal name and address of charitable entity*]_ _.

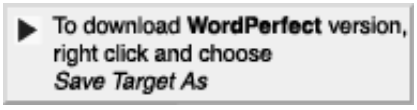
Comment: For a definition of "issue," see §10.134. The phrase "by right of representation" refers to the distribution plan under Prob C §246(a).

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.49A 4. Form: Distribution to CUTMA Custodian

§9.49A 4. Form: Distribution to CUTMA Custodian





***Distribution to Custodian*. If any person otherwise entitled to a distribution from this trust is under the age of _ _[*number 18 to 25*]_ _ at the time distribution is to be made, the trustee is authorized to make the distribution to a custodian named by the trustee under the California Uniform Transfers to Minors Act (CUTMA) (Probate Code §§3900-3925) or a comparable statute of another state. The custodianship shall remain in effect until the beneficiary reaches age _ _[*number 18 to 25*]_ _.**

Comment: This clause provides an alternative to the continuing trust for minor and others provided by the clause in §9.47.

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B. Beneficiary as Trustee

§9.50 1. Problems of Nonsettlor Beneficiary

To avoid confusion, the problems encountered by a beneficiary who is not a settlor of a trust are discussed separately from the various dispositive clauses discussed in this chapter. Obviously, these problems can arise from any dispositive plan.

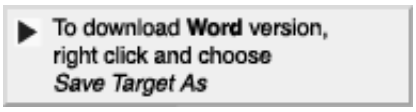
Probate Code §16081(b) provides that if a trust beneficiary who is also a trustee or cotrustee has absolute, sole, or uncontrolled discretion to distribute income or principal to himself or herself, the beneficiary will exercise that power reasonably and according to the standard imposed by the instrument. Probate Code §16081(c) provides that unless the standard governing the exercise of the power clearly indicates that a broader power is intended by express reference to the statute, the beneficiary may exercise the power in his or her favor only for his or her health, education, support, or maintenance. The primary purpose of these sections is to avoid the inadvertent creation of a general power of appointment in a beneficiary who is acting as trustee. These sections seem to have been enacted to avoid repetition of what occurred in *Estate of Friedman* (1979) 94 CA3d 667, 156 CR 597, in which the court found that a beneficiary's power as trustee to invade principal for support, care, maintenance, and education exercisable "in his uncontrolled discretion" was a general power of appointment.

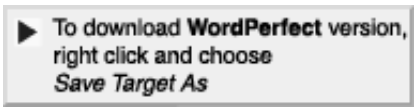
The discussion of estate and gift tax considerations in §9.52 assumes that a beneficiary is one of two or more trustees of the trust. The need for two trustees is also discussed.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.51 2. Form: Beneficiary as Trustee

§9.51 2. Form: Beneficiary as Trustee





***Discretionary Distributions*. As long as any of the group consisting of _ _[*e.g., A, B, C, and D*]_ _ are living, the trustee shall, from time to time, pay to or apply for the benefit of one or more of them as much of the net income and principal of the trust as the trustee, in the trustee's discretion, considers necessary for their proper support, health, or education, considering, to the extent the trustee considers advisable, any of the several beneficiaries' other income or resources known to the trustee. In exercising the discretion conferred by this clause, the trustee may pay more to or apply more for the benefit of some beneficiaries than others and may make payments to or applications of benefits for one or more beneficiaries to the exclusion of others, if the trustee considers this necessary or appropriate in light of the circumstances, the size of the trust estate, and the probable future needs of the beneficiaries.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/ 3. Tax Considerations for Nonsettlor Beneficiary/§9.52 a. Estate and Gift Tax on Trust

3. Tax Considerations for Nonsettlor Beneficiary

§9.52 a. Estate and Gift Tax on Trust

In general, if a beneficiary, acting as the trustee or a cotrustee, is empowered (either alone or in conjunction with other trustees or persons) to apply the principal of the trust for his or her own benefit and the power is not limited by an ascertainable standard (as defined in IRC §2041(b)(1)(A); Treas Reg §20.2041-1(c)(2)), the power is treated as a general power of appointment and estate tax is incurred on the beneficiary-trustee's death. It is immaterial that the power can be exercised only in conjunction with another person, except in the following cases when it is not considered to be a power of appointment:

- If the power can be exercised only in conjunction with the creator of the power (IRC §2041(b)(1)(C)(i));
- If the power can be exercised only in conjunction with a person having a substantial adverse interest in the property (IRC §2041(b)(1)(C)(ii)); or
- If the power is exercisable only in conjunction with other persons who are also permissible appointees of the property (IRC §2041(b)(1)(C)(iii)).

For the last exception, a fractional part of the property is included in the gross estate of the beneficiary-trustee based on the number of persons who are permissible appointees.

This situation is commonly presented when a child acts as one of several trustees of a trust created by his or her parents for the benefit of the child and his or her spouse. The parents often wish the child, as cotrustee, to have the power to distribute principal to himself or herself. A power that is limited by an ascertainable standard relating to the child's "health, education, support, or maintenance" is not considered to be a general power of appointment. Treas Reg §20.2041-1(c)(2).

It is unclear whether a power to make payments to minor children for their support or under any ascertainable standard, vested in a parent as cotrustee or sole trustee, constitutes a general power of appointment. Internal Revenue Code §2041(b)(1)(A) excludes from the definition of "general power of appointment" the power to appoint to oneself subject to an ascertainable standard; appointments for the benefit of one's dependents are not addressed. A power to discharge a person's legal obligations is a general power of appointment under the definition. Treas Reg §20.2041-1(c)(1).

A special power of appointment to make payments for the support of the powerholder's minor children can be a general power of appointment to the extent that the holder, in the IRS's viewpoint, may discharge his or her legal obligation of support. Rev Rul 79-154, 1979-1 Cum Bull 301. Conservative practice dictates that only a nonparent trustee should be given the power to distribute to minor children of the beneficiary-cotrustee.

The IRS has ruled that a deceased beneficiary-trustee of a trust who had the right as trustee to invade principal for maintenance and medical care did not have a general power of appointment over the trust, because the power of invasion was limited by an ascertainable standard. The fact that the decedent held the power as trustee was not material. Rev Rul 78-398, 1978-2 Cum Bull 237. The courts look to state law to determine the extent of a power of invasion. In *Estate of John Russell Little* (1986) 87 TC 599, the Tax Court held that the beneficiary-trustee's power to invade principal for his "support, maintenance, welfare, health, and general happiness in the manner to which he is accustomed at the time of the death of [his predeceased spouse]" was a general power of appointment because a California court would construe "general happiness" more broadly than health, education, support, or maintenance. See also *de Oliveira v U.S.* (9th Cir 1985) 767 F2d 1344 (beneficiary-trustee's power to consume the trust estate for her "benefit" was not limited by an ascertainable standard); *Estate of Sowell v Commissioner* (10th Cir 1983) 708 F2d 1564 (beneficiary-trustee's power to invade principal "in cases of emergency or illness" is limited by an ascertainable standard); Treas Reg §25.2511-1(g)(2) (for gift tax purposes, a power "to maintain his accustomed standard of living" is limited by an ascertainable standard).

A special power of appointment to make payments for the support of the powerholder's minor children can be a general power of appointment to the extent that the powerholder, in the IRS's viewpoint, may discharge his or her legal

obligation of support. Rev Rul 79-154, 1979-1 Cum Bull 301.

Besides express powers of appointment, a beneficiary may have a hidden power of appointment causing taxation of the trust in his or her estate. See *Maytag v U.S.* (10th Cir 1974) 493 F2d 995, in which trusts were included in a beneficiary's estate under IRC §2041 when the beneficiary acted as a trustee and all the trustees acting together could terminate the trusts and distribute trust assets to the beneficiary at any time. See also IRS Letter Ruling 8330004 (decedent beneficiary's power to buy stock at nominal cost tantamount to power to withdraw stock from trust); *Myra B. Robinson* (1980) 75 TC 346, aff'd (5th Cir 1982) 675 F2d 774, cert denied (1982) 459 US 970 (powers with respect to widow's election trust). But see *Estate of Richard C. Maxant*, TC Memo 1980-414, nonacq AOD 1981-97 (cotrustees' interests were adverse).

If a trustee's powers are equivalent to a general power of appointment, the release of those powers or resignation by the trustee will constitute a taxable gift. *Myra B. Robinson, supra*; Rev Rul 79-421, 1979-2 Cum Bull 347. However, if the power is released but the powerholder retains a life estate (or income for life) in the property, the property will be included in the powerholder's estate. See IRC §2036(a).

CAVEAT: Care must also be taken when giving a beneficiary a power to remove a trustee and name a successor. If there are no limitations on this power, the beneficiary may be deemed to hold the powers of the trustee. If the trustee has powers to distribute to the beneficiary that are not limited by an ascertainable standard, this could result in the beneficiary's being deemed to have a general power of appointment under IRC §2041. See *First Nat'l Bank v U.S.* (10th Cir 1981) 648 F2d 1286. This problem can be avoided if trustee distributions to the beneficiary are limited by an ascertainable standard. It can also be avoided by providing that the successor trustee cannot be the beneficiary or a related or subordinate party to the beneficiary within the meaning of IRC §672(c). See Rev Rul 95-58, 1995-2 Cum Bull 191, which expressly applies in retained settlor power situations but appears to apply here by analogy. Another approach is to avoid giving trustee removal and replacement power to the beneficiary, instead giving it to someone who will be responsive to the beneficiary's concerns.

If a beneficiary has a general power of appointment, the property subject to the power will be included in the beneficiary's estate at death under IRC §2041, even if the beneficiary was, at all times after the grant of the power, incompetent and incapable of exercising the power. *Estate of Lester J. Whitlock*, TC Memo 1982-272.

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§9.53 b. Income Tax on Trust Income

A person other than a settlor of the trust is treated as the owner of any portion of a trust over which that person has a power, exercisable solely by himself or herself, to vest the corpus or its income in himself or herself. IRC §678(a)(1). The same rule applies if the beneficiary-trustee has the power, exercisable solely by himself or herself, to apply income or corpus of the trust in discharge of his or her legal obligations, other than the obligation of support. The rule relating to trusts established by a third party is more liberal than the rules applicable to settlors. See §3.38.

A cotrustee who has a power to distribute income to himself or herself with another cotrustee's consent is not treated as the owner of the trust income under IRC §678(a), because the power may be exercised only in conjunction with a third person. Any power to withdraw income (including capital gain) vested only in the powerholder will, however, cause the holder to be taxed on that income or gain. *William Peyton Campbell*, TC Memo 1979-495.

The income of the trust is not taxed to the beneficiary-trustee merely because he or she is given the right to apply the income of the trust for the support of persons whom he or she is obligated to support, except to the extent that the income is so applied. IRC §678(c). This power in the beneficiary-trustee may be treated, however, as a general power of appointment for estate tax purposes. See §9.52.

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C. Additional Considerations

1. Powers of Appointment

§9.54 a. Purpose of Powers of Appointment

Vesting a beneficiary with a limited power of appointment in case he or she dies before becoming entitled to receive trust principal creates desirable flexibility to adapt to unexpected future circumstances (*e.g.,* a grandchild's illness or inability to manage wealth) and future changes in the tax law (*e.g.,* generation-skipping transfer (GST) tax, changes in trust income tax rates, and multiple-trust rules). The power should be drafted to avoid imposition of estate taxes on the death of the holder of the power.

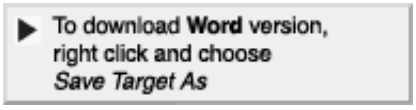
Limited powers of appointment can minimize the effect of the GST tax. If property is appointed outright to the beneficiary's spouse, the GST tax is avoided, at least during the spouse's lifetime (although the spouse may consume the property or divert it), because the spouse is in the same generation as the beneficiary. Similarly, if property is appointed in trust to the beneficiary's spouse with the remainder going to beneficiaries two or more generations younger than the spouse, the tax is deferred until the spouse's death. Note that property appointed outright to the spouse is included in his or her estate on his or her death and is also subject to his or her right of disposition. Alternatively, the beneficiary could be given a general power of appointment causing inclusion in the beneficiary's estate. A general power eliminates application of the GST tax. See §4.39.

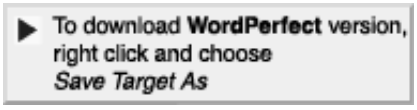
In some circumstances, it may be desirable to give the beneficiary a testamentary general power of appointment that will cause inclusion of trust property in the beneficiary's estate to obtain a step-up in basis at death that would not otherwise occur under IRC §1014. See §2.46. However, it is difficult to predict when those circumstances might arise. For the sake of flexibility, the grantor could give the trustee the power to create testamentary powers of appointment that could be exercised only with respect to particular appreciated assets during periods in which the trustee believes that the exercise or lapse of the power by the beneficiary would have favorable consequences.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.55 b. Form: Power of Appointment Created

§9.55 b. Form: Power of Appointment Created





[*Use one of the following alternatives*]

[*Alternative 1: Limited broad power of appointment*]

***Beneficiary's Power of Appointment*. On the death of _ _[*name of beneficiary*]_ _, the trustee shall distribute any remaining balance of _ _[*the trust estate/his trust/her trust*]_ _ (including both principal and any accrued or undistributed income) to one or more persons and entities other than the beneficiary, _ _[*his/her*]_ _ estate, _ _[*his/her*]_ _ creditors, or the creditors of _ _[*his/her*]_ _ estate on terms and conditions (either outright or in trust) appointed by _ _[*name of beneficiary*]_ _ in a _ _[*will or codicil/written instrument filed with the trustee*]_ _ specifically referring to and exercising this power of appointment.**

[*Alternative 2: Narrow limited power of appointment*]

***Beneficiary's Power of Appointment*. On the death of _ _[*name of beneficiary*]_ _, the trustee shall distribute any remaining balance of _ _[*the trust estate/his trust/her trust*]_ _ (including both principal and any accrued or undistributed income) to one or more of the group consisting of the settlors' issue and the spouses of those issue other than the beneficiary, _ _[*his/her*]_ _ estate, _ _[*his/her*]_ _ creditors, or the creditors of _ _[*his/her*]_ _ estate on terms and conditions (either outright or in trust) appointed by _ _[*name of beneficiary*]_ _ in a _ _[*will or codicil/written instrument filed with the trustee*]_ _ specifically referring to and exercising this power of appointment.**

[*Alternative 3: General power of appointment*]

***Beneficiary's Power of Appointment*. On the death of _ _[*name of beneficiary*]_ _, the trustee shall distribute the entire balance then remaining, if any, of the beneficiary's trust (including both principal and any accrued or undistributed income) to one or more persons and entities, including the beneficiary, _ _[*his/her*]_ _ estate, _ _[*his/her*]_ _ creditors, or the creditors of _ _[*his/her*]_ _ estate, on terms and conditions (either outright or in trust) appointed by _ _[*name of beneficiary*]_ _ in a _ _[*will or codicil/written instrument filed with the trustee*]_ _ specifically referring to and exercising this power of appointment.**

Comment: Clauses should be added to cover a default in the exercise of the power of appointment. Charitable organizations can be added to the permitted class of appointees in the narrow limited power. Considerations, including tax considerations, relating to powers of appointment conferred on beneficiaries in permanent trusts are basically no different from those relating to powers of appointment conferred in testamentary trusts except for the Rule Against Perpetuities. For a definition of "issue," see §10.134.

This clause can be used if property in trust for the beneficiary is otherwise subject to a generation-skipping transfer tax on the beneficiary's death. See comment in §9.26 concerning the generation-skipping transfer tax and a beneficiary's general power of appointment See also chap 4.

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c. Tax Considerations in Creating and Exercising Power of Appointment

§9.56 (1) Estate and Gift Tax on Trust

Only a general power of appointment causes property subject to the power to be included in the estate of the holder of the power. If the power is a limited power, the property subject to the power is not includable in his or her estate.

General and limited powers of appointment are precisely defined for gift and estate tax purposes. On generation-skipping transfer (GST) taxes, see §9.60. A general power of appointment is defined as a power exercisable directly or indirectly in favor of the holder of the power, the holder's estate, the holder's creditors, or the creditors of the holder's estate. IRC §§2041(b)(1) (estate tax), 2514(c) (gift tax). All other powers are limited powers. A power in the beneficiary to consume trust property, as a trustee or otherwise, is considered to be a general power of appointment unless limited by an ascertainable standard relating to "health, education, support, maintenance" in IRC §§2041(b)(1)(A) (estate tax), 2514(c)(1) (gift tax). See §9.52.

The holder of a limited or special power of appointment who also has another beneficial interest in the trust, such as a right to income, may be making a taxable gift if he or she exercises the limited power. The result of the exercise is a reduction or elimination of that person's other interest in the trust. For example, if the income beneficiary of a trust has a limited power to appoint the principal of the trust to a class of beneficiaries effective during the income beneficiary's lifetime, the exercise of that power constitutes a gift of the remaining income interest. Rev Rul 79-327, 1979-2 Cum Bull 342; *Estate of Ruth B. Regester* (1984) 83 TC 1. See also *Myra B. Robinson* (1980) 75 TC 346, aff'd (5th Cir 1982) 675 F2d 774, cert denied (1982) 459 US 970. But see *Self v U.S.* (Ct Cl 1956) 142 F Supp 939.

Drafters should be aware that Treas Reg §25.2514-1(b)(2) provides that although the inter vivos exercise of a nongeneral power of appointment by a life income beneficiary is not taxable under IRC §2514, it does result in a taxable gift of that person's remaining income interest under IRC §2511.

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§9.57 (2) Income Tax on Trust Income

A testamentary power of appointment has no adverse income tax consequences unless it is coupled with an inter vivos power under which the holder of the power is among the class of beneficiaries eligible to benefit from its exercise, either directly or through discharge of his or her legal obligation. See §9.53.

The settlors may be subject to income tax under IRC §674(a) if a nonadverse party has an inter vivos power of appointment that can be exercised during the settlors' lives (*e.g.,* the settlors' son has a limited inter vivos power of appointment over a trust for the settlors' grandchildren). Note that a beneficiary who has a substantial interest in the property or the portion of it affected by the exercise or nonexercise of the power is an adverse party. See §5.17.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/ 2. Perpetuities Clause/§9.58 a. Rule Against Perpetuities

2. Perpetuities Clause

§9.58 a. Rule Against Perpetuities

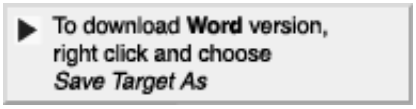
California has enacted the Uniform Statutory Rule Against Perpetuities (USRAP) (Prob C §§21200-21231). The general subject of this rule, with special emphasis on its relation to testamentary trusts, is covered in California Will Drafting, chap 34 (3d ed Cal CEB 1992). Elaboration on this discussion is necessary only in the following respects:

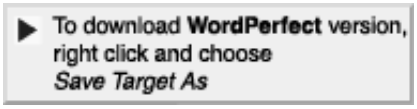
- For irrevocable trusts, the period of the rule begins to run on the date on which the trust is created, except for any portion of a trust subject to a general power of appointment exercisable during the holder's lifetime;
- All other powers (*i.e.,* special and testamentary general powers) are valid only if the act of exercise cannot occur beyond the perpetuities period. These powers cannot be conferred on unborn persons unless the power is specially limited by terminating within the perpetuities period.

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.59 b. Form: Perpetuities Savings Clause Trust Including Power of Appointment

§9.59 b. Form: Perpetuities Savings Clause Trust Including Power of Appointment





***Perpetuities Savings Clause*. Each trust created by this instrument shall terminate no later than 21 years after the death of the last survivor of the beneficiaries of the trust who are living on the date the trust becomes irrevocable. If a trust terminates by reason of the previous sentence, the remaining trust estate shall be distributed to the persons then entitled to the trust income in the proportions of their income entitlement unless the trustee has discretion to distribute income among a class, in which case the trustee shall have the same discretion to distribute the remaining trust estate among the members of that class. For purposes of this paragraph, a trust created by the exercise of a special power of appointment as defined in California Probate Code §611 is not a new trust.**

Comment: Although a savings clause should be included if possible, Prob C §21220 (reformation) is helpful when solving the problems that arise when a savings clause has not been used.

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§9.60 3. Generation-Skipping Transfer Tax

The benefit of avoiding estate taxes on the death of the settlors' children by using a trust and limited powers is entirely eliminated by the imposition of the generation-skipping transfer (GST) tax, when the trust is not sheltered by the settlors' GST exemptions. For a trust completely sheltered by the exemptions, no taxes are payable if the trust is not included in the children's estates, by reason of giving the children a general power of appointment, either express or hidden.

The GST tax does not apply to property subject to a general power of appointment by a person in the first generation below the settlor. Such property is included in the estate of the holder of the power under IRC §2041. Absent certain exceptions, the GST tax applies to property subject to a special power of appointment if (1) the power is exercised in favor of members of a generation two or more generations younger than a settlor of the trust or (2) the power lapses in favor of these beneficiaries.

PRACTICE TIP: Giving the child a general power of appointment allows the child to dispose of the property as he or she desires, which may not be as the settlor intended. See §4.39.

If estate taxes are avoided on the child's death, the trust property is subject to the GST tax when the trust is not sheltered by the settlors' IRC §2631 GST exemption. Alternatively, the child incurs estate taxes if he or she is given a testamentary general power of appointment (see §9.56). The applicable GST tax rate on taxable terminations is the same as the estate tax rate for all estates above the IRC §2010(c) applicable exclusion amount.

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§9.61 4. Retention of Reversionary Interest

If either of the settlors retains a reversionary interest in the trust property, other than an interest in the income alone, and the value of that reversionary interest immediately before a settlor's death is more than 5 percent of the value of the trust property contributed by a settlor, under some limited circumstances trust corpus is includable in that settlor's estate. Treas Reg §20.2037-1(a)(2). See §2.57.

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§9.62 5. Marital Deduction

For the use of the marital deduction in conjunction with irrevocable insurance trusts, see chap 11. An unlimited federal estate and gift tax marital deduction is available for trusts for the benefit of the other spouse if properly drafted. IRC §2523(c). Requirements are similar to a marital deduction testamentary trust. See California Will Drafting, chap 17 (3d ed Cal CEB 1992).

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.63 D. Guidelines for Exercising Discretion to Distribute

§9.63 D. Guidelines for Exercising Discretion to Distribute

When the trust instrument gives the trustee discretionary powers of distribution, the drafter should furnish guidelines to the trustee to assist him, her, or it in the exercise of that discretion. These guidelines perform two functions:

- They enable the settlors to communicate to the trustee those factors that the settlors believe the trustee should consider in making or failing to make distributions; and
- They provide tools for the trustee's use in exercising the powers to enable the trustee to implement the purposes of the trust.

Some trustees feel the need for guidelines so strongly that they will not accept a trust giving them undefined discretion to distribute income and principal without any other description of how the power should be exercised.

EXAMPLE: The settlors' son is 25 years old, unemployed, and purports to be an artist but has never sold a work of art and has no studio. Should the trustee force the son to seek employment by withholding distributions, or should the trustee provide sufficient funds to enable the son, and perhaps his family, to live comfortably? If the trustee seeks to have the son earn a living, should the trustee accede to the son's request for $100,000 to start a business? The settlors should provide some standards for the trustee to apply or at least consider.

The following types of questions should be addressed by the trustee:

- Whose interests are most important: the income beneficiary's or the remainder beneficiary's?
- Should the beneficiary be either productively engaged or disabled before becoming entitled to distributions?
- Does being productively engaged include being a homemaker?
- Should the beneficiary's independent resources be considered?
- Should the needs of the beneficiary's spouse and minor or adult issue be a factor?
- Should the beneficiary be provided luxuries such as funds to travel abroad or to purchase expensive artwork or jewelry?
- Should a request for a downpayment on a personal residence be considered and, if so, to what extent?
- To provide a standard for the trustee's application, the consulting editor occasionally inserts a sentence such as: "As a general guideline to the trustee, I prefer that, until age 30, my son drive a modest car like a Honda as opposed to a luxurious car like a Lexus."

Guidelines should be set out in precatory, rather than mandatory, language, unless the settlors wish the guidelines to become standards binding on the trustee. Guidelines may also be used to permit distributions for special occasions (*e.g.,* birthdays or weddings) or for special purposes (*e.g.,* education or medical expenses). The extent to which the settlors include guidelines in the instrument depends on the settlors' intentions. For discussion, with forms, of incentive clauses for trust beneficiaries, see §§12.111-12.121. When a settlor, nonadverse party, or beneficiary holds the power of invasion, care should be taken not to destroy any required ascertainable standards. See §§9.52-9.53.

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E. Protecting the Spendthrift

§9.64 1. When Spendthrift Protection Necessary

Occasionally, a client recognizes that he or she cannot manage his or her own affairs, and a trust must be established for his or her own protection. An irrevocable trust designating a corporate or other independent trustee provides a good solution. It is usually better to use a corporate fiduciary because any individual selected by the client could come under great pressure from the client to allow the client to continue his or her spendthrift ways. The only tax problem inherent in such a trust is to avoid the gift tax (see §9.66), but provision must be made concerning payment of income taxes (see §9.67).

The power of appointment in §9.65 should not be exercisable in favor of the settlor, the settlor's estate, the settlor's creditors, or the creditors of his or her estate because the purpose of the trust is to protect the settlor against himself or herself and, to the extent possible, against his or her creditors. The power should be a limited power of appointment. See §§9.55-9.57. The second paragraph of this clause is a narrow limited power, but it is also possible to use a broad limited power that allows the settlor to appoint the trust property to anyone other than the settlor, the settlor's estate, the settlor's creditors, or the creditors of the settlor's estate. The clauses on default of appointment (see the third paragraph of this clause) can create a trust for the settlor's issue, rather than providing for outright distribution.

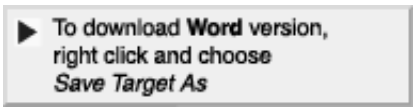
An irrevocable trust established by a settlor for his or her own benefit is void as against the settlor's creditors and transferees during his or her lifetime. See Prob C §15304; 13 Witkin, Summary of California Law, *Trusts* §§153, 160 (10th ed 2005). Thus, the trust does not protect against the possibility that the settlor may incur debts that can be collected from the trust, assuming that the settlor is competent to enter into contracts. Moreover, the trust protects the settlor only to the extent that a trustee, rather than the settlor, controls the settlor's assets by reason of the conveyance of title to the trustee.

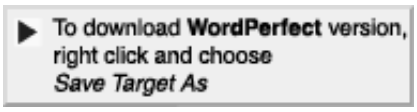
It is unclear whether, after the settlor's death, the corpus of an irrevocable trust for his or her benefit can be reached by his or her creditors when the settlor has retained a limited power of appointment. This question is not specifically addressed in the Probate Code provisions relating to spendthrift trusts. See Prob C §15304. (The procedures under Prob C §§19000-19403 for filing and cutting off creditors' claims apply only to revocable trusts.)

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Source: Estate Planning/Drafting California Irrevocable Trusts/9 Dispositive Clauses/§9.65 2. Form: Spendthrift Settlor Clause

§9.65 2. Form: Spendthrift Settlor Clause





***Discretionary Distributions to Settlor*. The trustee shall pay to or apply for the benefit of the settlor as much of the income and principal of the trust as the trustee, in the trustee's discretion, considers necessary or appropriate for the settlor's proper support, maintenance, health, and comfort, after taking into consideration to the extent the trustee considers advisable any of the other income or resources of the settlor known to the trustee. Any net income not distributed shall be added to principal.**

On the settlor's death, the trustee shall distribute the trust as then constituted to one or more of the settlor's issue _ _[*and any charitable organization or other designated person*]_ _ on terms and conditions (either outright or in trust) appointed by the settlor in a _ _[*will or codicil/written instrument filed with the trustee*]_ _ specifically referring to and exercising this power of appointment.

Any part of this trust not effectively appointed by the settlor in this manner shall be distributed on the date of _ _[*his/her*]_ _ death to _ _[*his/her*]_ _ then-living issue by right of representation. If there are none, that part of this trust shall be distributed to the issue of the settlor's parents based on the principle of representation.

Comment: For a definition of "issue," see §10.134. The phrase "by right of representation" refers to the distribution plan under Prob C §246(a).

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3. Tax Considerations in Spendthrift Trust

§9.66 a. Estate and Gift Tax on Trust

This trust does not have estate and give tax savings as its objective. The assets of this trust will be included in the settlor's gross estate because he or she has retained the income for life. IRC §2036. See §2.52.

Absent the power of appointment, establishment of this trust would result in a gift of the actuarial present value of the remainder interest given irrevocably to the settlor's children (or others). *Robinette v Helvering* (1943) 318 US 184, 87 L Ed 700, 63 S Ct 540. Existence of a power of invasion in a third party will not alter this result unless the right to invade has an ascertainable value. Treas Reg §25.2511-2(b).

Although credit for gift tax against the estate tax payable on the settlor's death is available (IRC §2012), the settlor's objective of conserving his or her estate is better served by avoiding payment of gift tax at the time the trust is created. Inclusion of any limited power of appointment, no matter how narrow the class of available appointees (but at least two), achieves this result. Treas Reg §25.2511-2(b). If the class is small, alternative appointees should be named so that if members of the class die or go out of existence, the class will not be a class of one. If the class is ever reduced to one, the gift becomes complete and the gift tax will be imposed.

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§9.67 b. Income Tax on Trust Income

The settlor is treated as the owner of this trust for income tax purposes because its income will either be distributed to him or her or accumulated for possible future distribution to him or her. IRC §677(a). The settlor is taxed on the capital gain of the trust for the same reason. The consulting editor believes that the trustee's powers are broad enough to make distributions to the settlor to enable the settlor to pay his or her taxes. Attorneys who feel otherwise can insert among the criteria of distribution "sums necessary to enable the settlor to pay his or her federal and state income tax and estimated tax liabilities from time to time."

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§9.68 F. When Disclaimers Effective

Both federal and California law have disclaimer statutes. See IRC §2518; Prob C §§260-295. If a beneficiary makes an effective disclaimer, the interest disclaimed will pass as if the disclaimant had predeceased the transferor of the interest. Absent a disclaimer, the beneficiary can only effect a similar transfer by incurring a gift tax.

The federal and California disclaimer laws are not identical:

- The federal law requires the disclaimer to be made within 9 months after the later of the date on which the transfer creating the interest in the beneficiary is made and the date on which the beneficiary reaches age 21. IRC §2518(b)(2).
- Under California law, an interest created by a living trust may be disclaimed within 9 months after the last of any of the following events or transactions occurs: (1) creation of the trust, (2) first knowledge of the interest by the disclaimant, and (3) the indefeasible vesting of the interest. Prob C §279(c). The term "living trust" in Prob C §279(c)(1) appears to include an irrevocable trust, because the terms "creation of the trust" and "gift" appear in the same phrase. Alternatives (2) and (3) are more liberal than the federal disclaimer statute provisions. This difference is significant, because federal tax law will normally be the chief area of concern. Although the California law provides that a disclaimer that is valid under federal law is valid under California law (see Prob C §295), federal law does not approve disclaimers that do not meet the requirements of IRC §2518. Federal law requires the disclaimer to be both effective and timely. It must cause the disclaimed property to pass from the disclaimant to another person without direction by the disclaimant under local law. Treas Reg §25.2518-1(c)(1). Under IRC §2518(c), a beneficiary may disclaim an undivided portion of an interest. For the beneficiary to make a qualified disclaimer, however, the undivided portion must consist of a fraction or percentage of each and every substantial interest owned by the beneficiary in the property. Treas Reg §25.2518-3(b). Therefore, the beneficiary of an outright gift of property cannot make a qualified disclaimer of a remainder interest in the property. See *Walshire v U.S.* (8th Cir 2002) 288 F3d 342.
- In IRS Letter Ruling 200846003, the IRS ruled that disclaimers by decedent's children that caused an individual retirement account (IRA) to pass to a QTIP trust as contemplated by a premarital agreement were not qualified under IRC §2518 because the QTIP remainder will pass to a trust benefiting the children. The ruling depends on the assumption that the decedent did not separately create "income" and "remainder" interests in the IRA, in which case a disclaimer of an income interest might be qualified despite the retention of the remainder interest.
- For transfers made before 1977, the disclaimer must be made within a reasonable time after knowledge of the existence of the transfer. Treas Reg §25.2511-1(c)(2). However, it appears that the IRS is willing to issue rulings concerning such disclaimers based on the current IRC §2518 regulations. See IRS Letter Ruling 200838026 (minor beneficiary of trust established before 1977 may disclaim trust interests within 9 months after attaining age 18, the age of majority, despite acceptance of benefits).

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10

Trust Administration and Trustee's Powers

Sandra J. Chan
Diana Hastings Temple

I. INTRODUCTION TO TRUST ADMINISTRATION §10.1
- A. Selection of Trustee
  - 1. Tax Considerations in Trustee Selection §10.2
  - 2. Settlor or Nonadverse Party as Trustee §10.3
    - a. Estate Tax Consequences §10.4
    - b. Income Tax Effects §10.5
  - 3. Beneficiary as Trustee §10.6
  - 4. Independent Trustee §10.7
  - 5. Cotrustees and Special Trustees §10.8
  - 6. Drafting Attorney as Trustee §10.9
- B. Limitations on Trustee's Exercise of Discretion
  - 1. Independent Trustee §10.10
  - 2. "Tax-Sensitive" Trustee §10.11

II. CLAUSES RELATING TO TRUSTEES
- A. Cotrustees or Special Trustees §10.12
  - 1. Trustee's Authority to Act §10.13
    - a. Form: Cotrustee Unanimity Not Required §10.14
    - b. Form: Cotrustee Delegation of Powers §10.15
    - c. Form: Cotrustee Action When Other Cotrustee Incapacitated §10.16
    - d. Form: Corporate Cotrustee to Have Custody of Assets §10.17
    - e. Form: Authority of Corporate Trustee to Expend No More Than Fixed Amount §10.18
    - f. Form: Appointment of Special Trustee §10.19
    - g. Form: Compensation; Effect of Powers of Special Trustee on Powers of Trustee §10.20
  - 2. Cotrustee Investment Powers §10.21
    - a. Form: Corporate Trustee's Right to Propose Purchases and Sales §10.22
    - b. Form: Power to Invest Vested Solely in Individual Trustee §10.23
  - 3. Discretionary Powers Relating to Principal and Income
    - a. Form: Power to Invade Principal Vested Solely in Individual Cotrustee §10.24
    - b. Special Trustee to Make Payments to Beneficiary-Trustee Other Than Settlor
      - (1) Avoiding Adverse Tax Consequences §10.25
      - (2) Form: Special Trustee to Make Payments to Beneficiary-Trustee §10.26
      - (3) Form: Trustee to Appoint Special Trustee to Make Payments to Beneficiary-Trustee §10.26A
- B. Resignation of Trustee
  - 1. Methods of Resigning §10.27
  - 2. Form: Resignation of Trustee §10.28
- C. Removal of Trustee §10.29
  - 1. Form: Trustee Removal and Replacement by Beneficiary or Third Party §10.30
  - 2. Form: Trustee Removal Due to Trustee Incapacity or Illness §10.31
  - 3. Form: Certificate of Independent Review §10.31A
- D. Designation of Successor Trustees §10.32
  - 1. Form: Designation of Successor Trustees §10.33
  - 2. Form: Remaining Cotrustee Acts as Sole Trustee; Settlor Designates Succession Thereafter §10.34
  - 3. Form: Settlor Designates Successor Trustees When Corporate Fiduciary Unwilling or Unable to Serve §10.35
  - 4. Form: Trustee's Power to Designate Successor §10.36
  - 5. Form: Beneficiaries' Power to Designate Successor §10.37
- E. Exculpating Trustee §10.38
  - 1. Form: Nonliability of Trustee §10.39

2. Form: Nonliability for Cotrustee's Acts §10.40
3. Form: Successor Trustee's Nonliability for Predecessor's Acts §10.41
F. Commingling Undivided Interests
1. Nature of Problem §10.42
2. Form: Authorization of Commingling of Undivided Interests §10.43
G. Self-Dealing
1. Potential for Self-Dealing §10.44
2. Form: Authorization of Self-Dealing §10.45
3. Form: Conflicts of Interest; Self-Dealing (Broad Powers) §10.46
4. Form: Nonliability of Trustee or Special Trustee for Conflicts of Interest §10.47
H. Trustee's Bond
1. Bond Generally Not Required §10.48
2. Form: Trustee's Bond §10.49
I. Trustee's Compensation
1. When Compensation Is Allowed §10.50
2. Form: Reasonable Compensation (Individual Trustee) §10.51
3. Form: Percentage of Net Value of Principal Plus Reasonable Compensation (Individual Trustee) §10.51A
4. Form: Reasonable Compensation (Cotrustees) §10.51B

III. SETTLOR'S CONTROL
A. Settlor's Power to Control Trust Investments §10.52
B. Form: Settlor's Veto Power Over Investments §10.53
C. Form: Settlor's Power to Direct Investments §10.54
D. Form: Settlor's Powers Personal to Settlor §10.55
E. Form: Investment Counsel §10.56
F. Form: Investment Consultant §10.56A

IV. CLAUSES GOVERNING TRUSTEE'S POWERS AND ADMINISTRATION
A. Form: Introduction to Trustee's Powers §10.57
B. Form: Trustee's Powers §10.58
C. Trustee Duties Regarding Investments §10.59
D. General Investment Powers
1. Broad or Restricted Investment Powers
a. Form: Broad Investment Powers Under Prudent Investor Rule §10.60
b. Form: Limited Investment Powers §10.61
2. Power to Retain Property and Operate a Business
a. Retaining Property and Operating a Business §10.62
b. Form: Power to Retain Property and Operate a Business (Standard Clause) §10.63
c. Form: Power to Retain or Purchase Unproductive or Underproductive Property §10.64
3. Diversification of Assets
a. Duty to Diversify Assets §10.65
b. Form: Diversification Not Required §10.66
4. Power to Sell, Exchange, Manage, Encumber, and Grant Options on Property
a. Disposing of and Managing Property §10.67
b. Form: Power to Sell, Exchange, Manage, Encumber, and Grant Options on Property (Standard Clause) §10.68
5. Power to Lease, Including Oil and Mineral Development (Standard Clause)
a. Leasing Property §10.69
b. Form: Power to Lease, Including Oil and Mineral Development (Standard Clause) §10.70
6. Securities Ownership
a. Managing Securities
(1) Authority to Manage Securities §10.71
(2) Form: Power to Manage Securities (Standard Clause) §10.72
(3) Form: Power to Register Shares for Sale (Closely Held or Controlled Public Corporation) §10.73
b. Holding Stocks and Other Securities in Nominee's, Broker's, or Street Name
(1) Authority to Hold Stocks and Other Securities §10.74
(2) Form: Authority to Hold Trust Property as Nominee §10.75
7. Power to Employ Agents or Investment Counsel
a. Use of Power §10.76
b. Form: Power to Employ Agents §10.77
c. Form: Individual Trustee's Power to Employ Investment Counsel §10.78

E. General Management Powers
1. Power to Borrow
a. Explicit Grant May Be Required §10.79
b. Form: Power to Borrow (Standard Clause) §10.80
2. Form: Power to Make Loans (Standard Clause) §10.81
3. Power to Lend to, Buy From, and Sell to Trust
a. Allowing Trustee as Individual to Purchase Assets or Make Loans to Trust §10.82
b. Form: Power to Lend to, Buy From, and Sell to Trust Individually §10.83
4. Power to Initiate and Defend Litigation and to Compromise Claims
a. Explicit Grant of Power Reinforces Trustee's Duty to Preserve Trust Property §10.84
b. Form: Power to Initiate and Defend Litigation and Power to Compromise (Standard Clause) §10.85
5. Power to Insure
a. Power to Insure Assets and Insure Against Liability §10.86
b. Form: Power to Insure (Standard Clause) §10.87
F. Powers to Deal With Settlor's Probate Estate
1. Use of Powers §10.88
2. Form: Power to Lend to Settlor's Probate Estate §10.89
3. Form: Power to Purchase Property From Settlor's Probate Estate §10.90
G. Powers Relating to Taxes
1. Trustee's Disclaimer, Release, or Restriction of Administrative Powers
a. Authority §10.91
b. Form: Disclaimer, Release, or Restriction of Administrative Powers §10.92
2. Power to Adjust for Consequences of Tax Elections and Other Decisions
a. Trustee Tax Elections §10.93
b. Form: Power to Adjust for Tax Consequences §10.94
3. Power to Consider Tax Consequences of Distributions
a. Throwback Rules §10.95
b. Form: Power to Consider Tax Consequences of Distributions §10.96
4. Form: Authority to Pay Estate Taxes §10.97
5. Generation-Skipping Transfer Taxes §10.98
H. Tax Consequences
1. Avoiding Adverse Tax Consequences to Settlor or Beneficiary-Trustee §10.99
2. Form: Trustee Prohibited From Exercising Certain Powers §10.100
I. Miscellaneous Management Clauses
1. Power to Consolidate or Divide Trusts §10.101
a. Form: Physical Division of Separate Trusts Created in Single Instrument Not Required; Division Into Separate Trusts Permitted (Standard Clause) §10.102
b. Form: Consolidated Administration of Trusts §10.103
2. Form: Power to Move Situs §10.104
3. Form: Payments to Beneficiary Under Disability or to Minor Beneficiary §10.105
4. Distribution on Termination of Trust
a. Issues to Consider §10.106
b. Form: Broad Powers of Distribution (Standard Clause) §10.107
5. Power to Delay Distribution Until Resolution of Claims or Liability
a. Use of Power §10.108
b. Form: Power to Withhold Payment if Conflicting Claims Arise §10.109
J. Notice of Proposed Action
1. When Notice May Be Used §10.109A
2. Notice Procedure §10.109B
3. Form: Notice of Proposed Action §10.109C

V. POWERS RELATING TO PRINCIPAL AND INCOME
A. Purpose of Clauses §10.110
B. Tax Considerations §10.111
C. Allocation Clauses §10.112
1. Form: Uniform Principal and Income Act to Govern §10.112A
2. Form: Broad Power to Determine Principal and Income (Standard Clause) §10.112B
3. Form: Power to Make Allocations Between Principal and Income With Limited Discretion (Tax-sensitive Trustee) §10.112C
D. Allocation of Income and Expenses Among Successive Beneficiaries
1. Allocation of Income §10.113
2. Form: Undistributed Income Payable to Successive Beneficiaries §10.114
3. Allocation of Expense Items §10.115

4. Form: Allocation of Expenses Among Successive Beneficiaries §10.116
E. Conversion of Income Interest to Unitrust Interest §10.116A

VI. ACCOUNTING BY TRUSTEE
A. Purpose of Accounting §10.117
B. Form: Accounting by Trustee §10.118

VII. MISCELLANEOUS ADMINISTRATIVE CLAUSES
A. Notice of Births, Deaths, and Other Events Affecting Interests
1. Purpose of Clause §10.119
2. Form: Notice to Trustee of Births, Deaths, and Other Events Affecting Interests §10.120
B. Additions to Trust
1. Purpose of Clause §10.121
2. Form: Clause Authorizing Additions to Trust §10.122
C. Spendthrift Clause
1. Purpose of Clause §10.123
2. Form: Spendthrift Clause §10.124
D. Choice-of-Law Clause
1. Enforceability and Desirability §10.125
2. Form: Specifying Law to Govern Validity, Construction, and Administration of Trust §10.126
E. Construction of Commonly Used Terms §10.127
1. Form: Gender and Number §10.128
2. Form: Trustees and Fiduciaries §10.129
3. Form: Distribution Among Beneficiaries §10.130
4. Form: "Shall" and "May" §10.131
F. Commonly Included Definitions
1. Form: Education §10.132
2. Issue and Children
a. Defining "Issue" and "Children" §10.133
(1) Natural Parent-Child Relationship Under Uniform Parentage Act §10.133A
(2) Conclusive Marital Presumption for Children of Spouses or Registered Domestic Partners §10.133B
b. Form: Issue and Children (California Law of Intestate Succession Applies) §10.134
c. Form: Issue and Children (Lineal Descendants) §10.134A
3. Form: Spouse, Husband, or Wife §10.135
4. Form: Spouse or Registered Domestic Partner §10.135A
G. Form: No-Contest Clause §10.136
H. Form: Annual Distributions of Income §10.137
I. Form: Distribution of Disclaimed Property §10.138
J. Form: Power to Distribute if Power of Appointment Not Exercised §10.139

VIII. IMPLEMENTING THE TRUST §10.140

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§10.1 I. INTRODUCTION TO TRUST ADMINISTRATION

The administrative clauses of an irrevocable trust must be drafted with great care. Although an irrevocable trust is normally created to reduce the tax burden on a settlor's estate, the desire to avoid taxation is often accompanied by a reluctance to give up control over, and sometimes enjoyment of, the property transferred to the trust. The legitimate tax avoidance purpose will be defeated if a settlor or a nonadverse party is given certain broad discretionary and administrative powers (*e.g.,* powers found in IRC §§2036, 2038-2042). See §§10.3, 10.52.

Thus, in drafting an irrevocable trust to achieve the tax benefits of a completed gift for estate and gift tax purposes, the practitioner should exercise great care in choosing a trustee (see §10.2) and drafting the trustee's powers (see §10.10). For discussion of tax aspects of trustee and settlor administrative powers, see Halbach, *Tax-Sensitive Trusteeships*, 63 Or L Rev 381 (1984).

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A. Selection of Trustee

§10.2 1. Tax Considerations in Trustee Selection

The choice of trustee is a crucial decision that the settlor must make when establishing an irrevocable trust. The tax consequences of this decision may be so important that they dictate the result.

The following sections discuss the tax impact of choosing the following persons as trustee:

- A settlor or a related or subordinate party (§§10.3-10.5);
- A beneficiary (§10.6); and
- An independent party (§10.7).

Nontax factors to consider in making this decision are discussed in §§10.8-10.9. See also Drafting California Revocable Trusts, chap 16 (4th ed Cal CEB 2003).

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§10.3 2. Settlor or Nonadverse Party as Trustee

Often, a settlor wishes to occupy the office of trustee, either alone or in conjunction with another. There may be tax hazards in a settlor's doing so. Although the trust may have been drafted to avoid the rights and powers described in IRC §§2036 and 2038 (see §§2.48-2.62), the Internal Revenue Service may nevertheless press its attack under those clauses if the settlor-trustee has retained broad administrative powers.

In *Old Colony Trust Co. v U.S.* (1st Cir 1970) 423 F2d 601, 603, the court held that no combination of "purely administrative powers" will cause the trust to be taxed in the settlor-trustee's estate. The drafter should, however, still avoid conferring a settlor-trustee with excessively broad powers on which the IRS could base an attack. See §§2.48-2.62.

A settlor need not be a trustee per se to hold a power affecting the trust that will have adverse tax consequences. The power rather than the office brings about the negative tax result. Nor does the fact that the settlor will not benefit from the exercise of the power necessarily eliminate adverse income tax consequences if the exercise will affect the beneficial enjoyment or control over the property subject to the power. See IRC §674. By the same token, many powers cannot be safely granted to any party who is not an adverse party. See IRC §§674-675. On who is an adverse party, see §3.26.

Exclusion of a settlor from the office of trustee does not guarantee the desired tax results, but it does significantly reduce the risk of adverse tax consequences. It is possible to vest safe powers (*e.g.,* power to direct investment) in a settlor while vesting other powers in a third party. See §§10.8, 10.54.

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§10.4 a. Estate Tax Consequences

A primary objective of most irrevocable trusts is to avoid inclusion of the trust property in the settlor's taxable estate. Achievement of this objective requires, among other things, avoiding inclusion under IRC §§2036, 2038, and 2042.

Irrevocable trust property is includable in a deceased settlor's estate under IRC §2036 if the settlor, at death, retained the right to possess or enjoy the property or its income or had the right to designate the persons who will possess or enjoy the property or its income. For example, the power of a settlor-trustee to pay or accumulate trust income or to distribute trust principal as the settlor-trustee deems necessary or proper will cause trust property to be included in the settlor's gross estate under IRC §2036(a)(2) unless the power is limited by an ascertainable standard. *Old Colony Trust Co. v U.S.* (1st Cir 1970) 423 F2d 601.

Similarly, under IRC §2038, the value of any interest in property transferred by the decedent in which the decedent retained the power to alter, amend, revoke, or terminate the transferred interest is included in the decedent's gross estate. If, as trustee or otherwise, the settlor has broad powers over trust investments and an unbridled power to allocate receipts and disbursements between income and principal, the IRS may argue that the settlor could in fact alter the dispositive clauses of the trust and the income beneficiaries' and remainder beneficiaries' rights through the exercise of these purely administrative powers. Thus far, the IRS has not been successful in its arguments. See, *e.g., Estate of Ralph Budd* (1968) 49 TC 468, acq 1973-2 Cum Bull 1. For further discussion of IRC §§2036 and 2038, see §§2.48-2.62.

Life insurance proceeds are included in the insured settlor's gross estate if he or she is the trustee or cotrustee of an insurance trust at the date of death, because this results in the insured's possessing incidents of ownership in the insurance policy. IRC §2042. Incidents of ownership include any rights of the insured or the insured's estate to economic benefits from the policy, including the power to change beneficiaries, to borrow against the policy, to surrender or cancel the policy, and to assign or revoke the assignment of the policy. Treas Reg §20.2042-1(c)(2). See §11.6.

If a decedent transfers an interest in property or gives up a power within 3 years of death, the decedent's gross estate includes the property subject to the interest or power to the extent it would be included under IRC §§2036-2038 if the decedent had retained the interest or power until death. IRC §2035(a).

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§10.5 b. Income Tax Effects

The powers that may be conferred on a settlor-trustee are also affected by income tax considerations. Retaining benefits in or particular powers over the trust may cause the trust to be treated as a grantor trust for federal income tax purposes under IRC §§671-677. If a settlor is given the power to allocate, distribute, or accumulate income among several beneficiaries or within a class of beneficiaries, or to pay corpus to several beneficiaries, the income of the trust will be taxed to that settlor. IRC §674(a); Rev & T C §17731. Section 674(a) does not apply to certain nondiscretionary powers specified in IRC §674(b) or to certain powers of independent trustees no more than half of whom are related or subordinate parties under IRC §674(c). See §§3.30, 3.36, 10.7, 10.100. (Note that under IRC §672(e), the settlor will also be treated as the holder of any powers held by his or her spouse.)

In many instances, the planner will intentionally retain certain powers to create a "defective" grantor trust so that trust income is taxed to the settlor. A defective grantor trust can be created that is not includable in the settlor's estate for estate tax purposes even though it is taxed as a grantor trust for income tax purposes. In other cases, a defective trust may be undesirable, particularly if the grantor may not have the funds with which to pay the taxes on the trust income that the settlor does not receive. See §§3.24, 3.40-3.44. For defective grantor trust language, see §5.10. See also chap 13A.

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§10.6 3. Beneficiary as Trustee

If a beneficiary is a trustee, the trustee's administrative powers must be restricted to prevent the unintentional inclusion of the trust assets in the beneficiary's estate. All the trust assets will be included in the beneficiary's estate if the beneficiary has any power that is exercisable in favor of "the decedent, his estate, his creditors, or the creditors of his estate." IRC §2041(b). To prevent trust assets from being included in the beneficiary-trustee's estate because the beneficiary-trustee is deemed to have a general power of appointment over them, the beneficiary-trustee's power to make discretionary distributions must be limited by an ascertainable standard. IRC §2041.

A beneficiary-trustee who has minor children must be precluded from using trust funds to discharge his or her legal support obligations. Treas Reg §20.2041-1(c)(1). For further discussion of IRC §2041, see §§2.11-2.13, 2.65. See also §§9.54-9.57.

Care must also be used when a beneficiary is given the power to remove a trustee and name a successor. If there are no limitations on this power, the beneficiary may be deemed to hold the powers of the trustee. This problem can be avoided if distributions to the beneficiary are limited by an ascertainable standard. See IRC §2041. It can also be avoided by providing that the successor trustee cannot be the beneficiary or a related or subordinate party to the beneficiary within the meaning of IRC §672(c). See Treas Reg §§20.2036-1(b)(3), 20.2038-1(a); Rev Rul 95-58, 1995-2 Cum Bull 191. Although Rev Rul 95-58 expressly applies in retained settlor power situations, it appears to apply to a beneficiary by analogy. Another approach is to give the trustee removal and replacement power to someone who will be responsive to the beneficiary's concerns.

Tax considerations do not impose real limitations on the administrative powers that may be given to a surviving spouse who is a United States citizen and the trustee of a marital deduction trust. Under the marital deduction provisions of IRC §2044, assets held in a marital deduction trust will be subject to estate tax on the surviving spouse's death in all events. Moreover, all the income of the trust will be taxed to the surviving spouse.

Limiting the administrative powers of a beneficiary-trustee is important, however, when the beneficiary-trustee is the settlor's spouse and the trust is a qualified terminable interest property (QTIP) trust which is includable in the spouse's estate (IRC §2044) and the income of which is taxed to the spouse or the settlor (IRC §§677(a), 652, 662). It is undesirable for the spouse to have a general power of appointment over a QTIP trust even though the property will be in his or her estate anyway, because:

- The ability to make a reverse QTIP election under IRC §2652(a)(3) is lost.
- The tax apportionment is different because IRC §2207A does not apply to a general power of appointment trust.

If the spouse has a general power of appointment over what was intended to be a QTIP trust, it is no longer a QTIP trust under IRC §2056(b)(7), but rather a trust that qualifies for the marital deduction as a general power of appointment trust under IRC §2056(b)(5).

If a trust beneficiary who is also a trustee or cotrustee has absolute, sole, or uncontrolled discretion to distribute income or principal to himself or herself, the beneficiary must exercise that power reasonably and according to the standard imposed by the instrument. Prob C §16081(b). Unless the standard clearly indicates that a broader power is intended by "express reference" to Prob C §16081(c), the beneficiary-trustee may exercise the power in his or her favor only for his or her health, education, support, or maintenance within the meaning of IRC §§2041 and 2514. Prob C §16081(c). On inclusion of trust assets in a beneficiary-trustee's taxable estate because of the trustee's right to terminate the trust, see §§9.6, 9.52.

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§10.7 4. Independent Trustee

As discussed in §§10.3-10.6, certain powers over trust property cannot be given to settlors or beneficiaries without causing unfavorable tax consequences to the settlors, beneficiaries, or to their estates. Although these powers may be given to a nontrustee, leaving a settlor or a beneficiary as the sole trustee, it is desirable that all persons exercising powers do so in a fiduciary capacity to avoid possible adverse tax consequences to the persons exercising the powers. If it is desirable that the trustee have powers that would cause adverse tax consequences to the settlor if held by the settlor, then the settlor should consider appointing an independent or adverse party as sole trustee, cotrustee, or special trustee of the trust. Appointing an independent trustee to exercise all tax-sensitive trustee powers will increase the trust's flexibility to handle changed circumstances in the future.

An independent trustee is defined as one or more trustees, none of whom is the grantor and no more than half of whom are related or subordinate to the grantor. IRC §674(c). An adverse party is any person with a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power that he or she possesses regarding the trust. IRC §672(a). For discussion of independent and adverse parties, see §§3.26, 3.36. On the powers that may be conferred on these parties, see §9.14. For discussion of cotrustees and special trustees, see §10.8.

If the settlor decides to name a corporate fiduciary as independent trustee, the drafter and settlor should be aware that a corporate trustee will often decline to serve if the value of the trust estate or the anticipated fee does not meet the corporation's requirements or if the trust estate contains undesirable assets such as property potentially contaminated with hazardous waste. Additionally, a corporate fiduciary may require that the trust instrument contain certain clauses and not others. The drafter should have the corporate fiduciary review a draft of the instrument before it is signed to ensure that it satisfies the corporate fiduciary's requirements.

If a corporate trustee is named as a primary or successor trustee, the instrument might also name individuals as alternate trustees or confer on some individual (or series of individuals) or a committee the power to designate an alternate trustee or a successor trustee in the event that the corporate trustee resigns or declines to serve.

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§10.8 5. Cotrustees and Special Trustees

The settlor may wish to appoint more than one trustee to take advantage of the different experiences and backgrounds they each will bring to the office of trustee. This often occurs when the settlor wants to combine a corporate trustee's permanence with an individual's familiarity with family circumstances. These benefits must be weighed, however, against the possible administrative inconvenience of having more than one trustee serve and the added expense of resolving problems if disagreements occur between trustees.

In utilizing the cotrustee relationship (as opposed to a special trustee), the settlor should bear in mind the strict standards to which cotrustees are held. Unless otherwise provided in the trust instrument, each cotrustee must participate in administering the trust and take reasonable steps to prevent a cotrustee from committing a breach of trust or to compel a cotrustee to redress a breach of trust. Prob C §16013. See, *e.g., Blackman v Hale* (1970) 1 C3d 548, 83 CR 194 (cotrustee was liable for trust fund loss when he surrendered trust assets to other cotrustee, failed to supervise his acts, and failed to account for trust funds). See Prob C §18003(c). See also §10.13.

A trustee can be relieved from liability for breach of trust in the trust instrument unless the breach of trust is committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the beneficiary's interest. Prob C §§16461-16462. See §§10.38-10.40.

A cotrustee, as opposed to a special-trustee, relationship (see §10.21) may solve income tax problems and yet be unsatisfactory from an estate tax point of view. If the administrative powers to be conferred on the trustees are sufficiently broad to create a hazard under IRC §§2036 and 2038, a settlor should not be a cotrustee—regardless of who the other cotrustee might be. See §§10.4-10.5. A special-trustee relationship can be used, however, because the unwanted power may be vested solely in the third party to the exclusion of the settlor-trustee.

A settlor can serve as trustee for powers that do not cause adverse tax consequences, and vest specified unwanted powers solely in a third party in a fiduciary capacity as special trustee. Use of a special trustee eliminates any requirement that a third party concur with the settlor's exercise of his or her powers—particularly the investment power. See *Jennings v Smith* (2d Cir 1947) 161 F2d 74. The special trustee's powers can be of indefinite duration or can be limited to the period that the settlor or other individual trustee needs the special trustee to hold the tax-sensitive powers.

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§10.9 6. Drafting Attorney as Trustee

A sole trustee who drafted the transfer instrument may be removed under Prob C §21350 as a disqualified person even if the drafter is not a beneficiary of the transfer. Prob C §15642(b)(6). The trustee will not be removed if, based on any evidence of the settlor's intent and all other facts and circumstances, the court finds that the trustee's continued service is consistent with the settlor's intent and that this intent was not the product of fraud, menace, duress, or undue influence.

The clause for removal of a sole trustee does not apply if:

- The settlor is related by blood or marriage or is a cohabitant with the trustee (Prob C §15642(b)(6)(A)); or
- The instrument is reviewed by an independent attorney who counsels the settlor about the intended trustee designation and provides the settlor and the trustee with a certificate of independent review (Prob C §15642(b)(6)(B)).

If a settlor wishes the drafting attorney to serve as a sole trustee, it is best to have an independent attorney review the trust instrument and issue a certificate of independent review, to avoid the risk that a court may later determine that the settlor's intent was otherwise. For a form of certificate of independent review, see §10.31A.

For discussion of ethical restrictions on an attorney who serves as a trustee, see Drafting California Revocable Trusts §2.39 (4th ed Cal CEB 2003).

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B. Limitations on Trustee's Exercise of Discretion

§10.10 1. Independent Trustee

Almost every trust instrument provides that the trustee is empowered, explicitly or implicitly, to take some discretionary action. This discretion may relate to dispositive clauses (*e.g.,* the trustee's power to distribute principal to an income beneficiary) or to purely administrative matters (*e.g.,* the power to determine what is income or principal). The drafter may provide that a discretionary power is to be exercised in the trustee's sole or absolute discretion. These additional words should not be used, however, without considering the possible adverse tax consequences.

An example can be drawn from the income tax area:

EXAMPLE: Assume that it is desired that trust income be taxed to a party other than the settlor. A settlor, under these circumstances, generally may not control the beneficial enjoyment of trust corpus (IRC §674(a)), except that he or she may have the power to distribute corpus to a beneficiary if "the power is limited by a reasonably definite standard" appearing in the trust instrument (IRC §674(b)(5)(A)). Although a power to distribute corpus for the beneficiary's support, maintenance, health, or education is sufficiently limited, the IRS takes the position that the discretion is not sufficiently limited if the power is exercisable in the trustee's sole or absolute discretion. If the trust instrument provides that the trustee's determination is "conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard." Treas Reg §1.674(b)-1(b)(5)(i).

Providing that a power is to be exercised in the trustee's sole or absolute discretion may create similar problems when used in conjunction with the trustee's administrative powers in a tax-sensitive trustee situation. See §§10.11, 10.99.

When the words "sole" or "absolute" describe powers conferred on an independent trustee (*e.g.,* a bank) in a non-tax-sensitive trustee situation, it may not cause tax problems, but the beneficiary's power to insist on a reasonable administration of the trust estate may be limited. See, *e.g., Coberly v Superior Court* (1965) 231 CA2d 685, 42 CR 64. Probate Code §§16080-16082 ameliorate these situations. Under those sections, a discretionary power conferred on a trustee may not be exercised arbitrarily but must be exercised reasonably and in accordance with fiduciary principles. See §10.6.

None of the forms in this chapter give the trustee absolute discretion in the exercise of his or her powers.

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§10.11 2. "Tax-Sensitive" Trustee

Tax problems can arise when a beneficiary or a settlor acts as trustee (see §§10.3-10.6) or when the trust is designed to qualify for the gift tax marital deduction or the gift tax annual exclusion.

One problem area concerns trust income that is intended to be taxed to someone other than a settlor. If a party other than an independent trustee serves as trustee of such a trust, the drafter must ensure that the nonindependent trustee does not have the power to determine whether income or corpus is to be distributed or retained, except within the permitted limits. Otherwise, the settlor may be taxed on the trust's income. IRC §674; Rev & T C §17731. See, *e.g.,* §§9.16-9.19.

In tax-sensitive situations, the trustee's powers usually should be limited. The term "tax-sensitive" trustee (see §10.99) is sometimes used to indicate the circumstances that suggest the choice of more limited administrative clauses.

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II. CLAUSES RELATING TO TRUSTEES

§10.12 A. Cotrustees or Special Trustees

Frequently, independent trustees or special trustees are appointed to serve either alone or as cotrustees because the settlor wishes to have the benefit of their skills and experience in administering the trust and to avoid the adverse tax consequences of vesting certain powers in the settlor or a trust beneficiary. Independent or special trustees are especially useful when one of the trustees is a settlor, a related or subordinate party, a nonadverse party, or a beneficiary. Powers may be given to an independent trustee or a special trustee that would create adverse tax consequences if given to a settlor, a related or subordinate party, a nonadverse party, or a beneficiary. See §§10.3-10.6.

The forms in §§10.14-10.26 are adapted from forms presented by the late John R. Cohan and Arnold D. Kahn at the Seventh Annual Estate Planning Forum presented by the Beverly Hills National Bank and are used in this book with the permission of the bank's successor, Wells Fargo Bank. The discussion and the forms assume that the cotrustee is a corporate trustee. The forms may be adapted for use when all cotrustees are individuals. See §10.13.

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§10.13 1. Trustee's Authority to Act

Cotrustees must act unanimously unless the trust instrument provides otherwise. Prob C §15620. This rule does not apply when voting stock because Corp C §704 permits a majority of trustees to vote stock in the absence of a trust provision. See *Edwards v Edwards* (1998) 61 CA4th 599, 71 CR2d 653. When an odd number of cotrustees will serve, the settlor can avoid the sometimes cumbersome requirement that the cotrustees' decisions be unanimous by providing that a majority of the cotrustees may bind the trust. See Alternative 1 in §10.14. The requirement of unanimity is particularly cumbersome for small transactions. The requirement can be avoided in those cases by granting the corporate trustee the power to act alone. See form in §10.18. When a clause permitting majority rule is used, a dissenting cotrustee is not liable for the acts or omissions of the majority under Prob C §18003(a)-(b).

When an even number of cotrustees will serve, the settlor can avoid a deadlock by conferring the power to make the ultimate decision on one particular cotrustee. Because any individual cotrustee nominated will probably cease to act before a corporate cotrustee, it may be prudent to give this power to the corporate cotrustee. See Alternative 2 in §10.14. The responsibility for breaking tie votes can also be split (*e.g.,* invasion of principal by the individual trustee and administrative matters by the corporate fiduciary).

The corporate cotrustee customarily has custody of trust assets, partly because it has facilities for their safekeeping and partly because it must maintain complete records and accounts regardless of whether it has custody. There is, however, little legal authority for this practice. Theoretically, each cotrustee has the right to custody. The corporate cotrustee's authority may be spelled out in the trust instrument. See form in §10.17. A national bank is required by bank regulations to keep the trust records. See 12 CFR §§9.1-9.20.

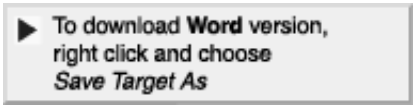
Trust documents appointing individual cotrustees may create administrative problems if one of the cotrustees is unavailable to act. The problem of the unavailable cotrustee may be addressed through a properly drafted delegation clause. See §10.15. Although a trustee generally has a duty not to delegate to others the performance of acts that the trustee can reasonably be required personally to perform, an express delegation clause will authorize an otherwise impermissible delegation. Prob C §§16000, 16012.

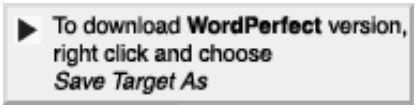
Unless the trust instrument provides otherwise, the remaining cotrustees may act for a trustee who is unable to perform due to absence, illness, or other temporary incapacity when it is necessary to accomplish the purposes of the trust or to avoid irreparable injury to trust property. Prob C §15622. See 18 Cal L Rev'n Comm'n Reps 648 (1986) (power to act when cotrustee temporarily unable to fulfill duties). See form in §10.16. For provisions authorizing appointment of special trustees, see §§10.19-10.20.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.14 a. Form: Cotrustee Unanimity Not Required

§10.14 a. Form: Cotrustee Unanimity Not Required





[*Use one of the following alternatives*]

[*Alternative 1: Majority rule*]

***Authority of Cotrustees*. Any action by a majority of the cotrustees shall be binding on the trust estate and may be relied on by third parties dealing with the cotrustees.**

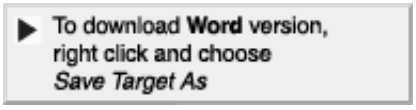
[*Alternative 2: Decisions of corporate or individual trustee to govern*]

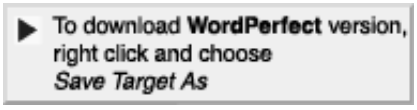
***Authority of Cotrustees*. If, after consultation with each other, the cotrustees cannot agree about any matter affecting the administration or distribution of the trust estate, the decision of the _ _[*individual/corporate*]_ _ cotrustee shall govern. The _ _[*individual/corporate*]_ _ cotrustee must advise the _ _[*corporate/individual*]_ _ cotrustee in writing of _ _[*his/her/its*]_ _ decision. The _ _[*corporate/individual*]_ _ cotrustee must comply with any decision of the _ _[*individual/corporate*]_ _ cotrustee and shall not be liable to any person for the actions or inactions of the trustees resulting from that decision.**

Comment: Alternative 2 may be modified so that the decision of a specified individual cotrustee or a designated special trustee governs.

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§10.15 b. Form: Cotrustee Delegation of Powers





[*Use one of the following alternatives*]

[*Alternative 1: Delegation of powers during vacation or absence from state*]

***Delegation by Cotrustee*. As long as any individual named in this trust serves as cotrustee of this trust, that individual shall have the power from time to time to delegate to the other cotrustee(s) all or any of his or her powers as cotrustee during temporary vacation periods or other temporary absences from the State of California. The delegation power shall be exercised by the individual cotrustee to the other cotrustee(s) of written notice specifying the delegated powers. This delegation will terminate when the individual cotrustee delivers to the other cotrustee(s) written notice that the delegation has terminated.**

[*Alternative 2: Delegation of powers for specified time*]

***Delegation by Cotrustee*. An individual cotrustee has the power from time to time to delegate to the other cotrustee(s) all or any of his or her powers as trustee during temporary absences due to vacation, business, employment, illness, emergency, or other similar causes. The delegation power shall be exercised by the delegating cotrustee's delivery to the other cotrustee(s) of written notice specifying the powers delegated and may be revoked or modified by delivery of another writing. No delegation shall last longer than _ _[*number*]_ _ months, and any two delegations for the same cause must be separated by at least _ _[*number*]_ _ days. The delegation shall terminate on the earlier of the date specified in the written notice, the delegating cotrustee's delivery to the other cotrustee(s) of written notice of termination of the delegation, or the expiration of _ _[*number*]_ _ months after the date of the delegation.**

[*Continue*]

The delegating cotrustee shall incur no liability to any beneficiary of this trust as a result of any actions taken or not taken within the scope of delegation during the period of delegation. Any third party may rely on a written delegation made under this clause and shall incur no liability for any action taken in reliance on the delegation in the absence of actual knowledge of its revocation or modification.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.16 c. Form: Cotrustee Action When Other Cotrustee Incapacitated

§10.16 c. Form: Cotrustee Action When Other Cotrustee Incapacitated

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***Incapacity of Cotrustee*. If an individual cotrustee cannot participate in trust activities because of illness or disability, the other cotrustee(s) shall, during any incapacity, make all decisions regarding the trust estate as though _ _[*he/she/it/they*]_ _ were the sole trustee(s). In determining whether an individual cotrustee is incapacitated, the other cotrustee(s) may rely on a certificate or other written statement from two physicians licensed to practice medicine in the state in which the individual cotrustee resides, who have examined the individual cotrustee within the last _ _[*number*]_ _ days.**

[*If appropriate, add the following option*]

[*Option: Cotrustee must petition court for authority to proceed as sole trustee when other cotrustee incapacitated*]

Absent a certificate or statement, the cotrustee(s) must petition the court having jurisdiction over this trust for authority to proceed as sole trustee(s), under authority of this clause. Any individual, by assuming the office of trustee, shall be deemed to have waived the doctor-patient privilege to the extent necessary to implement this clause.

[*Continue*]

The cotrustee acting as sole trustee shall incur no liability to any beneficiary of the trust or to the incapacitated cotrustee as a result of any action taken under this clause.

Comment: This clause specifically permits a cotrustee to act when an individual cotrustee is incapacitated as long as the individual cotrustee's incapacity has been clearly established.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.17 d. Form: Corporate Cotrustee to Have Custody of Assets

§10.17 d. Form: Corporate Cotrustee to Have Custody of Assets

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***Custody of Trust Assets by Corporate Trustee*. At all times when there are two or more cotrustees serving as cotrustees under this trust and one is a corporate trustee, the corporate cotrustee shall have exclusive custody of all or any assets of the trust estate.**

Comment: This clause clarifies that there should not be a problem under state law regarding possession of assets.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.18 e. Form: Authority of Corporate Trustee to Expend No More Than Fixed Amount

§10.18 e. Form: Authority of Corporate Trustee to Expend No More Than Fixed Amount

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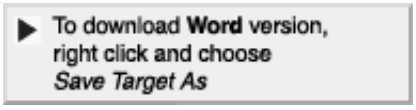
***Authority of Corporate Trustee*. The corporate trustee has the power to bind the trust in any transaction obligating the cotrustees to expend _ _[*dollar amount*]_ _ or less, and the corporate cotrustee may be the sole signatory of all checks necessary to accomplish the expenditure.**

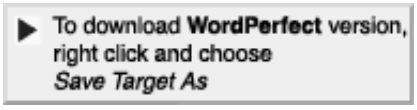
Comment: This clause permits the corporate trustee to act alone in smaller transactions. The maximum limit should be set to suit the individual trust. Some corporate fiduciaries resist this clause because they routinely obtain a blanket waiver from the individual trustee authorizing the corporate trustee to sign all checks regardless of the amount.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.19 f. Form: Appointment of Special Trustee

§10.19 f. Form: Appointment of Special Trustee





[*Use one of the following alternatives*]

[*Alternative 1: Power to appoint special trustee vested in trustee*]

Appointment of Special Trustee. **While serving as trustee, _ _[*name of individual trustee*]_ _ may appoint _ _[*an individual and one or more successor individuals/name of special trustee*]_ _ as special trustee, who shall be vested with all the rights and powers granted to a trustee under this trust exclusively with reference to _ _[*specify special trustee's duties, e.g., management and investment of commercial real estate held in trust*]_ _, including without limitation _ _[*specify any specific powers*]_ _.**

[*Alternative 2: Power to appoint special trustee vested in settlor*]

Appointment of Special Trustee. **The person(s) listed below, in the order and priority indicated, shall be vested with all the rights and powers granted to a trustee under this trust exclusively with reference to _ _[*specify special trustee's duties, e.g., management and investment of commercial real estate held in trust*]_ _, including without limitation _ _[*specify any specific powers*]_ _.**

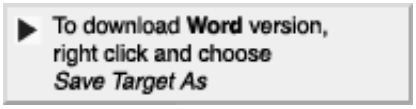
_ _[*First: Name of special trustee*]_ _

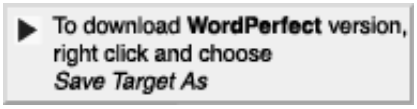
_ _[*Second: Name of successor special trustee*]_ _

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.20 g. Form: Compensation; Effect of Powers of Special Trustee on Powers of Trustee

§10.20 g. Form: Compensation; Effect of Powers of Special Trustee on Powers of Trustee





***Special Trustee Powers*. The special trustee shall receive reasonable compensation. The powers granted in this trust to the special trustee shall not limit in any way the power granted in this trust to the trustee, except that, while the appointed special trustee serves as special trustee of this trust, no other trustee may exercise any powers granted in this trust to the special trustee.**

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§10.21 2. Cotrustee Investment Powers

Cotrustee investment powers should be drafted based on the settlor's desires about each trustee's role in making investments. Giving an individual trustee or a special trustee a veto power only, while giving the other trustee the right to propose investments, achieves a better balance between the responsibilities assigned to the trustees. This division of duties places the initiative with the corporate trustee yet still allows the individual or special trustee to have a decisive voice. The form in §10.22 gives the corporate trustee the power to take the initiative to change investments and to make purchases and sales. It gives the individual trustee the power to veto any proposed actions. The clause may, however, prevent the corporate trustee from acting quickly in a fast-moving market. The corporate trustee should keep all trust funds invested, pending a decision by the individual trustee on its proposed actions.

A settlor or nonadverse party may hold the investment or reinvestment power without adverse estate tax consequences to the settlor and without trust income being taxed to the settlors, as long as it is held in the capacity of trustee. IRC §675 and Rev & T C §17731 (income tax); IRC §§2036, 2038 (estate tax). See also *Estate of Willard V. King* (1962) 37 TC 973, nonacq 1963-1 Cum Bull 5, approved by the Supreme Court in *U.S. v Byrum* (1972) 408 US 125, 133 n6, 33 L Ed 2d 238, 246 n6, 92 S Ct 2382. Similarly, because the trustee is under a fiduciary duty and must consider the relative equities of the income and the remainder beneficiaries, a power to invest and reinvest exercisable by the settlor or by a nonadverse party will not constitute a general power of appointment. Treas Reg §20.2041-1(b)(1).

As an alternative, a settlor may give both the special trustee and the corporate trustee the power to initiate action, subject to the other party's veto. When a settlor wishes to name a corporate fiduciary but also has confidence in a particular independent investment adviser, the settlor may allow the trustee to rely on the adviser's advice without liability. See §10.78. In addition, when the settlor wants an individual to participate in the trust's administration but does not want the trustee to be bound by that person's decisions, the trust instrument can name that person as a consultant to the trust, making it clear that the decisions of that consultant do not bind the trust. If the special trustee is to be given sole power to decide the manner in which trust assets will be invested (not just the power to veto a particular proposed investment), the form in §10.23 can be adapted for that use.

Whenever such investment powers are proposed, the person nominated as successor trustee should be consulted. If such clauses are included, some institutions may be unwilling to serve or may charge extra fees for serving. For a form of power to invade principal vested solely in an individual cotrustee, see §10.24.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.22 a. Form: Corporate Trustee's Right to Propose Purchases and Sales

§10.22 a. Form: Corporate Trustee's Right to Propose Purchases and Sales

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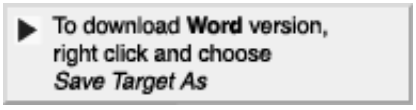
***Trustee's Power to Propose Investments*. The corporate trustee shall make periodic reviews of the investments held by the trust estate and, based on these reviews, shall make written recommendations to the _ _[*individual trustee/special trustee*]_ _ regarding proposed purchases and sales of trust assets. Failure to notify the corporate trustee in writing of the approval or disapproval of any proposed sale or investment within _ _[*number*]_ _ days after notice of the recommendation has been mailed to the _ _[*individual trustee/special trustee*]_ _ at his or her last-known address shall be considered approval of the action. The corporate trustee is not liable for any loss resulting from retention of any property if its sale has been expressly disapproved by the _ _[*individual trustee/special trustee*]_ _, or from failure to invest any money if its investment has been expressly disapproved by the _ _[*individual trustee/special trustee*]_ _.**

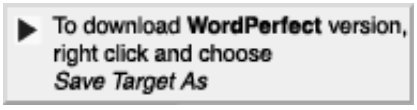
Comment: For clauses giving a settlor the power to veto or to direct investments, see §§10.53-10.54.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.23 b. Form: Power to Invest Vested Solely in Individual Trustee

§10.23 b. Form: Power to Invest Vested Solely in Individual Trustee





***Trustee's Power to Direct Investments*. As long as _ _[*name of individual trustee*]_ _ serves as a cotrustee of this trust, _ _[*he/she*]_ _ has the power to direct the corporate trustee in writing; to retain, sell, exchange, or lease any property in the trust estate on specified terms and conditions; and to invest funds of the trust estate in the manner that _ _[*name of individual trustee*]_ _ specifies. The corporate trustee must comply with all written directions received from _ _[*name of individual trustee*]_ _. The corporate trustee is not responsible for reviewing trust investments and is not liable to any beneficiary of the trust or to any other person for following the written direction received from _ _[*name of individual trustee*]_ _ or for failing to act in the absence of a written direction.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/ 3. Discretionary Powers Relating to Principal and Income/§10.24 a. Form: Power to Invade Principal Vested Solely in Individual Cotrustee

3. Discretionary Powers Relating to Principal and Income

§10.24 a. Form: Power to Invade Principal Vested Solely in Individual Cotrustee

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***Trustee's Power to Invade Principal*. As long as _ _**[*name of individual trustee*]**_ _ serves as a trustee of this trust, the power to invade principal for the benefit of the beneficiaries of this trust, as provided elsewhere in this trust, shall be exercised solely by _ _**[*him/her*]**_ _. If _ _**[*name of individual trustee*]**_ _ determines that such an invasion is warranted, _ _**[*he/she*]**_ _ shall notify _ _**[*name of other trustee(s)*]**_ _ in writing. _ _**[*Name of other trustee(s)*]**_ _ shall comply with all written directions about such invasions received from _ _**[*name of individual trustee*]**_ _ but shall incur no liability to any beneficiary of the trust or to any other person for following those written directions or for failing to act in the absence of a written direction. If _ _**[*name of individual trustee*]**_ _ is unable, unwilling, or ceases to serve as trustee under this trust, the power of direction provided here _ _**[*shall be exercised by _ _[name of individual]_ _/any independent successor individual trustee/shall lapse, and the corporate trustee shall exercise the power to invade principal in its discretion*]**_ _.**

Comment: This clause is useful if the independent individual trustee is particularly familiar with the settlor's intentions and the beneficiaries' needs. It should not be used if a settlor, nonadverse party, or beneficiary is the individual cotrustee, unless that person could have acted as sole trustee for invasions of principal without adverse estate tax consequences. See §§2.11, 2.17, 2.59, 10.12. For tax implications if the trustee is a beneficiary and a possible recipient of the invasion, see §2.12.

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b. Special Trustee to Make Payments to Beneficiary-Trustee Other Than Settlor

§10.25 (1) Avoiding Adverse Tax Consequences

To avoid adverse income and estate tax consequences to a beneficiary-trustee who has discretion to make payments from income or principal to himself or herself, the drafter should give the discretion to make these payments to a special trustee who is familiar with the beneficiary-trustee's personal needs. See form in §10.26. The beneficiary-trustee also may be given the power to appoint, but not to remove, an independent special trustee to make such discretionary payments. See form in §10.26A. For a form of sprinkling power exercised by a special trustee, see §9.11.

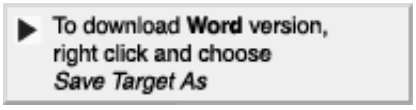
If a beneficiary acting as the trustee or as a cotrustee has the power, either alone or in conjunction with other trustees or persons, to apply the principal of the trust for his or her own benefit and the power is not limited by an ascertainable standard (as defined in IRC §2041(b)(1)(A); Treas Reg §20.2041-1(c)(2)), the power is treated as a general power of appointment and the assets over which the power was exercisable are included in the beneficiary-trustee's estate. For further discussion, see §2.11.

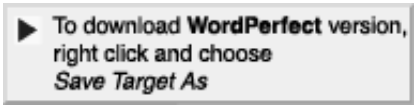
A special trustee may be used to eliminate adverse tax consequences if the beneficiary-trustee's powers are not governed by an ascertainable standard. When the trust is drafted, it may appear that the beneficiary-trustee will never need principal. If the unexpected occurs, however, this clause gives the beneficiary-trustee a way to obtain distributions of principal. When the need for invasion seems more likely, the settlor should appoint a special trustee to act at the outset of the trust if the beneficiary-trustee's powers to invade principal are not governed by an ascertainable standard.

For income tax purposes, IRC §678 literally applies to a power to withdraw income, even if the power is governed by an ascertainable standard, although most decisions are favorable to the taxpayer. See *U.S. v Smither* (5th Cir 1953) 205 F2d 518 (income was distributable only to extent necessary for beneficiaries' "support, maintenance, comfort and enjoyment"); *Funk v Commissioner* (3d Cir 1950) 185 F2d 127; *Allen v Nunnally* (5th Cir 1950) 180 F2d 318. Use of an ascertainable standard eliminates adverse estate tax consequences. See IRC §2041(b)(1); Treas Reg §20.2041-1(c)(2).

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§10.26 (2) Form: Special Trustee to Make Payments to Beneficiary-Trustee



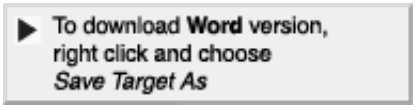


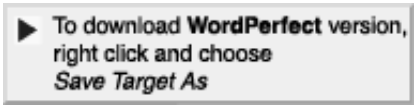
***Distributions to Beneficiary-Trustee*. In the event a beneficiary serves as a trustee of the trust, any such beneficiary shall be disqualified from making any distributions to himself or herself or for his or her benefit (including payments discharging his or her obligation to support any person). If such a beneficiary believes that the circumstances justify any such distributions and there is not a trustee qualified to act, the trustee shall apply to _ _[*name of special trustee*]_ _, who shall serve as special trustee of this trust and make all decisions regarding the requested distributions. The special trustee's responsibilities shall be limited to the exercise of discretion under this clause, and the special trustee shall not be concerned with any other aspects of trust administration.**

If _ _[*name of special trustee*]_ _ is unable or unwilling to serve as special trustee, _ _[*name of successor special trustee*]_ _ shall serve as special trustee. If _ _[*name of successor special trustee*]_ _ is also unable or unwilling to serve as special trustee, _ _[*name of corporate special trustee*]_ _ shall serve as special trustee.

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§10.26A (3) Form: Trustee to Appoint Special Trustee to Make Payments to Beneficiary-Trustee





***Distributions to Beneficiary-Trustee*. Despite any provision to the contrary in this trust, if at any time the trustee is a current beneficiary or discretionary beneficiary of this trust and that trustee is also authorized (1) to make discretionary distributions of income or principal to or for the benefit of himself or herself, to or for the benefit of a beneficiary who he or she is legally obligated to support, or that would constitute a gift for federal gift tax purposes if made directly by a serving trustee, or (2) to make discretionary allocations of receipts and expenditures between principal and income in favor of a person who is then serving as a trustee, that then-serving trustee shall not have the power to make discretionary distributions of income or principal or to make discretionary allocations of receipts and expenditures between principal and income.**

Only trustees who are not beneficiaries of this trust shall make discretionary distributions and discretionary allocations. If each person serving as a trustee is also a beneficiary, a majority of the then-serving trustees shall appoint, in a writing delivered to the then-living beneficiaries of the trust, a special trustee who is not a settlor or a beneficiary of the trust and who is not a person who is related, subordinate, or subservient to a living settlor. The special trustee may make discretionary distributions of income or principal or discretionary allocations of receipts and expenditures between principal and income. The special trustee's responsibilities shall be limited to the exercise of discretion under this provision, and the special trustee shall not be concerned with any other aspects of trust administration. The special trustee shall not be liable for any reason for failure to act or for acting in accordance with the power granted to the special trustee in this clause.

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B. Resignation of Trustee

§10.27 1. Methods of Resigning

Under Prob C §15640, the trustee of an irrevocable trust who has accepted the trust may resign only by one of the following methods:

- As provided in the trust instrument (see §10.28);
- With the consent of all adult beneficiaries entitled to receive income or to receive a distribution of principal if the trust were terminated at the time consent is sought; or
- Under a court order obtained on petition by the trustee under Prob C §17200.

The court must accept the resignation and may make any orders necessary to preserve trust property, including appointing a receiver or a temporary trustee.

The resigning trustee or any sureties on the trustee's bond are not released from liability for acts or omissions by the trustee's resignation. Prob C §15641.

If a successor trustee is designated in the trust instrument, third parties will usually conduct business with the successor when given the prior trustee's written resignation and the successor's written acceptance. Some third parties also want a copy or abstract of the trust instrument or a trustee's certification under Prob C §15603 or §18100.5.

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§10.28 2. Form: Resignation of Trustee

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***Resignation of Trustee*. Any trustee may resign at any time. The resigning trustee must give written notice of the resignation by personal delivery or registered mail to all adult beneficiaries. The resignation becomes effective on the acceptance of office by a designated successor trustee.**

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§10.29 C. Removal of Trustee

Under Prob C §15642(a), a trustee may be removed:

- As provided in the trust instrument;
- By the court on its own motion; or
- On petition of a settlor, cotrustee, or beneficiary to remove a trustee under Prob C §17200(b)(10).

The statutory grounds for removal by a court include: (1) breach of trust; (2) insolvency or unfitness to administer the trust; (3) hostility or lack of cooperation among cotrustees; (4) failure to act; (5) excessive trustee compensation under the circumstances; (6) sole trustee's disqualified person status, unless the trust instrument is reviewed by an independent attorney who counsels the settlor and certifies that the trustee designation is clearly the settlor's intent and is not the product of fraud, menace, duress, or undue influence (see form in §10.31A); (7) substantial inability to manage financial resources; (8) substantial inability to resist fraud or undue influence; or (9) other good cause. See Prob C §15642(b). See also Prob C §16420(a)(5) (if trustee commits breach of trust, beneficiary or cotrustee may commence proceeding to remove trustee).

A sole trustee may be removed if he or she is a disqualified person under Prob C §21350(a) (relating to invalidity of provision of instrument making donative transfers to, among others, persons who drafted the instrument under which the transfer is made). See §10.9.

A beneficiary's power to replace a corporate fiduciary does not have adverse tax consequences if the fiduciary has voluntarily resigned or been removed by judicial process. Rev Rul 77-182, 1977-1 Cum Bull 273. Revenue Ruling 77-182 has been liberalized by Rev Rul 95-58, 1995-2 Cum Bull 191, so that even if the beneficiary retains the power to remove the trustee and appoint an *individual* or a corporate successor trustee who is not related or subordinate to the decedent (within the meaning of IRC §672(c)), the beneficiary will not be considered to have retained the trustee's discretionary control over the trust for purposes of IRC §§2036 and 2038. Related and subordinate parties under IRC §672(c) include the settlor's spouse, parents, issue, siblings, employees, controlled corporations, and a business executive's subordinates. See §3.36.

The settlor may wish to provide for removal and replacement of a trustee for lesser reasons than those set out in Prob C §15642, *e.g.,* unsatisfactory but not culpable performance or deterioration of personal relationships. See form in §10.30. Most settlors, however, do not want beneficiaries to overturn their choices of trustees except for serious reasons (for which the statute provides). See form in §10.31. The need to protect the beneficiary from himself or herself and the trustee from a complaining spendthrift or otherwise unreasonable beneficiary should also be considered before a trustee's removal is authorized because of deteriorating personal relationships.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.30 1. Form: Trustee Removal and Replacement by Beneficiary or Third Party

§10.30 1. Form: Trustee Removal and Replacement by Beneficiary or Third Party

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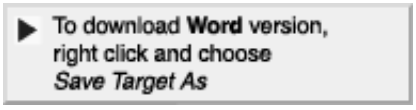
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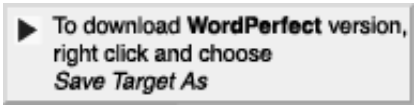
Removal of Trustee. **By written instrument delivered to the trustee, _ _[*name of beneficiary or third party*]_ _ may remove any trustee serving under this trust and appoint any _ _[*person/corporation*]_ _ _ _[*except _ _[himself/herself/*]_ _ _ _[*or any party related or subordinate to the settlor (within the meaning of Internal Revenue Code §672(c))*]_ _]_ _ as successor trustee or cotrustee, with this designation superseding any appointment made under this trust. After written acceptance by the appointed successor trustee, the removed trustee shall promptly deliver all trust assets in _ _[*his/her/its*]_ _ possession to the successor trustee _ _[*together with an accounting for all acts affecting the trust since the date of any prior accounting*]_ _.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.31 2. Form: Trustee Removal Due to Trustee Incapacity or Illness

§10.31 2. Form: Trustee Removal Due to Trustee Incapacity or Illness





Removal of Trustee. **If the trustee is unable to serve because of physical or mental incapacity or illness, the successor trustee(s) named in this trust _ _[*in the order designated*]_ _ shall serve as trustee, having all rights and powers granted to the trustee by this trust. Physical or mental incapacity or illness shall be conclusively established if two physicians authorized to practice medicine in the State of California or any other place in which the trustee resides, who are unrelated to the settlor and the trustee by blood or marriage, examine the trustee and issue written declarations under penalty of perjury that state that the trustee is unable to serve because of incapacity or illness that is more likely than not to continue for an additional _ _[*number*]_ _ days _ _[*and _ _[name(s) of particular physician _ _[and/or]_ _ trusted friend*]_ _ *concur(s) that the trustee is incapacitated*]_ _. By assuming the office of trustee, any individual shall be deemed to have waived the doctor-patient privilege to the extent necessary to implement this clause.**

[*If appropriate, add the following option*]

[*Option: Court removal of incapacitated trustee*]

In the absence of declarations of incapacity, the successor trustee designated in this trust _ _[*or one or more of the beneficiaries*]_ _ may petition the Court having jurisdiction over this trust to remove the then-serving trustee and replace _ _[*him/her*]_ _ with the designated successor trustee. The successor trustee or beneficiary who petitions the Court shall incur no liability to any beneficiary of the trust or to the substituted trustee as a result of this petition unless the petition is filed in bad faith or without a reasonable belief that the substituted trustee is physically or mentally incapacitated or otherwise unable to serve.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.31A 3. Form: Certificate of Independent Review

§10.31A 3. Form: Certificate of Independent Review

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I, _ _[*name of attorney*]_ _ have reviewed _ _[*name of instrument*]_ _ and counseled my client, _ _[*name of client*]_ _ , on the nature and legal effect of the designation as trustee of _ _[*name of trustee*]_ _ contained in such instrument. I am so disassociated from the interest of the person named as trustee as to be in a position to advise my client impartially and confidentially as to the consequences of the designation. On the basis of this counsel, I conclude that the designation of a person who would otherwise be subject to removal under Probate Code §15642(b)(6) is clearly the settlor's intent and that intent is not the product of fraud, menace, duress, or undue influence.

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§10.32 D. Designation of Successor Trustees

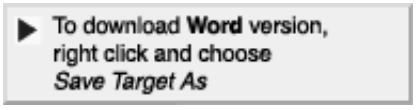
One or more successor trustees may be named in the trust to eliminate the inconvenience and expense of having the court appoint a successor, even if a corporate trustee is named. An institutional trustee may resign if the trust corpus becomes smaller than institutional requirements. The same considerations that affect the selection of the original trustee apply to the selection of a successor trustee.

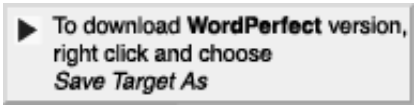
The power to name successor trustees can also be given to the trustee in office or to trust beneficiaries. This power is particularly useful if the trust is likely to last for a long time. Caution should be used, however, if a beneficiary is given the power. If the beneficiary has the power to remove the trustee and appoint a successor, including himself or herself, and if the trustee has powers that constitute a general power of appointment when held by the beneficiary, the beneficiary may be considered to hold a general power of appointment for estate tax purposes under IRC §2041. See §10.29.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.33 1. Form: Designation of Successor Trustees

§10.33 1. Form: Designation of Successor Trustees





10.33-1 Designation of successor trustees

***Nomination of Successor Trustees*. If at any time the _ _[*person/institution*]_ _ named as trustee fails to qualify or ceases to serve as trustee, the _ _[*person(s)/institution(s)*]_ _ listed below shall serve as successor trustee(s) in the order named:**

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

_ _[*If the nominated successors also fail to qualify or cease to serve, _ _[name]_ _ may name a successor trustee.*]_ _

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.34 2. Form: Remaining Cotrustee Acts as Sole Trustee; Settlor Designates Succession Thereafter

§10.34 2. Form: Remaining Cotrustee Acts as Sole Trustee; Settlor Designates Succession Thereafter

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10.34-1 Remaining cotrustee acts as sole trustee; settlor designates succession thereafter

***Nomination of Successor Trustees*. If a person named as cotrustee is unable or unwilling to serve in that office, the other trustee(s) shall act as _ _[*sole*]_ _ trustee(s). If the last of the named cotrustees is unable or unwilling to serve in that office, the person(s) listed below shall serve as successor trustee(s) _ _[*in the order named*]_ _:**

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

Comment: If IRC §678 would apply if a trustee acts alone, this clause must be modified so that two trustees always act.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.35 3. Form: Settlor Designates Successor Trustees When Corporate Fiduciary Unwilling or Unable to Serve

§10.35 3. Form: Settlor Designates Successor Trustees When Corporate Fiduciary Unwilling or Unable to Serve

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10.35-1 Settlor designates successor trustees when corporate fiduciary unwilling or unable to serve

***Nomination of Successor Trustees*. If the person named as individual trustee is unable or unwilling to serve in that office, the corporate trustee shall serve as sole trustee. If at any time the corporate trustee is unable or unwilling to serve in that office, the corporate trustee(s) listed below shall serve as successor cotrustee or sole trustee** _ _[*in the order named*]_ _**:**

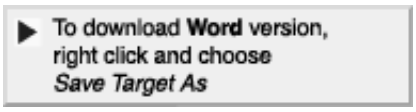
_ _[*First: Name and address of successor corporate trustee*]_ _

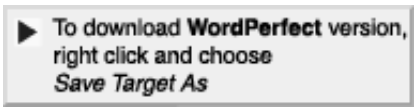
_ _[*Second: Name and address of second successor corporate trustee*]_ _

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.36 4. Form: Trustee's Power to Designate Successor

§10.36 4. Form: Trustee's Power to Designate Successor



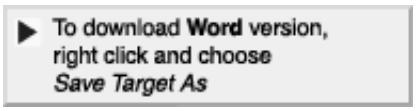


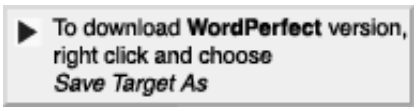
10.36-1 Trustee's power to designate successor

***Trustee's Power to Appoint Successor Trustee*. Any serving trustee _ _[*, including special trustee,*]_ _ may designate one or more individuals or corporate fiduciaries to serve concurrently or serially to succeed the trustee on his or her inability or unwillingness to serve _ _[*in the event a vacancy in the position of trustee would otherwise occur*]_ _. Any designation or revocation of that designation shall be made in a written instrument signed by the trustee while serving as trustee. A designation of a successor trustee by a serving trustee shall supersede any designation of a successor trustee by the settlor(s) elsewhere in this trust. In exercising this power, the serving trustee shall consider the tax consequences of any designation. Different trusts may have different trustees.**

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§10.37 5. Form: Beneficiaries' Power to Designate Successor





10.37-1 Beneficiaries' power to designate successor

***Beneficiary's Power to Appoint Successor Trustee*. In the event of a vacancy in the office of trustee without a successor provided for in this trust, an independent successor trustee shall be appointed in writing by a majority of the adult beneficiaries currently entitled to trust income. If there are none, an independent successor trustee shall be appointed in writing by a majority of adult beneficiaries who are entitled to distribution in the discretion of the trustee. If there are none, an independent successor trustee shall be appointed in writing by the guardians or parents of the minor beneficiaries belonging to the oldest generation of beneficiaries having living members to whom income or principal may be distributed currently.**

Comment: See §10.30 for a clause that gives the beneficiary or a third party the power to remove and replace the trustee.

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§10.38 E. Exculpating Trustee

Whether a trustee receives compensation or not, he or she must use ordinary care and diligence in administering the trust. Prob C §§16040-16041. A trustee who fails to exercise reasonable care is liable personally. See *White v Citizens Nat'l Trust & Sav. Bank* (1941) 46 CA2d 418, 422, 116 P2d 117. A cotrustee is personally liable for breaches of trust by another trustee when the trustee improperly delegates trust administration to the cotrustee, participates in or acquiesces to a breach of trust committed by the cotrustee, negligently permits the cotrustee to commit a breach of trust, or fails to take reasonable steps to compel the cotrustee to redress a breach of trust. Prob C §16402. See also *Bermingham v Wilcox* (1898) 120 C 467, 52 P 822.

A trustee can be relieved of liability for breach of trust by provision in the trust agreement except for breaches of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the interests of the beneficiaries, or for any profit that the trustee derives from a breach of trust. Prob C §16461. Exculpatory clauses do not affect the liability of trustees to third persons as determined under Prob C §§18000-18005.

NOTE: The trustee cannot require a beneficiary to relieve the trustee of liability as a condition for making a distribution or payment to the beneficiary if the distribution or payment is required by the trust instrument. Prob C §16004.5(a). However, the trustee may seek a voluntary release of liability from the beneficiary, and the trustee is apparently still free to demand a release as a condition of waiving its right to a court settlement of its accounts. Prob C §16004.5(b)(2), (5).

The exculpatory clause does not defeat the ascertainable standard and the protection from adverse tax consequences provided by that standard. See §3.38. Unless the settlor clearly indicates that a broader power is intended by "express reference" to Prob C §16081(c), a beneficiary-trustee may exercise the power in his or her favor only for his or her health, education, support, or maintenance within the meaning of IRC §§2041 and 2514. Prob C §16081(c).

Usually an exculpatory clause is inappropriate for a professional trustee, except for unusual acts to be taken (or not taken) by the trustee, following the settlor's request or direction (*e.g.,* retention of a family business or a large block of stock when the retention prevents diversification of the trust's assets) or for acts of a cotrustee. See *Coberly v Superior Court* (1965) 231 CA2d 685, 42 CR 64.

When there are cotrustees, each may be more willing to act if one is not liable for the other's acts, except for acts committed in bad faith or with reckless indifference to the beneficiaries' interests. See Restatement (Second) of Trusts §222 (1959). See also *Corbett v Benioff* (1932) 126 CA 772, 14 P2d 1028.

Under Prob C §16403, a successor trustee is not liable to a beneficiary for a breach of trust committed by a predecessor trustee unless the successor:

- Knows or reasonably should know about a predecessor trustee's breach of trust and improperly permits the breach to continue;
- Neglects to take reasonable steps to compel the predecessor trustee to deliver trust assets to the successor trustee; or
- Neglects to take reasonable steps to redress a predecessor's breach of trust that the successor trustee knows or reasonably should know about.

Clauses such as the one in §10.41 help limit a successor trustee's liability for a predecessor's acts. Because of a lack of specificity in the statute, the settlor may also wish to include language that exculpates a trustee from having to require the predecessor trustee to account.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.39 1. Form: Nonliability of Trustee

§10.39 1. Form: Nonliability of Trustee

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10.39-1 Nonliability of trustee

[*Use one of the following alternatives*]

[*Alternative 1: Nonliability of all trustees*]

Nonliability of Trustee. **No trustee _ _**[*or special trustee*]**_ _ named in this trust _ _**[*or designated as authorized in this trust*]**_ _ _ _**[*(other than a corporate trustee)*]**_ _ shall be liable to any beneficiary or to any heir of _ _**[*the/either*]**_ _ settlor for the trustee's acts or failure to act, except for willful misconduct or gross negligence.**

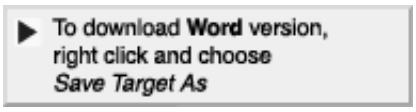
[*Alternative 2: Nonliability of independent trustees only*]

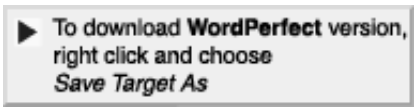
Nonliability of Trustee. **No trustee _ _**[*or special trustee*]**_ _ named in this trust _ _**[*or designated as authorized in this trust*]**_ _ who is an independent person (other than a corporate trustee) shall be liable to any beneficiary or to any heir of _ _**[*the/either*]**_ _ settlor for the trustee's acts or failure to act, except for willful misconduct or gross negligence. The term "independent person" means anyone other than a beneficiary, _ _**[*the spouse of a beneficiary,*]**_ _ anyone appointed by a beneficiary or a beneficiary's spouse, or anyone appointed by a beneficiary's or a beneficiary's spouse's appointee.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.40 2. Form: Nonliability for Cotrustee's Acts

§10.40 2. Form: Nonliability for Cotrustee's Acts





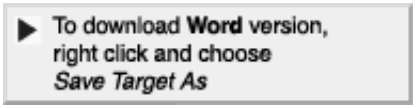
10.40-1 Nonliability for cotrustee's acts

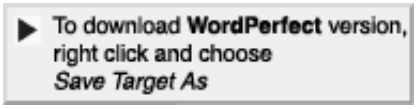
Nonliability of Cotrustee. **No trustee shall be liable or responsible for any act, omission, or default of any other trustee** _ _[*as long as the trustee has no knowledge of facts that might reasonably be expected to put the trustee on notice of it*]_ _**.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.41 3. Form: Successor Trustee's Nonliability for Predecessor's Acts

§10.41 3. Form: Successor Trustee's Nonliability for Predecessor's Acts





10.41-1 Successor trustee's nonliability for predecessor's acts

Nonliability of Successor Trustee. **No successor trustee shall be liable for any act, omission, or default of a predecessor trustee. The successor trustee may accept the accounting records of the predecessor trustee showing assets on hand without further investigation and without incurring any liability to any person claiming or having an interest in the trust.**

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F. Commingling Undivided Interests

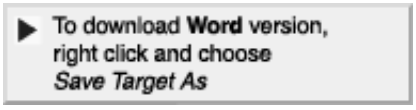
§10.42 1. Nature of Problem

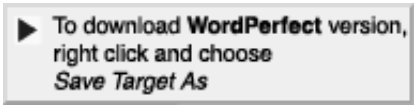
The trustee has a duty to keep trust property separate from property not subject to the trust. Prob C §16009. Sometimes, however, the trust's interest in an asset will be commingled with interests held by other trusts or persons. Examples include investments in mutual funds or undivided interests as tenants-in-common in real property or securities. Restatement (Second) of Trusts §179, Comment d, §180 (1959); 3 Scott & Ascher on Trusts §§17.11-17.11.3 (5th ed 2007).

The clauses in §10.43 may be used for individual or corporate trustees to permit the commingling of assets. For discussion of the self-dealing aspects of commingling in common trust funds, see §10.44.

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§10.43 2. Form: Authorization of Commingling of Undivided Interests





10.43-1 Authorization of commingling of undivided interests

[*Use one of the following alternatives*]

[*Alternative 1: Authorization of broad discretion to commingle*]

***Commingling of Undivided Interests*. Any property belonging to any trust or share established by this trust may, in the discretion of the trustee, be held in undivided ownerships. The property of the trust or share may _ _[*, if deemed convenient in the administration of this trust,*]_ _ be commingled with the property of any other trust or person _ _[*including property of the trustee*]_ _. The trustee must maintain proper books of account showing the property belonging to such trust and the income properly credited to it.**

[*Alternative 2: Authorization of commingling only between shares created under this instrument*]

***Commingling of Undivided Interests*. Each share set aside by this trust in trust shall constitute a separate trust and be held and administered as a separate trust. The property belonging to any share may, in the discretion of the trustee, be held in undivided ownerships and be commingled with the property of any other share under this trust, but not with any other trust or person _ _[*, if deemed convenient in the administration of the separate shares*]_ _. The trustee must maintain proper books of account showing the property belonging to each share and the income properly credited to it.**

Comment: Alternative 1 gives the trustee broad discretion to commingle assets of the trust with assets owned by the trustee as an individual or as the trustee of another trust. Alternative 2 limits the trustee's power to commingle to shares created under the trust instrument. Both clauses provide optional language that would require the trustee to determine that any commingling would be convenient to the trust's administration.

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G. Self-Dealing

§10.44 1. Potential for Self-Dealing

Probate Code §16004 prohibits a trustee from self-dealing:

> The trustee has a duty not to use or deal with trust property for the trustee's own profit or for any other purpose unconnected with the trust, nor to take part in any transaction in which the trustee has an interest adverse to the beneficiary.

This prohibition appears to apply without qualification to individual trustees. Statutory exceptions to the general prohibition exist for corporate trustees. See Prob C §§16015, 16225(b), 16247; Fin C §786. Many corporate trustees, however, prefer that the trust instrument specifically allow self-dealing.

Individual trustees selected by a settlor are frequently family members, business associates, or trustees of more than one trust that own interests in the same assets as the trust. To facilitate continuation of the settlor's business or management of his or her assets, the settlor should consider waiving any conflict of interest that may arise between the trustee's handling of trust assets when the trustee has a personal interest or multiple interests in the same assets. Without a clause that allows the trustee to engage in self-dealing, any self-dealing would violate the trustee's duty of loyalty and would require instructions from the court to permit the transaction. Prob C §16004. See 3 Scott & Ascher on Trusts §§17.2-17.14.6 (5th ed 2007); 4 Scott on Trusts §24.10. See also §10.82.

Technically, investment in common trust funds of a corporate fiduciary would be a prohibited act of self-dealing. California law and Comptroller of the Currency regulations, however, specifically permit such investments. See Fin C §1564 (unless prohibited by the trust instrument, a trust company may commingle trust assets in a common trust fund administered by it or an affiliated trust company); IRC §584 (to avoid a second layer of income taxation, a common trust fund must follow Comptroller of the Currency regulations regarding trust investments even if the corporate trustee is not ordinarily subject to such regulations); 12 CFR §§9.11(a), 9.18(a)(1) (Comptroller of the Currency regulations permit national banks serving as trustee to invest in common trust funds to the extent not prohibited by local law or the trust instrument).

The clauses in §10.45 authorize self-dealing by the trustee and are separate from a power to commingle trust property. These clauses do not, however, absolve the trustee from the duty to act fairly with regard to the beneficiaries. See Prob C §§16002(b), 16004(c), 16463(c), 16464(b), 16465(b); 3 Scott on Trusts §216.3. See also discussion in §10.82.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.45 2. Form: Authorization of Self-Dealing

§10.45 2. Form: Authorization of Self-Dealing

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10.45-1 Authorization of self-dealing

[*Use one of the following alternatives*]

[*Alternative 1: Individual trustee*]

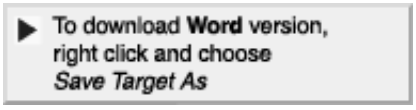
***Permitted Transactions*. The trustee may enter into transactions (including the purchase or sale of trust assets, the lease of assets to or from the trust, the exchange of assets with the trust, and the making of secured loans at reasonable rates of interest to or from the trust) with the trustee, as an individual, as an agent of any other person or entity, or as the trustee of any other trust for which the trustee is serving. Any purchase, sale, lease, or exchange of assets under this clause shall be made at fair market value at the time of the transaction.**

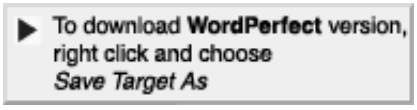
[*Alternative 2: Corporate trustee*]

***Permitted Transactions*. The trustee may accept or otherwise acquire for the trust (from any source) and retain in the trust any interests in any securities issued by the trustee or by any affiliated or subsidiary corporation. The trustee may invest in any common trust fund administered by it or any affiliated trust company as defined in Financial Code §1564. Any purchase, sale, lease, or exchange of assets under this clause shall be made at fair market value at the time of the transaction.**

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§10.46 3. Form: Conflicts of Interest; Self-Dealing (Broad Powers)





10.46-1 Conflicts of interest; self-dealing (broad powers)

***Exercise of Trustee Powers Not Limited*. Any serving trustee may exercise all the rights and powers given to a trustee under the law or under this instrument with respect to any asset that is _ _[*or may become*]_ _ part of the trust estate, regardless of any interest that the trustee may have in that asset (either as an individual or as a fiduciary of any estate or trust). Without limiting the generality of the foregoing, any serving trustee may exercise the rights and powers given to a trustee under the law or under this instrument even if at the time of the exercise the trustee is:**

(a) An officer, director, employee, or shareholder of any corporation the securities of which are at any time a part of the trust estate;

(b) A partner, participant, or employee of any partnership, joint venture, or business enterprise in which a trust created under this instrument has an interest; or

(c) A fiduciary of any estate or trust having an interest in a corporation, partnership, joint venture, or other business enterprise in which a trust created under this instrument has an interest.

A serving trustee shall not be subject to surcharge or any other claim by or on behalf of anyone who may be interested in any trust created under this instrument arising out of, or claimed to arise out of, any possible conflict of interest based on the interest of any serving trustee (either individually or as a fiduciary of any estate or trust) in any asset that is _ _[*or may become*]_ _ a part of the trust estate of any trust created under this instrument. A serving trustee in the trustee's individual capacity or as a fiduciary of another estate or trust may deal with himself, herself, or itself as trustee under this instrument in an arm's-length manner with respect to any asset that is or may become a part of the trust estate of any trust created under this instrument as if the trustee were a stranger to the trust created under this instrument.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.47 4. Form: Nonliability of Trustee or Special Trustee for Conflicts of Interest

§10.47 4. Form: Nonliability of Trustee or Special Trustee for Conflicts of Interest

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10.47-1 Nonliability of trustee or special trustee for conflicts of interest

***Nonliability of Trustee*. The settlor(s) recognize that the _ _[*trustee/special trustee*]_ _ may have current or potential conflicts of interest in the management and investment of _ _[*name of specific property or properties*]_ _ and nevertheless wish _ _[*him/her*]_ _ to serve as _ _[*trustee/special trustee*]_ _. The _ _[*trustee/special trustee*]_ _ shall not be liable to any beneficiary, cotrustee, or successor trustee for any acts performed in relation to management and investment in _ _[*his/her*]_ _ fiduciary capacity except for fraudulent or grossly negligent conduct.**

Comment: If the conflict of interest involves a trustee's position in a business, the clause may also state that the trustee (1) shall be entitled to compensation both as a trustee and as an officer, a director, a partner, or an employee of that business and (2) may determine his or her own fair compensation from the business.

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H. Trustee's Bond

§10.48 1. Bond Generally Not Required

A bond is not required of a trustee named in the trust instrument unless the instrument requires a bond. Prob C §15602.

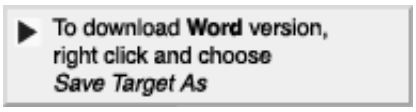
A bond can give the beneficiaries additional financial protection if the trustee intentionally breaches his or her fiduciary duty. It can also be an unnecessary expense if the trustee is someone who, in the settlor's judgment, will never incur liability in the performance of his or her duties. If the settlor does not have enough confidence in the person appointed as trustee to have that person serve without bond, the settlor should seriously consider the appropriateness of naming that person in the first instance.

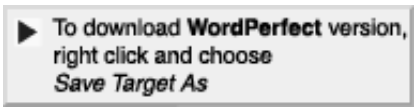
Limiting the waiver of the bond to persons designated in the instrument as trustee is prudent, because the settlor will have no opportunity to evaluate any successor trustee that may be appointed by the court or another person as provided by the trust instrument.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.49 2. Form: Trustee's Bond

§10.49 2. Form: Trustee's Bond





10.49-1 Trustee's bond

***Waiver of Trustee Bond*. No bond shall be required of any person named in this trust as trustee _ _**[*or as special trustee*]**_ _ _ _**[*or of any person appointed as trustee _ _*[*or as special trustee*]**_ _**, *in the manner specified in this trust,*]**_ _ for the faithful performance of his or her duties as trustee.**

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I. Trustee's Compensation

§10.50 1. When Compensation Is Allowed

"If the trust instrument does not specify the trustee's compensation, the trustee is entitled to reasonable compensation under the circumstances." Prob C §15681. If the trust instrument specifies the amount of compensation, the court can set compensation in a greater or lesser amount when (Prob C §15680(b)):

- The trustee's duties are substantially different from the duties contemplated when the trust was created;
- The compensation fixed by the instrument is inequitable or unreasonably low or high; or
- Extraordinary circumstances require equitable relief.

If a corporate trustee is appointed, the settlor or drafting attorney should provide for reasonable compensation, compensation based on the corporate trustee's fee schedule as it exists from time to time, or compensation equal to a fixed percentage of trust assets redetermined annually. Such a clause eliminates the common problem that the fee specified in the trust instrument may fall far short of the prevailing rate for trustee's fees. During the drafting stage, the settlor or attorney should try to ascertain whether this clause is acceptable to the trustee.

Unless the trust instrument provides otherwise, compensation set by the instrument is apportioned among cotrustees according to the services performed by each. Prob C §15683. Often, a professional fiduciary will not consent to sharing the fee, particularly if the corporate fiduciary is handling all the day-to-day trustee work. It is good practice to check the policies of the proposed corporate trustee before finalizing the trust instrument's compensation clause.

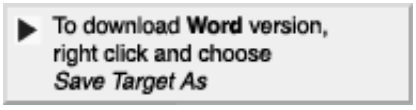
The clause permitting reimbursement for expenses paid by the trustee restates the rule set forth in Prob C §15684.

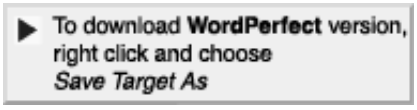
Additional compensation for litigation carried on by the trustee will be disallowed unless the trustee has a legitimate interest in the controversy. See *Estate of Huber* (1973) 31 CA3d 126, 107 CR 89, in which the court disallowed fees to an executor-trustee in a dispute between the income beneficiary and the remainder beneficiaries over the amount of income payable to the income beneficiary.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.51 2. Form: Reasonable Compensation (Individual Trustee)

§10.51 2. Form: Reasonable Compensation (Individual Trustee)





10.51-1 Reasonable compensation (individual trustee)

***Compensation of Trustee*. The trustee _ _[*other than a settlor*]_ _ shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.51A 3. Form: Percentage of Net Value of Principal Plus Reasonable Compensation (Individual Trustee)

§10.51A 3. Form: Percentage of Net Value of Principal Plus Reasonable Compensation (Individual Trustee)

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10.51A-1 Percentage of net value of principal plus reasonable compensation (individual trustee)

***Compensation of Trustee*. The trustee _ _[*other than a settlor*]_ _ shall be paid _ _[*one-half/three-fifths/three-fourths*]_ _ of 1 percent of the average net value of the principal of the trust estate during each calendar year for all ordinary services rendered by the trustee and reasonable additional compensation for any extraordinary services. If the trustee serves for part of a calendar year, the annual compensation shall be prorated. In any event, the trustee shall be entitled to reimbursement for any expenses of the trust that the trustee has paid. Compensation and reimbursement may be made without court order.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.51B 4. Form: Reasonable Compensation (Cotrustees)

§10.51B 4. Form: Reasonable Compensation (Cotrustees)

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10.51B-1 Reasonable compensation (cotrustees)

***Compensation of Trustee*. Cotrustees shall be entitled to reasonable compensation, which shall be apportioned among the cotrustees according to the services rendered by them.**

Comment: Form 10.51B-1 may either be added to forms 10.51-1 or 10.51A-1 or be used in place of these forms if cotrustees are appointed.

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III. SETTLOR'S CONTROL

§10.52 A. Settlor's Power to Control Trust Investments

Holding a veto power may be deemed to be the equivalent of holding the power subject to veto, because the holder of the veto power may exercise the veto until his or her desires are met. See Rev Rul 70-513, 1970-2 Cum Bull 194 (settlor's reserved power to consent to or veto termination of trust in favor of income beneficiary caused inclusion of the trust in the settlor's estate under IRC §2038). The holder of a veto power affecting beneficial enjoyment of trust property (*e.g.,* the power to sprinkle trust income; see §3.36) may face adverse tax consequences if the power is deemed to be the equivalent of holding the power subject to veto.

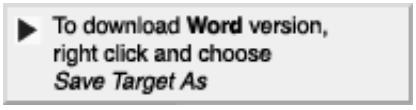
The power in a nonfiduciary capacity to veto investments and control the voting of trust shares of corporate stock does not cause trust income to be taxable to a settlor unless the power relates to shares or securities in which the settlor's holdings and the trust are significant for control purposes. See IRC §675(4). Even when the power relates to such shares or securities, only trust income from those shares or those securities is taxable to the settlor. See IRC §675.

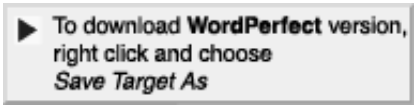
A settlor's power to direct investments held in a fiduciary capacity does not constitute the right to designate the persons who may possess or enjoy the property under IRC §2036(a)(2). *Estate of Willard V. King* (1962) 37 TC 973, nonacq 1963-1 Cum Bull 5, approved in *U.S. v Byrum* (1972) 408 US 125, 133, 33 L Ed 2d 238, 245, 92 S Ct 2382. Retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation by a person who has irrevocably transferred the stock for other than full consideration after June 22, 1976, causes the transferred shares to be includable in the transferor's taxable estate. IRC §2036(b)(1). Thus, the power to vote the stock of most family-owned business should be omitted. See also §§2.48-2.62.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.53 B. Form: Settlor's Veto Power Over Investments

§10.53 B. Form: Settlor's Veto Power Over Investments





10.53-1 Settlor's veto power over investments

[*Use one of the following alternatives*]

[*Alternative 1: Veto power given to specified settlor*]

***Settlor's Power to Veto Investments*. The trustee shall give _ _[*number*]_ _ days written notice to _ _[*name of settlor*]_ _ of the exercise of any investment power given under this trust _ _[*in which the total consideration exceeds* _ _[*dollar amount*]_ _]_ _ and shall make no binding agreement relating to the power until that period expires (unless the trustee has received, within that period, written approval from _ _[*name of settlor*]_ _). If the trustee has not received written notice of disapproval from _ _[*name of settlor*]_ _ within _ _[*number*]_ _ days after the date on which notice is mailed, the trustee may exercise the power. If _ _[*name of settlor*]_ _ notifies the trustee in writing of _ _[*his/her*]_ _ disapproval within _ _[*number*]_ _ days after the date on which the trustee mailed notice of the intended exercise of a power, the trustee shall not take the action set forth in the notice and shall not be liable to any beneficiary for failure to take the action disapproved by _ _[*name of settlor*]_ _. The trustee need not notify _ _[*name of settlor*]_ _ of actions required or necessary to complete the exercise of powers, of which notice was previously given by the trustee and approved or not disapproved by _ _[*name of settlor*]_ _ under the terms of this clause. After the death or legally declared disability of _ _[*name of settlor*]_ _ or a certification by two physicians licensed to practice medicine in the state in which the individual cotrustee resides, _ _[*with the concurrence of* _ _[*name*]_ _]_ _ that _ _[*name of settlor*]_ _ cannot exercise _ _[*his/her*]_ _ right to disapprove, the trustee may exercise these powers without notice to _ _[*name of settlor*]_ _. _ _[*Name of settlor*]_ _, acting under this clause, shall be deemed to have waived the doctor-patient privilege to the extent necessary to implement this clause.**

[*Alternative 2: Veto power given to other settlor*]

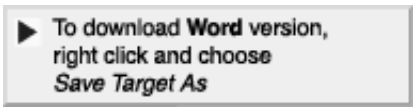
***Settlor's Power to Veto Investments*. _ _[*Name of other settlor*]_ _ shall have the right to disapprove the exercise of powers on the same terms and conditions as specified in paragraph _ _[*number*]_ _. After the death or legally declared disability of _ _[*name of other settlor*]_ _ or a certification by two physicians licensed to practice medicine in the state in which the individual cotrustee resides, _ _[*with the concurrence of* _ _[*name*]_ _]_ _ that _ _[*name of other settlor*]_ _ cannot exercise _ _[*his/her*]_ _ right to disapprove, the trustee may exercise these powers without notice to _ _[*name of other settlor*]_ _. _ _[*Name of other settlor*]_ _, acting under this clause, shall be deemed to have waived the doctor-patient privilege to the extent necessary to implement this clause.**

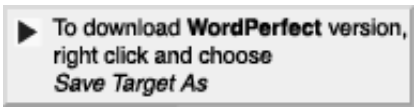
Comment: This clause may be modified to limit the veto power to the sale or exchange of specific property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.54 C. Form: Settlor's Power to Direct Investments

§10.54 C. Form: Settlor's Power to Direct Investments





10.54-1 Settlor's power to direct investments

***Settlor's Power to Direct Investments*. _ _[*Name of settlor*]_ _ shall have the power in a fiduciary capacity to direct the trustee to purchase, sell, exchange, or otherwise acquire or dispose of assets _ _[*and to exercise all voting rights connected with assets of the trust other than the power to vote any securities that are securities of a controlled corporation as defined by Internal Revenue Code §2036(b)(2) or any successor statute*]_ _. During the settlor's lifetime, the trustee shall not exercise any of the trustee's powers over those matters without receiving written directions from the settlor. During the settlor's lifetime and unless the foregoing powers have been relinquished, the trustee shall have no duty to review investments or to suggest investments and shall not be liable to any beneficiary of this trust or any heir of the settlor for losses resulting from such investments or from failure to make investments while the settlor retains these powers.** _ _[*While the trustee is subject to that settlor's direction concerning investments, the trustee's compensation shall be* _ _[*reduced by* _ _[*number*]_ _ *percent/reasonably reduced*]_ _ *because of the trustee's lack of responsibility for investments.*]_ _

_ _[*Name of settlor*]_ _ **may release** _ _[*his/her*]_ _ **power to control trust investments by written instrument delivered to the trustee and may reassume that power at any time by written instrument delivered to the trustee. If** _ _[*name of settlor*]_ _ **dies or the trustee receives certificates of two state licensed physicians that the specified settlor cannot exercise any of these powers, that settlor shall be deemed to have released the powers and the trustee shall have full power to take any such action.** _ _[*Name of Settlor*]_ _ **shall be deemed to have reassumed the powers if the trustee receives certificates from two physicians licensed to practice medicine in the state in which the individual cotrustee resides that the settlor has recovered the ability to exercise the powers.**

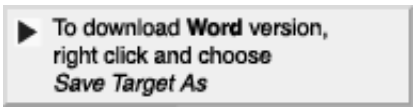
_ _[*After the death or disability of* _ _[*name of specified settlor*]_ _, _ _[*name of other settlor*]_ _ *may direct investments on the same terms and conditions as specified in paragraph* _ _[*number*]_ _.]_ _

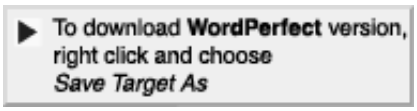
A settlor acting under this clause shall be deemed to have waived the doctor-patient privilege to the extent necessary to implement this clause. Any person may transact business with the trustee without inquiring whether the settlor has directed the action and without inquiring whether the settlor has relinquished or become unable to exercise the power.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.55 D. Form: Settlor's Powers Personal to Settlor

§10.55 D. Form: Settlor's Powers Personal to Settlor





10.55-1 Settlor's powers personal to settlor

***Settlor's Power Personal to Settlor*. Unless otherwise provided in this trust, any power or right given to or retained by _ _[*the/either*]_ _ settlor is personal to that settlor and may not be exercised on _ _[*his/her*]_ _ behalf by any other person, including any conservator of _ _[*his/her*]_ _ person or estate.**

Comment: A settlor who has retained managerial powers (see §§10.53-10.54) usually does not want these powers (other than possibly the power to remove the trustee) to be exercised by another fiduciary (*e.g.,* a conservator or guardian). This clause is not appropriate if no powers or rights are retained.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.56 E. Form: Investment Counsel

§10.56 E. Form: Investment Counsel

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10.56-1 Binding decisions by independent investment counsel named by settlor

***Power to Retain Investment Counsel*. _ _**[*Name of settlor,*]**_ _ during _ _**[*his/her*]**_ _ lifetime _ _**[*and, on his or her death or incapacity, determined as described elsewhere in this trust, _ _*[*name of other settlor*]**_ _]_ _, shall have the power, in his or her discretion, to direct that the trustee employ or remove a reputable professional investment counsel of _ _**[*name of settlor*]**_ _'s choice.**

Any investment counsel designated by _ _[*the/either*]**_ _ settlor shall continue to be retained in that capacity after the death of the _ _**[*settlor/last surviving settlor*]**_ _, absent compelling circumstances to the contrary or except as provided below. On the death or incapacity of the _ _**[*settlor/surviving settlor*]**_ _, each child of the settlor who has attained age _ _**[*e.g., 25*]**_ _ shall have the power, in his or her discretion, to direct that the trustee employ a reputable professional investment counsel of his or her choice to supervise the investment of the trust set aside for that child and his or her issue and to remove any previously acting investment counsel.** _ _[*Any investment counsel selected for employment must be, e.g., currently handling at least five other accounts of similar or larger size.*]_ _

The trustee shall abide by the investment counsel's decision regarding property placed under _ _[*his/her/its*]**_ _ control but shall not be held liable or otherwise surcharged for losses directly attributable to investments made or retained on the investment counsel's advice. While the investment counsel is employed by the trustee, the trustee need not review trust investments subject to the investment counsel's supervision unless the trustee is apprised of facts clearly indicating that the investment counsel is not performing competently. The trustee need not take action on trust investments subject to the investment counsel's supervision other than to invest otherwise idle cash, unless the trustee receives written instructions from the investment counsel.**

If investment counsel is retained, the trustee's fees for its ordinary services as set out elsewhere in this trust for property subject to the investment counsel's supervision for the period that investment counsel is retained shall be _ _[*reduced by _ _*[*number*]**_ _ percent/reasonably reduced*]**_ _ to account for the absence of investment responsibility for that property.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.56A G. Form: Investment Consultant

§10.56A G. Form: Investment Consultant

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10.56A-1 Nonbinding recommendations by consultant

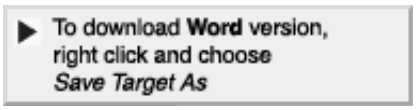
***Trustee Consultation*. The trustee is requested, when practicable, to consult with _ _[*name of consultant*]_ _, hereafter called the consultant, who presently resides at _ _[*address*]_ _, on proposed sales, exchanges, or leases of trust assets, purchases of property for the trust, investment of trust funds, or retention of trust assets. The trustee is requested to consider the consultant's recommendations but need not follow them.**

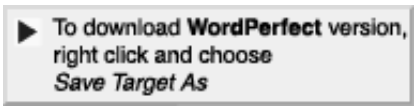
Comment: The stipulation that the trustee need not review trust investments may not relieve a trustee from the responsibility to ensure that the investment counsel is acting competently. See §10.59.

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IV. CLAUSES GOVERNING TRUSTEE'S POWERS AND ADMINISTRATION

§10.57 A. Form: Introduction to Trustee's Powers





10.57-1 Introduction to trustee's powers

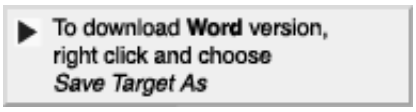
To carry out the purposes of the trusts created by this instrument, and subject to any limitations provided elsewhere in this instrument, the trustee shall have, without necessity of application to any Court, the following powers in addition to those conferred by California Trust Law.

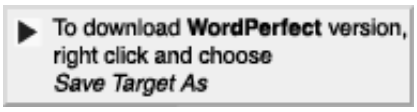
Comment: Drafters may use this or a similar clause at the beginning of the section in the trust document in which the powers and duties are described instead of the stand-alone provision in §10.58, when for example, the trust will hold out-of-state assets or assets with particular management problems (a partnership or other business interests, such as an interest in a farm or ranch) or to carry out specific objectives of the settlor (to preserve the family farm, residence, or business).

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.58 B. Form: Trustee's Powers

§10.58 B. Form: Trustee's Powers





10.58-1 Trustee's powers

***Trustee Powers*. The trustee of each trust established under this instrument is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:**

(1) Each power enumerated in California Probate Code §§16047, 16052, 16200, 16220-16249, and any successor statutes as amended from time to time.

(2) The power to invest and reinvest in any kind of property or type of investment.

(3) The power to operate any business at the risk of the trust estate.

(4) The power to retain, purchase, or otherwise acquire unproductive property.

(5) The power to divide any trust created under this instrument into two or more trusts and to administer any addition to a trust as a separate trust.

(6) The power to exercise all rights, powers, and privileges of an owner of securities, insurance, or any other property owned by the trust.

(7) The power to borrow money and to encumber trust property.

(8) The power to lend money to persons not currently entitled to distributions from the trust as long as the loan is adequately secured and bears a reasonable rate of interest.

(9) The power to loan or advance the trustee's own funds to the trust for any trust purpose, with interest at current rates; to receive security for such loans; to purchase assets of the trust at their fair market value as determined by an independent appraisal of those assets; and to sell property to the trust at a price not in excess of its fair market value as determined by an independent appraisal.

(10) The power to make or decline to make any tax election affecting the trust or its beneficiaries.

(11) The power to partition, allot, and distribute trust assets on any prorata or nonprorata division or distribution of any trust, in undivided interests or in kind or partly in money and partly in kind. For such purposes, assets shall be valued as of the date they are distributed or otherwise allocated.

Comment: Probate Code §16047 contains the prudent investor rule. See §10.59. Probate Code §16052 permits the trustee to delegate investment and management functions. See §10.76. See Prob C §§16220-16249 for specific trustee powers, including the power to acquire and dispose of property; manage, encumber, repair, and alter property; purchase insurance; borrow, pay, and settle claims; pay taxes; and make loans to beneficiaries.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.59 C. Trustee Duties Regarding Investments

§10.59 C. Trustee Duties Regarding Investments

In 1995, California adopted the Uniform Prudent Investor Act (UPIA) (Prob C §§16002(a), 16003, 16045-16054). This Act, which regulates trustee investment authority and responsibility except as otherwise provided in the trust instrument, abandons previous notions that some investments were bad per se. Adapted from Restatement (Third) of Trusts: Prudent Investor Rule §227 (1992), UPIA assumes that:

- All investments are subject to risk (even bank deposits may lose value as a result of inflation);
- An investor can be both risk-taking and prudent; and
- Evaluation of investment management requires an analysis of the trust portfolio as a whole and the needs and objectives of the trust and the beneficiaries.

UPIA expressly permits a trustee to invest in any kind of property or type of investment or engage in any course of action or investment strategy "consistent with the standards of this chapter." Prob C §16047(e). Probate Code §16047(a)-(b) states:

> A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
>
> A trustee's investment and management decisions respecting individual assets and courses of action must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

Under Prob C §16225, a court order is required to deposit trust funds in an account in a financial institution in an amount greater than the maximum insured or collateralized amount. This limitation on portfolio content appears to conflict with the trustee power to invest in any kind of asset under Prob C §16047(e).

UPIA rejects common-law prohibitions against delegation of trustee authority as it formerly applied to investment management, substituting a requirement for prudent delegation. See Prob C §§16012(c), 16052(a). The trustee, however, remains liable for the selection and periodic review of the agent and for determining the scope of the delegation. Prob C §16052(a).

If the trustee operates prudently in the establishment of the scope and terms of the delegation, in the selection of the agent, and in the periodic review of the agent's performance and compliance with the terms of the delegation, the trustee will not be liable to the beneficiaries of the trust for the decisions or actions of the agent—unless, of course, the trustee directs the agent's offending acts or omissions or unless any other condition under Prob C §16401(b) exists. The settlor may expand or contract this statutory power to delegate the investment and management functions in the trust instrument. Prob C §16046(b).

In the majority of cases, the drafter will want to confirm that UPIA applies to the trust and to expressly confirm the trustee's broad investment power. For further discussion, see Horwood & Zaluda, *A Trustee's Balancing Act: Income and Remainder Beneficiaries' Rights*, 30 Est Plan 12 (2003). See also *Trustee Administration Powers: Drafting Considerations*, 25 CEB Est Plan Rep 68, 72 (Dec. 2003).

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D. General Investment Powers

1. Broad or Restricted Investment Powers

§10.60 a. Form: Broad Investment Powers Under Prudent Investor Rule

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10.60-1 Broad investment powers under prudent investor rule

***Broad Investment Powers*. The trustee may invest in any kind of property (real, personal, or mixed) or any kind of investment (specifically including, but not limited to, corporate obligations of every kind; preferred or common stocks; shares of investment trusts, investment companies, and mutual funds _ _**[*including any common trust funds administered by the trustee*]**_ _; life insurance policies; notes, real estate, bonds, debentures, mortgages, deeds of trusts, mortgage participations, market funds, and index funds appropriate under the then-prevailing circumstances) or engage in any course of action or investment strategy consistent with the standards of the Uniform Prudent Investor Act (UPIA) (Probate Code §§16002(a), 16003, 16045-16054). These powers may be exercised without regard to any current or future statutory insurance or collateralization requirements that would apply in the absence of express authorization in the trust document.**

[*If appropriate, add the following option*]

[*Option: Power to establish margin accounts and to buy or sell options, puts, and calls*]

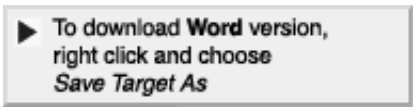
The trustee may also establish and maintain margin accounts and buy or sell options, puts, and calls.

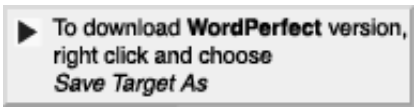
Comment: See §10.59. The bracketed language may be added for corporate trustees. The optional addition should be used if the settlor wants the trustee to have broad stock market investment powers. For power to invest in specialized investments, see §§10.30-10.31. Some brokerage firms require express authorization for a trustee to exercise such investment powers.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.61 b. Form: Limited Investment Powers

§10.61 b. Form: Limited Investment Powers





10.61-1 Limited investment powers

***Limited Investment Powers*. The trustee may invest and reinvest trust funds in the following kinds of property and no other: _ _**[*Describe types of investments to be permitted, e.g., bank deposits, United States government bonds and notes, common stocks listed on any national securities exchange, improved real estate, any common trust fund administered by the trustee*]**_ _.**

Comment: If the settlor wants to limit the kinds of property in which the trustee may invest, a clause such as this one may be used. Time, however, may change the appropriateness of even the most well-thought-out investment directions. If the property that is the subject of this clause is or may become unproductive, the beneficiary of a qualified terminable interest property or power-of-appointment marital deduction trust must be given the power to override the directive in the clause and instruct the trustee to dispose of that property to qualify for the marital deduction. See Treas Reg §20.2056(b)-5(f)(4). See also §§19.44-19.46; Drafting California Revocable Trusts §13.5 (4th ed Cal CEB 2003).

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2. Power to Retain Property and Operate a Business

§10.62 a. Retaining Property and Operating a Business

The trustee has the power to retain trust property received from a settlor or any other person as long as the trustee considers it advisable to do so. Prob C §16220. Within a reasonable time after becoming trustee, the trustee must review the assets and decide whether to retain or dispose of them, based on the purposes, terms, distribution requirements, and other circumstances of the trust. Prob C §16049. In deciding whether a particular trust asset should be retained, the trustee may take into consideration any special relationship or special value the asset may have to the purposes of the trust or to one or more of the beneficiaries. Prob C §16047(c)(8). While the trustee has the power to retain trust property, the trustee generally does not have the power to operate a business received or acquired by the trustee under the trust without a court order, in the absence of express authorization in the trust document. Prob C §16222. In view of these considerations, it is often desirable to expressly address asset retention issues in the trust document and to include language in the trust document expressly authorizing the trustee to operate a business. See form 10.63-1.

Normally, the trustee has a duty to make trust property productive (Prob C §16007) unless the trust instrument specifically provides otherwise. A non-income-producing, nonappreciating asset generally is not a proper trust investment unless it is held for the use of the beneficiaries, except when circumstances indicate otherwise. If the trust document directs the trustee to retain unproductive property, however, the trustee does so without risk of liability to the income beneficiaries. Prob C §16040(c). See form 10.64-1.

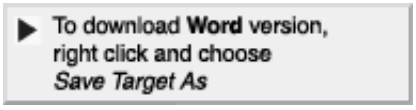
Giving the trustee the power to retain cash without investment has been held not to show the intent to deprive the surviving spouse of beneficial enjoyment of trust property when the spouse has the right to require the trustee to make the trust property productive or convert it into productive property within a reasonable time. See Rev Rul 66-39, 1966-1 Cum Bull 223. For discussion of holding unproductive or underproductive property in trust, see §§19.34-19.49.

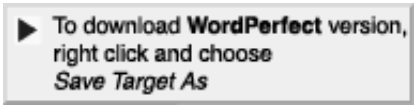
Diversification is normally prudent and generally required by Prob C §16048. Nevertheless, inclusion of form 10.66-1 may be appropriate under certain circumstances, *e.g.,* when the trust holds the assets of a family business. For further discussion, see *Trustee Administration Powers: Drafting Considerations*, 25 CEB Est Plan Rep 68, 73 (Dec. 2003).

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.63 b. Form: Power to Retain Property and Operate a Business (Standard Clause)

§10.63 b. Form: Power to Retain Property and Operate a Business (Standard Clause)





10.63-1 Power to retain property and operate a business (standard clause)

***Power to Retain Trust Property*. The trustee may continue to hold any property _ _**[*, including any shares of the trustee's own stock,*]**_ _ and to operate at the risk of the trust estate any business that the trustee receives or acquires under the trust as long as the trustee, in the trustee's discretion, considers it advisable to do so.**

[*If appropriate, add the following option*]

[*Option: Aggregate return must be reasonable*]

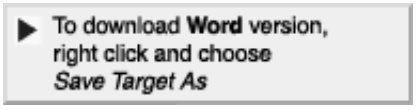
The aggregate return from all investments from time to time must, however, be reasonable under the then-prevailing circumstances.

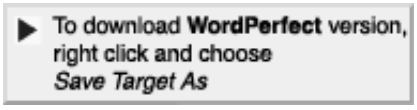
Comment: This clause may be appropriate for a long-term trust that may receive future contributions of different kinds of assets. If the trust assets are ascertainable when the clause is drafted, the clause could be customized to address the issues presented by the particular assets. On problems that may arise when underproductive property is held in trust, see §19.34.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.64 c. Form: Power to Retain or Purchase Unproductive or Underproductive Property

§10.64 c. Form: Power to Retain or Purchase Unproductive or Underproductive Property





10.64-1 Power to retain unproductive or underproductive property

***Power to Hold Unproductive Property*. The trustee may retain, purchase, or otherwise acquire unproductive or underproductive property _ _**[*subject to the provisions set out elsewhere in this trust*]**_ _.**

[*If appropriate, add the following option*]

[*Option: Power to retain cash*]

The trustee may keep reasonable amounts of cash in a low- or non-interest-bearing bank or savings account if deemed advisable for the protection of principal or for the payment of income.

Comment: It is highly recommended that this clause be modified to identify the particular asset that may be acquired or retained, and the reason for this clause explained in the clause itself. See §19.35. If this is not done, the clause may not protect the trustee. Under Prob C §16202, the mere grant of a power does not permit exercise of the power; exercise of the power is subject to the trustee's fiduciary duties.

The bracketed language is for use in a qualified terminable interest property marital deduction trust. The trust clause referred to is a clause giving the surviving spouse the power to require the trustee to make unproductive or underproductive property productive or to sell it. See Drafting California Revocable Trusts, form 13.14-1 (4th ed Cal CEB 2003).

For extensive discussion of holding underproductive property in trust, see §§19.34-19.49.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/ 3. Diversification of Assets/§10.65 a. Duty to Diversify Assets

3. Diversification of Assets

§10.65 a. Duty to Diversify Assets

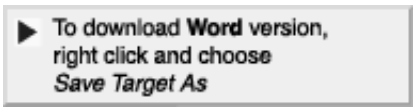
The trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so. Prob C §16048. The settlor may, however, wish to absolve the trustee of this duty if:

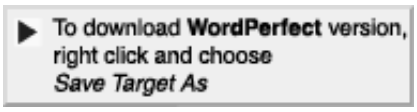
- The settlor wishes to maintain control of the family business or be assured that control of the business lies in friendly hands; or
- The trust will consist of a limited number or type of assets until they can be sold for a maximum price.

A clause that permits the trustee not to diversify the trust's investments may be general or specific.

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§10.66 b. Form: Diversification Not Required





10.66-1 Diversification not required

***Power to Retain Trust Property*. In making and implementing investment decisions, the trustee shall not have a duty to diversify the investments of the trust and is expressly authorized** _ _[*e.g., to retain the assets of a specified family business or farm or the assets initially or at any time transferred to the trust by a settlor*]_ _**.**

Comment: It is highly recommended that this clause be modified to identify the particular asset that may be acquired or retained without diversification, and the reason for the clause explained in the clause itself. If this is not done, the clause may not protect the trustee. Under Prob C §16202, the mere grant of a power does not permit exercise of the power; exercise of the power is subject to the trustee's fiduciary duties. See Lipton & Kornspan, *Expansion of Trustee's Authority May Not Relax the Standard of Care*, 29 Est Plan 343 (2002).

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4. Power to Sell, Exchange, Manage, Encumber, and Grant Options on Property

§10.67 a. Disposing of and Managing Property

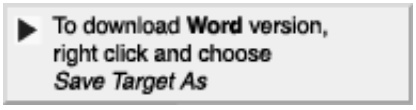
Under California law, the trustee has the power to sell trust property to carry out trust purposes and to invest in any kind of property or type of investment that is consistent with the trustee's duties and standard of care. Prob C §§16047(e), 16226. Giving the trustee broad powers to sell and manage trust property allows the trustee to deal with economic fluctuations and changed circumstances.

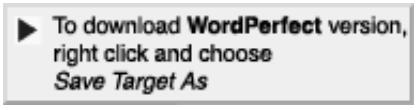
Although an express grant of these powers in the trust instrument is not strictly necessary (see Prob C §16200), many drafters incorporate the statute by reference or include an express authorization to facilitate negotiations with third parties and encourage the trustee to make a sale for the benefit of the trust estate. An express authorization is also helpful if the trust holds or may acquire out-of-state real property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.68 b. Form: Power to Sell, Exchange, Manage, Encumber, and Grant Options on Property (Standard Clause)

§10.68 b. Form: Power to Sell, Exchange, Manage, Encumber, and Grant Options on Property (Standard Clause)





10.68-1 Power to sell, exchange, manage, encumber, and grant options on property (standard clause)

***Power to Acquire and Dispose of Trust Property*. The trustee may acquire or dispose of trust property, at public or private sale, for cash or credit (including deferred payments extending beyond the duration of this trust); exchange trust property; manage, control, divide, develop, improve, exchange, partition, change the character of, repair, alter, or abandon trust property; encumber, mortgage, or pledge trust property for a term within or beyond the term of the trust in connection with the exercise of any power vested in the trustee; and grant options on trust property.**

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5. Power to Lease, Including Oil and Mineral Development (Standard Clause)

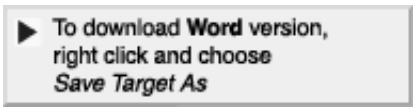
§10.69 a. Leasing Property

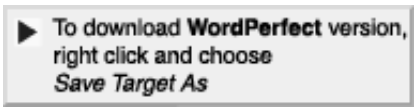
The trustee is authorized to lease trust property to carry out trust purposes under Prob C §16231. The trustee has similar powers to enter into a lease or an arrangement for exploration and removal of gas, oil, minerals, or geothermal energy and to enter into a community oil lease or pooling or unitization agreements. Although specific authorization in the trust instrument is not strictly necessary, including these powers may assist the trustee in dealing with third parties or in leasing out-of-state real property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.70 b. Form: Power to Lease, Including Oil and Mineral Development (Standard Clause)

§10.70 b. Form: Power to Lease, Including Oil and Mineral Development (Standard Clause)





10.70-1 Power to lease, including oil and mineral development (standard clause)

***Power to Lease Trust Property*. The trustee may lease trust property for terms within or beyond the term of the trust for any purpose (including exploration for and removal of gas, oil, minerals, and geothermal energy) and enter into community oil leases and pooling and unitization agreements.**

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6. Securities Ownership

a. Managing Securities

§10.71 (1) Authority to Manage Securities

The trustee's power to manage securities is found in Prob C §§16234-16237. Because a settlor-trustee holds the power in a fiduciary capacity, it is not within the prohibited powers set out in IRC §675(4) (Rev & T C §17731). See §10.99. A settlor should not, however, be given the power to vote the shares of a controlled corporation transferred in trust, whether as trustee or in his or her individual capacity. IRC §2036. See §§2.56, 2.58-2.60.

A trustee who sells a majority stock interest to a buyer who loots the corporation is liable to the corporation for losses incurred through the sale if the trustee had facts indicating that the buyer intended to loot the corporation. *DeBaun v First W. Bank* (1975) 46 CA3d 686, 120 CR 354.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.72 (2) Form: Power to Manage Securities (Standard Clause)

§10.72 (2) Form: Power to Manage Securities (Standard Clause)

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10.72-1 Power to manage securities (standard clause)

***Power to Manage Securities*. The trustee shall have all the rights, powers, and privileges of an owner of the securities held in the trust, including, but not limited to, the powers to:**

(1) Vote, give proxies, and pay assessments;

(2) Participate in voting trusts and pooling agreements and enter into shareholders' agreements, including, but not limited to, buy-sell agreements, close corporation and S corporation shareholders' agreements, and limited liability company member agreements;

(3) Consent to foreclosures, reorganizations, consolidations, mergers, and liquidations;

(4) Deposit securities with and transfer title to any protective or other committee on any terms that the trustee, in the trustee's discretion, considers advisable; and

(5) Exercise or sell stock subscription or conversion rights.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.73 (3) Form: Power to Register Shares for Sale (Closely Held or Controlled Public Corporation)

§10.73 (3) Form: Power to Register Shares for Sale (Closely Held or Controlled Public Corporation)

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10.73-1 Power to register shares for sale (closely held or controlled public corporation)

***Power to Register Shares*. The trustee may register, or qualify for exemption from registration, shares of stock in any corporation with any agency of any government (including, but not limited to, the United States Securities and Exchange Commission); participate in any such registration or exemption from registration; apply for and secure approval of the agency for sale of these shares; sell these shares or participate in the public or private sale of these shares; enter into any agreement for the sale with any broker, investment banker, or underwriter; incur and pay all expenses connected with the registration, qualification, or sale; execute any indemnification agreement or other instrument required to consummate the registration, underwriting, or sale; and take all other actions necessary or appropriate to consummate the registration, qualification, or sale.**

Comment: This power should be inserted only when trust corpus includes shares of a closely held business or controlled public corporation and the trustee is likely to sell shares to the public.

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b. Holding Stocks and Other Securities in Nominee's, Broker's, or Street Name

§10.74 (1) Authority to Hold Stocks and Other Securities

California law gives trustees the power to hold securities (but not other property) in the name of nominees or in other form without disclosure of the trust "so that title to the security may pass by delivery." Prob C §16238. Moreover, California law also specifically authorizes a trust company, when acting as a trustee or custodian, to register securities (but not other property) in a third person as nominee and to aggregate groups of the same securities owned by different trusts all in the name of one nominee. The trust company, however, would be liable for any loss incurred as a result of the nominee's acts. Fin C §1563.

Placing stock or securities in the name of a nominee or in the name of the securities broker who handled the asset purchase ("street name") facilitates quicker and easier transfer of securities on sale by eliminating the need to obtain the trustee's signature on actual share certificates.

The settlor may also wish to provide the trustee with the power to hold property (including, but not limited to, securities), without disclosing the trust relationship to facilitate trading in other property as well. For example, it might not be in the trust's best interests for its ownership of the property to be a matter of public record. Also, if record title is not transferred into the name of the trust, even though the settlor intended to transfer ownership, a clause such as form 10.75-1 might negate any evidentiary implication that the asset was not intended to be transferred to the trust.

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§10.75 (2) Form: Authority to Hold Trust Property as Nominee

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10.75-1 Authority to hold trust property as nominee

***Power to Hold Property as Nominee*. The trustee may hold:**

(1) Stocks and other securities in the trustee's name as trustee under this trust, in a nominee's name, with or without any express designation of the status of the person as nominee, or in the name of the broker who handled the asset purchase (what is commonly called "street name"). The trustee also may, in the trustee's discretion, hold unregistered securities in "bearer" form, which enables ownership of the shares to pass on delivery.

(2) The property of the trust in the name of the trustee individually, with or without disclosing the capacity as trustee, or as trustee, with or without designation of any beneficiary.

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7. Power to Employ Agents or Investment Counsel

§10.76 a. Use of Power

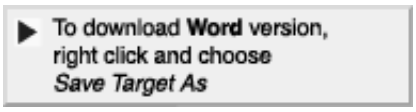
The power to hire assistants is granted by Prob C §16247. Although the trustee may be surcharged for delegating to others acts that the trustee reasonably should perform (Prob C §16012(a)), it is generally recognized that a trustee may seek the advice of experts such as attorneys and accountants. See Restatement (Second) of Trusts §171 (1959).

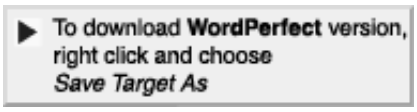
The general rule prohibiting delegation of trustees' functions does not apply to investment and management functions. The Uniform Prudent Investor Act (Prob C §§16002(a), 16003, 16045-16054) specifically authorizes the prudent delegation of investment and management functions. Prob C §§16012(c), 16052. Also, the settlor may encourage the use of experts by including in the trust instrument a clause specifically authorizing the trustee to employ attorneys, accountants, and other consultants and to charge the trust with the cost of their services. The authority to employ agents, including a corporate fiduciary, to assist the trustee in mechanical matters is helpful when an individual is designated as trustee. Because the scope of "management functions" is unclear, a drafter desiring to provide a broad power of delegation should expressly expand the delegation power, limit the statutory duty not to delegate, or both. For further discussion, see *Trustee Administration Powers: Drafting Considerations*, 25 CEB Est Plan Rep 68, 72 (Dec. 2003).

A settlor who has used investment counsel may wish to provide for use of the same counsel by the trustee to provide continuity of investment management. On use of investment counsel selected by the settlor, see §10.56. A trustee who delegates investment functions must exercise prudence in selecting the agent and must periodically review the agent's performance. Prob C §16052.

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§10.77 b. Form: Power to Employ Agents





10.77-1 Power to employ agents

***Power to Employ Agents*. The trustee may employ any custodian, attorney, accountant, corporate fiduciary, or any other agent or agents to assist the trustee in the administration of this trust _ _**[*and to rely on the advice given by these agents*]**_ _.**

[*If appropriate, add one or more of the following options*]

[*Option 1: Power to delegate investment and management functions*]

The power to employ agents includes the power to delegate management and investment functions according to Probate Code §16052.

[*Option 2: Compensation for agent or adviser*]

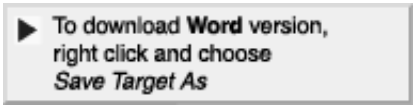
Any agent or adviser shall receive reasonable compensation for all services performed, which shall be paid from the trust estate from either income or principal, as the trustee, in the trustee's discretion, determines, and shall _ _[*not*]**_ _ decrease the compensation to which the trustee is entitled.**

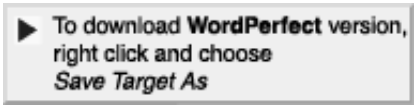
Comment: The trust should specify whether the trustee's compensation is to be reduced if he or she employs consultants. The bracketed word in Option 2 should be used with discretion because it enables the trustee to escape most duties by delegating them to others while still collecting the entire trustee fee. On the trustee's power to employ managers and real estate brokers, see §§19.6-19.8. On exoneration clauses generally, see §§10.38-10.40.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.78 c. Form: Individual Trustee's Power to Employ Investment Counsel

§10.78 c. Form: Individual Trustee's Power to Employ Investment Counsel





10.78-1 Individual trustee's power to employ investment counsel

***Power to Retain Investment Counsel*. The trustee may retain professional investment counsel of the trustee's choice, regarding investments held by these trusts, as long as the selected counsel is currently handling _ _[*specify parameters, e.g., at least five other accounts of similar or greater size*]_ _. If investment counsel is retained, the trustee shall abide by the counsel's decision but shall not be held liable or otherwise surcharged for losses directly attributable to investments made on the investment counsel's advice. While investment counsel is retained by the trustee, the trustee shall not be required to review trust investments subject to the investment counsel's supervision unless the trustee is apprised of facts clearly indicating that counsel is not performing competently. The trustee need not take action on those investments unless the trustee receives written instructions from the investment counsel. If counsel is retained, the trustee's fees for the trustee's ordinary services while counsel is retained shall be _ _[*reduced to a sum equal to* _ _[*number*]_ _ *percent of the fee normally charged by the trustee for ordinary services to such property/reasonably reduced*]_ _. The trustee shall have the power exercisable in the trustee's discretion to discharge such counsel and to employ other counsel or to administer the trust without such counsel.**

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E. General Management Powers

1. Power to Borrow

§10.79 a. Explicit Grant May Be Required

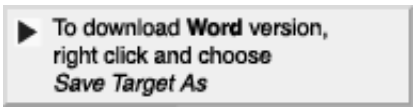
The trustee is authorized to borrow money to be repaid from trust property for any trust purpose (Prob C §16228) and to encumber, mortgage, or pledge trust real and personal property in connection with the exercise of any other trustee power, including borrowing (Prob C §16241).

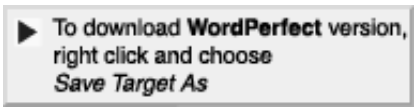
Banks or insurance companies may refuse to lend money to a trust unless the trustee is given explicit authorization to borrow in the trust instrument. Specific authorization is also helpful if the trust may acquire out-of-state real property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.80 b. Form: Power to Borrow (Standard Clause)

§10.80 b. Form: Power to Borrow (Standard Clause)





10.80-1 Power to borrow (standard clause)

***Power to Borrow*. The trustee may borrow money and encumber trust property by mortgage, deed of trust, pledge, or otherwise, for the debts of the trust or the joint debts of the trust and a co-owner of the property in which the trust has an interest.**

Comment: Some title insurance companies may refuse to issue a policy covering a loan on a trust property owned in common with another person unless the last phrase regarding debts is included.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.81 2. Form: Power to Make Loans (Standard Clause)

§10.81 2. Form: Power to Make Loans (Standard Clause)

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10.81-1 Power to make loans (standard clause)

***Power to Lend*. The trustee may make loans from trust assets to anyone, including a beneficiary of any trust created under this instrument, on the giving of adequate security and the payment of a reasonable rate of interest.**

Comment: The power to make loans to trust beneficiaries and to guarantee loans made to trust beneficiaries is granted by Prob C §16244. If a beneficiary is a trustee, see §10.44.

Under IRC §§672(e) and 675(3), when the settlor or the settlor's spouse actually borrows trust corpus or income without completely repaying the loan before the beginning of the taxable year, the settlor will be considered the owner of trust corpus and taxed on its income, unless the loan provides for adequate interest and security and is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor.

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3. Power to Lend to, Buy From, and Sell to Trust

§10.82 a. Allowing Trustee as Individual to Purchase Assets or Make Loans to Trust

Generally, a trustee may not deal as an individual with the trust. The trustee has a duty to administer the trust solely in the interest of the beneficiaries and may not use or deal with trust property for the trustee's own profit or for any purpose unconnected to the trust. Prob C §§16002, 16004.

In some circumstances, it may be desirable to give the trustee the power to deal individually with the trust. A clause giving the trustee the power to engage in self-dealing will probably be sustained. See Restatement (Third) of Trusts: Prudent Investor Rule §170, Comment t (1992). The settlor may wish to include form 10.83-1 if the trustee has special knowledge of trust property and is likely to be a purchaser of trust assets or a source of borrowed capital.

The power to engage in self-dealing is not among the powers that cause the settlor-trustee to be taxed on trust income under IRC §675 (Rev & T C §17731). Sales of trust assets must be for adequate consideration. IRC §675(1); Treas Reg §1.675-1(c). See *Estate of Ralph Budd* (1968) 49 TC 468, acq 1973-2 Cum Bull 1 (estate tax case in which settlor-trustee had right to engage in arm's-length self-dealing). On the trustee's self-dealing, see §10.44.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.83 b. Form: Power to Lend to, Buy From, and Sell to Trust Individually

§10.83 b. Form: Power to Lend to, Buy From, and Sell to Trust Individually

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10.83-1 Power to lend to, buy from, and sell to trust individually

***Permitted Transactions*. The trustee may lend or advance the trustee's own funds to the trust for any trust purpose, with interest at current rates; receive security for such loans in the form of a mortgage, pledge, deed of trust, or other encumbrance of any assets of the trust; purchase assets of the trust at their fair market value as determined by an independent appraisal of those assets; and sell property to the trust at a price not in excess of its fair market value as determined by an independent appraisal.**

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4. Power to Initiate and Defend Litigation and to Compromise Claims

§10.84 a. Explicit Grant of Power Reinforces Trustee's Duty to Preserve Trust Property

The trustee has a duty to preserve trust property. Prob C §16006. More specifically, the trustee has the duty to enforce claims that are part of the trust property (*e.g.,* rents, accounts payable (Prob C §16010)) and to defend actions that could cause trust losses (Prob C §16011). Probate Code §16249 also gives the trustee the power to prosecute or defend actions, claims, or proceedings for the protection of trust property. Probate Code §859 imposes liability for twice the value of the property on any person who in bad faith wrongfully takes, conceals, or disposes of property in or belonging to the trust recovered by the trustee in an action under Prob C §§850-859. The power to prosecute or defend actions does not permit a trustee to represent a trust in court unless the trustee is a member of the State Bar. *Ziegler v Nickel* (1998) 64 CA4th 545, 75 CR2d 312. However, the trustee may appear as trustee to petition to modify or terminate the trust without being represented by counsel. *Finkbeiner v Gavid* (2006) 136 CA4th 1417, 39 CR3d 871.) Under Prob C §16242, the trustee may pay, settle, arbitrate, compromise, or release a claim. See generally Restatement (Second) of Trusts §192 (1959). For a clause empowering the trustee to take these courses of action, see form 10.85-1.

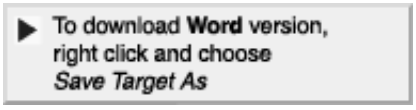
Failure to take any action when reasonably required may cause the trustee to be personally liable for the resulting loss. *Purdy v Johnson* (1917) 174 C 521, 163 P 893. See *Estate of Prior* (1952) 111 CA2d 464, 244 P2d 697; see also 3 Scott & Ascher on Trusts §17.9 (5th ed 2007). On the trustee's duty to defend claims, see *Metzenbaum v Metzenbaum* (1953) 115 CA2d 395, 252 P2d 31; Restatement (Second) of Trusts §178 (1959).

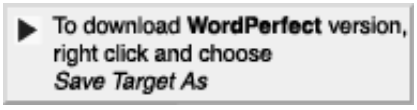
PRACTICE TIP: Form 10.85-1 clearly states that the trustee's powers to litigate and defend actions continue after the trust terminates. The extension of this power is important because, although under California law the power to litigate continues beyond the life of the trust, the power terminates in other states. Compare *Botsford v Haskins & Sells* (1978) 81 CA3d 780, 146 CR 752 (under California law, complaint could be filed after trust termination), with *Harold Patz Trust* (1977) 69 TC 497 (under Wisconsin law, trustee unable to litigate tax deficiency after distribution of trust assets). See also *Ranghild Elton*, TC Memo 2000-9 (former trustee unable to litigate tax deficiency after trust was declared void by state court). In the absence of this clause, a California trust owning real estate in another state may not be able to defend actions after the trust terminates.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.85 b. Form: Power to Initiate and Defend Litigation and Power to Compromise (Standard Clause)

§10.85 b. Form: Power to Initiate and Defend Litigation and Power to Compromise (Standard Clause)





10.85-1 Power to initiate and defend litigation and power to compromise (standard clause)

***Power to Litigate and Compromise Claims*. The trustee may initiate or defend, at the expense of the trust, any litigation that the trustee considers advisable relating to the trust or any property of the trust estate, and compromise, submit to arbitration, abandon, or otherwise adjust any claims or litigation against or in favor of the trust, as long as the trustee determines, in the trustee's discretion, that such action will be beneficial to the trust. The trustee's powers under this clause shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no obligations or duties, however, for any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss connected with these matters.**

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5. Power to Insure

§10.86 a. Power to Insure Assets and Insure Against Liability

Probate Code §16240 gives the trustee the power to insure the trust's assets as well as to insure the trustee against liability to third persons. The obligation to protect the trust estate and to carry insurance that would customarily be carried by a prudent person who owned the property is implicit in the trustee's fiduciary duty. Restatement (Second) of Trusts §176 (1959). If the trust owns a business that the trustee is responsible for operating, the settlor may wish to authorize acquisition of liability insurance at the expense of the trust to protect the trustee as well.

The general insurance clause probably does not authorize the trustee to purchase life insurance.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.87 b. Form: Power to Insure (Standard Clause)

§10.87 b. Form: Power to Insure (Standard Clause)

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10.87-1 Power to insure (standard clause)

***Power to Insure*. The trustee may carry, at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.**

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F. Powers to Deal With Settlor's Probate Estate

§10.88 1. Use of Powers

Frequently, a settlor while living will create an irrevocable trust, usually funded with life insurance, that is intended to provide a source of liquid assets for paying death taxes on the settlor's death. It is important that such trusts not contain any provisions that will directly benefit the settlor's estate or revocable trust. Such a provision would cause the insurance to be included in the settlor's estate for estate tax purposes under IRC §2042. In these situations, the irrevocable trust must provide liquidity indirectly by making arm's-length transaction loans to the estate or revocable trust or by purchasing assets from the estate or revocable trust.

When such loans or purchases are contemplated, the trust instrument may authorize such loans or purchases, although some practitioners believe that such provisions add nothing useful to the trustee's more general loan and purchase powers. See §§10.89-10.90.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.89 2. Form: Power to Lend to Settlor's Probate Estate

§10.89 2. Form: Power to Lend to Settlor's Probate Estate

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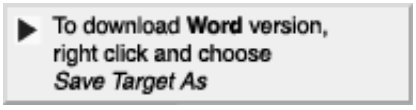
10.89-1 Power to lend to settlor's probate estate

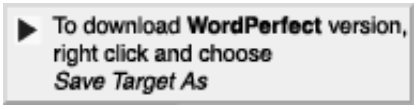
***Power to Lend to Settlor's Estate*. The trustee may lend money to the probate estate of any person, including a settlor or any trust created by a settlor that is no longer revocable at the time of the loan, regardless of whether the executor of that estate or trustee of that trust and the trustee of this trust are the same person or entity. Any loan must be adequately secured and bear a reasonable rate of interest.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.90 3. Form: Power to Purchase Property From Settlor's Probate Estate

§10.90 3. Form: Power to Purchase Property From Settlor's Probate Estate





10.90-1 Power to purchase property from settlor's probate estate

***Power to Purchase from Settlor's Estate*. The trustee may purchase property from the probate estate of any person, including a settlor or any trust created by a settlor that is no longer revocable at the time of the purchase, regardless of whether the executor of that estate or trustee of that trust and the trustee of this trust are the same person or entity. Any purchase must be for fair and equivalent value.**

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G. Powers Relating to Taxes

1. Trustee's Disclaimer, Release, or Restriction of Administrative Powers

§10.91 a. Authority

Because certain administrative powers held by a trustee may have adverse tax consequences, it may be advisable to allow the trustee to disclaim, release, or restrict those powers. For instance, if a beneficiary of a trust is also the trustee, the administrative powers of that person may be so broad that he or she may be treated as the owner for income tax purposes and as the holder of a general power of appointment for transfer tax purposes. See IRC §§678, 2041, 2514.

Neither California law nor the federal disclaimer statute explicitly permits the selective disclaimer or release by a trustee of any of his or her administrative powers under the trust. Although the California statutes broadly define "interests" that may be disclaimed to include "powers" (Prob C §267(a)), they do not specifically authorize the disclaimer of an administrative power. See Prob C §§260-295. The statutes address disclaimers of interests by beneficiaries (Prob C §275), persons executing disclaimers on the beneficiaries' behalf (Prob C §264), and guardians, conservators, or personal representatives executing disclaimers (Prob C §§276-277), but they do not directly mention disclaimers by a trustee. Because Prob C §267(b)(14) defines "interest" to include "[a]ny other interest created by any testamentary or inter vivos instrument," however, a trustee can probably disclaim an administrative power if the trust expressly permits it.

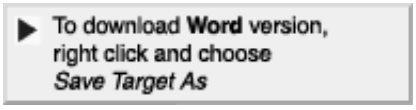
Under federal law, disclaimers of an interest in property are allowed under IRC §2518, and IRC §2518(c)(2) provides that a power with respect to property must be treated as an interest in that property. Therefore, a disclaimer probably encompasses the administrative powers of a trustee. Even if not technically authorized by statute, the release of a trustee's administrative powers will almost certainly be effective if authorized in the trust instrument. See Prob C §16200(a); Rev Rul 90-110, 1990-2 Cum Bull 209 (disclaimer by trustee of power to invade principal of trust created primarily for benefit of surviving spouse not effective because not authorized by governing instrument or state law). A settlor who serves as trustee cannot effectively disclaim powers, however, because he or she has already accepted the office. See IRC §2518.

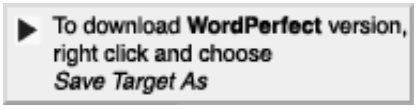
Under Treas Reg §25.2518-2(d)(2), the beneficiary may disclaim an interest in property while still serving as a fiduciary, but after the disclaimer that fiduciary cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. Therefore, if the trustee disclaims the right to receive distributions from the trust as beneficiary, but retains the discretionary power as trustee to allocate that interest to other beneficiaries, the disclaimer may be ineffective. See Treas Reg §25.2518-2(e). In IRS Letter Ruling 200649023, the IRS ruled that a disclaimer that resulted in property passing to a foundation was qualified, even though the disclaimant was the trustee of the foundation, because the trust document would be amended before the disclaimer in a manner that would create a separate fund for the property passing to the foundation and vest the distribution powers for that fund in a special trustee other than the disclaimant.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.92 b. Form: Disclaimer, Release, or Restriction of Administrative Powers

§10.92 b. Form: Disclaimer, Release, or Restriction of Administrative Powers





10.92-1 Disclaimer, release, or restriction of administrative powers

***Release of Trustee Powers*. The trustee may, in the trustee's discretion, disclaim, release, or restrict the scope of any power that the trustee may hold in connection with the trust created under this instrument, whether the power is expressly granted in this trust or implied by law. The trustee shall exercise this power in a written instrument specifying the powers to be disclaimed or restricted and the nature of any restriction. Any disclaimed power shall** _ _[*be extinguished/pass to and be exercised by* _ _[*e.g., the other cotrustee/insert name of person to whom power passes*]_ _]_ _**.**

Comment: Form 10.92-1 is useful for a tax-sensitive trustee or for a successor trustee who wishes to disclaim certain powers.

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2. Power to Adjust for Consequences of Tax Elections and Other Decisions

§10.93 a. Trustee Tax Elections

Elections made by the trustee may have favorable tax consequences for some beneficiaries but unfavorable ones for others. The trustee's selection of trust investments may affect the beneficiaries' tax situations in varying ways. Form 10.94-1 permits the trustee to make tax allocations and elections to save taxes without requiring equitable adjustments between the income beneficiaries and the remainder beneficiaries.

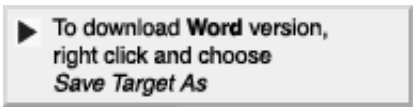
PRACTICE TIP: The express power to make an adjustment between principal and income to offset the shifting of economic interests and tax benefits between income beneficiaries and remainder beneficiaries arising from tax allocations and elections is provided by Prob C §16375(a)(1). In exercising a discretionary power of administration, the trustee is required to act impartially except to the extent that the trust expresses an intention that the trustee favor one or more of the beneficiaries. Prob C §16335(b).

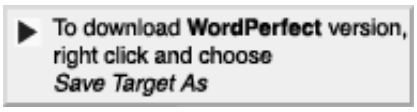
The trustee who is permitted but not required to make adjustments has the power to affect the economic benefits from the trust and may have a general power of appointment under IRC §2041 if an exercise of the power can increase the value of property distributable to the holder of the power. Therefore, a tax-sensitive trustee should not be given discretion in this respect.

When the trust includes a marital deduction trust that is not an estate-type trust, the trustee must be required to allocate the benefits among the beneficiaries and to make adjustments among the beneficiaries, instead of being given the discretionary power to do so. Otherwise, the marital deduction trust may be disqualified for failure to meet the income distribution requirement.

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§10.94 b. Form: Power to Adjust for Tax Consequences





10.94-1 Power to adjust for tax consequences

***Power to Adjust for Tax Consequences*. The trustee may take any action and make any election to minimize the tax liabilities of this trust and its beneficiaries. The trustee _ _[*shall/may*]_ _ make adjustments between the principal and income accounts, to compensate for the consequences of any tax decision or election or investment or administrative decision that has directly or indirectly benefited one beneficiary or group of beneficiaries over others.**

Comment: As discussed in §10.93, the authors question whether it is advisable to include any clause regarding equitable election of tax adjustments in the trust. If a clause is included, however, it should be mandatory in a tax-sensitive trustee situation (*e.g.,* a marital deduction or charitable deduction trust). In the second sentence, "shall" should be used in a tax-sensitive trustee situation; "may" can be used in all other situations.

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3. Power to Consider Tax Consequences of Distributions

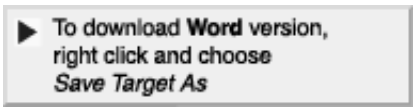
§10.95 a. Throwback Rules

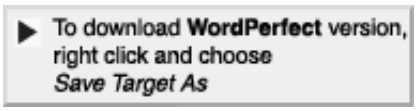
In general, the throwback rules, now substantially limited in scope, provide that any accumulated trust income will eventually be taxed to the beneficiary who ultimately receives that income. IRC §§665-668. The rules no longer apply to "qualified trusts." IRC §665(c). A qualified trust is any trust other than a foreign trust or a trust created before March 1, 1984, that would be aggregated with other trusts under IRC §643(f), which aggregates multiple trusts having the same grantors and beneficiaries if the use of multiple trusts had a tax avoidance purpose. See §3.3. In addition, because of the compression of trust income tax brackets, the income tax payable by a trust on accumulated income will often be higher than the income tax that would otherwise have been payable by the beneficiary had the income been distributed. Under these circumstances, the application of the throwback rules are unlikely to have a negative tax impact on the beneficiaries who may ultimately receive accumulated income. The complex throwback computations will, however, have to be made.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.96 b. Form: Power to Consider Tax Consequences of Distributions

§10.96 b. Form: Power to Consider Tax Consequences of Distributions



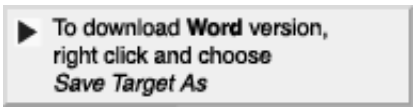


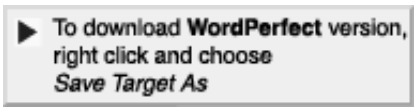
10.96-1 Power to consider tax consequences of distributions

***Power to Consider Tax Consequences*. When determining whether to distribute income or corpus authorized by this trust and the person to whom it is made, the trustee may consider the tax consequences to the trust and to the beneficiaries to whom distribution may be made.**

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§10.97 4. Form: Authority to Pay Estate Taxes





10.97-1 Authority to pay estate taxes

***Payment of Estate Taxes*. Except as otherwise provided in this trust or in _ _[*the/either*]_ _ _ _[*settlor's/settlors*]_ _ will, the trustee may pay federal and state estate taxes imposed on, or by reason of the inclusion of any portion of, the trust estate in the gross estate of _ _[*the/either*]_ _ settlor under any federal tax law. The trustee shall also have the power to charge such taxes to, prorate such taxes among, or recover such taxes from the trust estate or the persons entitled to the benefits under these trusts as and to the extent provided by any applicable tax law or proration statute.**

Comment: Usually, the corpus of a properly drafted irrevocable trust is not includable in the settlor's estate. Form 10.97-1 permits the trustee to pay any estate tax imposed due to the inclusion of trust assets in a settlor's gross estate and to charge that tax to the beneficiary entitled to those assets.

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§10.98 5. Generation-Skipping Transfer Taxes

The trustee is responsible for paying generation-skipping transfer (GST) tax and any applicable state tax on a taxable termination (IRC §2603(a)(2)), and the distributee is responsible for paying the tax on a taxable distribution (IRC §2603(a)(1)). If the trust instrument provides for payment of GST taxes on a taxable distribution, the tax payment itself is included as part of the taxable distribution for purposes of the GST tax and therefore generates additional GST tax. IRC §2621(b). If the drafter does not include any directives in the trust instrument for payment of the GST tax, it will be payable according to the statutory provisions. See chap 4.

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H. Tax Consequences

§10.99 1. Avoiding Adverse Tax Consequences to Settlor or Beneficiary-Trustee

When the trustee is "tax-sensitive" (*i.e.,* a trustee who is also a settlor or a beneficiary), the trustee must be subject to fiduciary duties to exercise his or her powers equitably, to counteract any inference that the trustee's discretion is unrestricted. An example of a tax-sensitive trustee is a beneficiary-trustee who may have the power to shift economic benefits under the trust to himself or herself. Such a power might be considered to be a general power of appointment under IRC §2041 (and not within one of the exceptions). See §§10.6, 10.11.

If certain administrative powers are given to the settlor, the settlor's wife, or a nonadverse party, the settlor will be considered to be the owner of trust corpus and taxed on its income. See IRC §§672(e), 675; Rev & T C §17731. Some of these powers cause trust income to be taxed to the settlor even though they are held by a settlor or a nonadverse party solely in a fiduciary capacity. IRC §675(1)-(3). The grantor is treated as the owner of any portion of a trust with respect to which:

- The grantor or a nonadverse party has the power to enable the grantor or any person to sell, exchange, deal with, or dispose of property for less than an adequate consideration in money or money's worth and without the approval or consent of any adverse party (IRC §675(1));
- The grantor or a nonadverse party has the power to enable the grantor or any person to borrow from the trust without adequate interest or security unless the trustee (other than the grantor or the grantor's spouse) may, under a general lending power in the trust instrument, loan to any person without regard to interest or security (IRC §675(2)); and
- The grantor or the grantor's spouse has actually borrowed trust corpus or income without completely repaying the loan before the beginning of the taxable year, unless the loan provides for adequate interest and security and is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor (IRC §675(3)).

Other powers have income tax consequences only if a settlor or a nonadverse party holds them in a nonfiduciary capacity not requiring a fiduciary's consent. A power held by a trustee is presumed to be held for the benefit of beneficiaries. Treas Reg §1.675-1(b)(4). For definitions of "nonadverse party" and "related or subordinate party," see §§3.26, 3.36.

The direct or indirect power to vote any securities of a controlled corporation transferred by the settlor to the trust will cause those securities to be included in the settlor's taxable estate. IRC §2036.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.100 2. Form: Trustee Prohibited From Exercising Certain Powers

§10.100 2. Form: Trustee Prohibited From Exercising Certain Powers

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10.100-1 Trustee prohibited from exercising certain powers

***Trustee Prohibitions*. The trustee is expressly prohibited from exercising any power vested in the trustee primarily for the benefit of the settlor(s) rather than for the benefit of the beneficiaries. Neither the settlor(s) nor any other person may:**

(1) Purchase, exchange, or otherwise deal with or dispose of the income or principal of the trust estate for less than adequate and full consideration in money or money's worth;

(2) Borrow the income or principal of the trust estate, directly or indirectly, without adequate interest or without adequate security; or

(3) Vote, directly or indirectly, any securities of a controlled corporation (as defined by Internal Revenue Code §2036(b)(2) or any successor statute) transferred by the settlor(s) to the trust.

[*If appropriate, add the following option*]

[*Option: Certain powers vested in special trustee*]

While a settlor is a trustee, the power to vote, directly or indirectly, any securities of a controlled corporation (as defined by Internal Revenue Code §2036(b)(2) or any successor statute) transferred by the settlor(s) to the trust, shall be vested in the first successor trustee who is not a settlor, as special trustee.

Comment: Because the settlor will also be treated as the holder of any powers held by his or her spouse under IRC §672(e), the settlor's spouse also must be prohibited from exercising certain powers. See §10.99.

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I. Miscellaneous Management Clauses

§10.101 1. Power to Consolidate or Divide Trusts

Unless otherwise provided by the trust instrument, a trustee who holds property under separate trusts has a duty to segregate the property of the trusts. 3 Scott & Ascher on Trusts §17.11.2 (5th ed 2007). The trustee must keep trust property separate from the trustee's own property and from the property of others and must designate it as property of the trust. Prob C §16009.

The clauses in §§10.102-10.103 provide for joint administration of the assets of:

- Trusts created under the same trust instrument that meet the criteria described in the form; or
- One or more trusts created under the same trust instrument and one or more trusts created by any other testamentary or nontestamentary instrument that meet the criteria described in the clause.

The trustee must consider whether joint administration will truly benefit the beneficiaries. In any event, care must be taken to maintain the separate tax status of the trusts.

In the absence of a specific trust clause, the Probate Code permits the court, on petition by a trustee or beneficiary, to combine trusts with substantially similar terms as long as the trust's purposes and the beneficiaries' interests will not be compromised. Prob C §15411. In addition, Prob C §15412 (popularly known as the Getty Amendment) permits a court to achieve the contrary result, *i.e.,* to divide a trust into two or more separate trusts, subject to the same limitations of achieving trust aims and protecting beneficiary interests. Dividing a trust will permit the trustee to use different investment strategies for the beneficiaries.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.102 a. Form: Physical Division of Separate Trusts Created in Single Instrument Not Required; Division Into Separate Trusts Permitted (Standard Clause)

§10.102 a. Form: Physical Division of Separate Trusts Created in Single Instrument Not Required; Division Into Separate Trusts Permitted (Standard Clause)

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10.102-1 Physical division of separate trusts not required; division into separate trusts permitted (standard clause)

***Division of Trust into Separate Trusts*. When property will be held as part of a separate trust, share, or part created under this instrument, the trustee shall not be required to physically segregate or divide such property unless the segregation or division is required by termination of one of the trusts. The trustee shall, however, be required to keep separate accounts for the separate undivided interests. The trustee may, in the trustee's discretion, divide any trust created under this instrument into two or more separate trusts that have the same terms without application to any court.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.103 b. Form: Consolidated Administration of Trusts

§10.103 b. Form: Consolidated Administration of Trusts

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10.103-1 Consolidated administration of trusts

***Consolidated Administration of Trusts*. The trustee may, in the trustee's discretion, administer the assets of any trust created under this instrument with the assets of any other trust(s) otherwise created, without physically segregating the assets of the various trusts (except on termination of any of the trusts), as long as:**

(1) The trustee determines that administration as a single trust will be consistent with the _ _[*settlor's/settlors'*]_ _ intent, including the intent with respect to the tax consequences of the trusts, and will facilitate trust administration without defeating or impairing beneficial interests; and

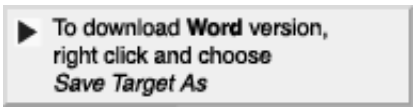
(2) The terms of the various trusts are substantially identical.

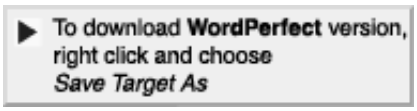
The trustee shall keep separate accounts for the separate undivided interests.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.104 2. Form: Power to Move Situs

§10.104 2. Form: Power to Move Situs





10.104-1 Power to move situs

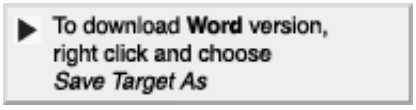
***Power to Move Trust*. The trustee may move the situs of administration of a trust as the trustee from time to time determines to be in the best interests of the trust and its beneficiaries, subject only to such court approval as required by applicable state law. On a change of place of administration of a trust created under this instrument, the laws of the State of California shall continue to govern its validity and construction, but the law of the new situs shall govern its administration.**

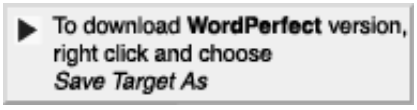
Comment: The inclusion of permission to move the situs of administration of a trust can save costly court proceedings.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.105 3. Form: Payments to Beneficiary Under Disability or to Minor Beneficiary

§10.105 3. Form: Payments to Beneficiary Under Disability or to Minor Beneficiary





10.105-1 Payments to beneficiary under disability or to minor beneficiary

***Distributions to Minors or Disabled Persons*. If the trustee is authorized or directed to make payments to or distribute trust property to a minor, a person under any other legal disability, or a person not adjudicated to have limited legal capacity but who, by reason of illness or mental or physical disability, is in the trustee's judgment unable to manage the distributed property properly, the trustee may, in the trustee's discretion, apply the payment for the person's benefit or make the payment or distribution to:**

(1) The beneficiary directly;

(2) A legally appointed guardian or conservator of the beneficiary's person or estate;

(3) A custodian for the minor beneficiary, up to the maximum age permitted, under the Uniform Transfers to Minors Act of any state selected by the trustee;

(4) A third party for the benefit of the beneficiary; or

(5) An adult relative or friend in reimbursement for amounts properly advanced for the beneficiary's benefit.

Such payments shall not be made to _ _[*the/either*]_ _ settlor. If no custodian exists for receipt of property under any applicable Uniform Transfers to Minors Act, the trustee may designate a custodian to receive the property.

No distribution under this trust to or for the benefit of a minor beneficiary shall discharge the legal obligation of the beneficiary's parents to support the minor in accordance with the laws of the state of the parents' domicile from time to time.

[*If appropriate, add the following option*]

[*Option: Meaning of "disability" and "disabled"*]

The terms "disability" and "disabled" include any physical, mental, or emotional condition that renders a person unable to conduct his or her financial affairs in a prudent and efficient manner and that is likely to extend for a period longer than _ _[*time period*]_ _. The condition of disability _ _[*must/may*]_ _ be evidenced by a written statement of the disabled person's regularly attending physician or, if the person does not have a regularly attending physician, by two physicians licensed to practice medicine in the state in which the person resides, filed with the trustee.

Comment: This clause eliminates the need to appoint a guardian for a minor or a conservator for any other beneficiary under a disability. To avoid any question that a settlor has retained an interest in the trust and the consequent possibility of adverse tax results, the settlor is excluded from those third parties to whom payments may be made.

The drafter should not use subparagraphs (4)-(5) if the settlor wishes the trust to qualify for the marital deduction.

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4. Distribution on Termination of Trust

§10.106 a. Issues to Consider

The power to make nonprorata distributions and to distribute undivided interests in an asset is granted by Prob C §16246.

Form 10.107-1 gives the trustee discretion to distribute in kind or sell the assets and distribute the proceeds. Giving the trustee discretion will allow the trustee to act in light of the circumstances existing at the time of distribution.

A nonprorata distribution that does not take into consideration the income tax basis of assets may cause a wide disparity in economic benefits to beneficiaries receiving property having the same fair market value. If the trustee will be given complete discretion to make distributions without regard to basis, Alternative 2 in form 10.107-1 should be used. Conservative practice dictates that the drafter should not use that clause when there is a tax-sensitive trustee.

If a trustee who is a beneficiary is given the right to make a nonprorata division or distribution of assets (except with the approval of other beneficiaries who have substantial interests that are adverse to the beneficiary-trustee's interest), adverse estate tax consequences could result. See §10.6.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.107 b. Form: Broad Powers of Distribution (Standard Clause)

§10.107 b. Form: Broad Powers of Distribution (Standard Clause)

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10.107-1 Broad powers of distribution (standard clause)

***Power to Make Nonprorata Distributions*. The trustee may partition, allot, and distribute the trust estate on any division or partial or final distribution of the trust estate, in undivided interests or in kind, or partly in money and partly in kind, and to sell any property the trustee considers necessary for division or distribution. For such purposes, assets shall be valued as of the date they are distributed or otherwise allocated. In making any division or partial or final distribution of the trust estate, the trustee is not obligated to make a prorata division or to distribute the same assets to similarly situated beneficiaries.**

[*Add one of the following alternatives*]

[*Alternative 1: Income tax basis to be considered with nonprorata distribution*]

The trustee may, in the trustee's discretion, make a nonprorata division between trusts or shares and nonprorata distributions to the beneficiaries if the respective assets allocated to separate trusts or shares, or distributed to the beneficiaries, have equivalent or proportionate fair market values and aggregate income tax bases.

[*Alternative 2: Nonprorata distribution or allocation to be made without regard to income tax bases*]

The trustee may, in the trustee's discretion, make a nonprorata division between trusts or shares and nonprorata distributions to the beneficiaries if the respective assets allocated to separate trusts or shares, or distributed to the beneficiaries, have equivalent or proportionate fair market values. The income tax bases of assets allocated or distributed nonprorata need not be equivalent and may vary to a greater or lesser amount, as determined by the trustee in the trustee's discretion. The trustee shall not be required to make any adjustment to compensate for any difference in bases. The trustee may make any adjustment that the trustee considers to be reasonable.

Comment: Any distribution or funding that is directed elsewhere in the instrument to be made in a manner inconsistent with the manner authorized in form 10.107-1, should be excepted from the application of form 10.107-1 with respect to valuation of assets distributed in kind.

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5. Power to Delay Distribution Until Resolution of Claims or Liability

§10.108 a. Use of Power

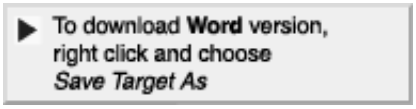
When the trust is terminated or distributed, questions may arise about the identity of persons entitled to the trust property, the amounts they may be entitled to receive, or potential tax deficiencies and liabilities or other claims against the trust. The trustee is justified, without an express clause in the trust instrument, in withholding from the beneficiary property that may be subject to conflicting claims. See *Feldmeier v Superior Court* (1938) 12 C2d 302, 83 P2d 929. See also Prob C §16220.

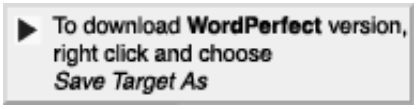
The drafter may wish to provide explicitly for such withholding to avoid any danger of surcharge of the trustee because of an error in judgment and to permit the trustee to specifically point to the power if questioned about the delay by a beneficiary. This clause should not be used in a charitable trust or a marital deduction trust.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.109 b. Form: Power to Withhold Payment if Conflicting Claims Arise

§10.109 b. Form: Power to Withhold Payment if Conflicting Claims Arise





10.109-1 Power to withhold payment if conflicting claims arise

***Power to Delay Distribution*. When an event occurs on which the trustee is required to divide or distribute trust property, the trustee may delay the division or distribution of all or part of the property (without later payment of interest) for the period of time necessary to ascertain and provide for the payment of any tax claim or other liability, contingent or otherwise, against the property. During this period, the trustee may pay the net income of the trust to the beneficiaries entitled to it. Any income not distributed shall, on resolution of any tax claim or other liability, be payable to the person entitled to it immediately after income is received by the trustee. This clause shall not be deemed to postpone or defer the vesting of any interest created under the dispositive clauses of the trust.**

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J. Notice of Proposed Action

§10.109A 1. When Notice May Be Used

As an additional precaution, a trustee may wish to consider sending a notice of proposed action to give beneficiaries an opportunity to object before the trustee takes, or does not take, a particular action. Probate Code §§16500-16504 provide a notice of proposed action procedure for trusts, which is similar to the notice of proposed action procedure for estates under the Independent Administration of Estates Act (see Prob C §§10582, 10585-10587).

The notice procedure is optional (Prob C §16504) and is available for actions governed by Prob C §§16200-16249 (regarding powers of trustees) or Prob C §§16320-16375 (the Uniform Principal and Income Act (UPAIA)) (Prob C §16500). The procedure cannot, however, be used in connection with certain actions, such as payment of trustee compensation, settlement of the trustee's accounts, compromise or settlement of claims by or against the trustee, or other specified transactions between the trust and the trustee or the attorney for the trustee. Prob C §16501(d). Examples of actions for which the procedure is useful include selling real property, changing investment accounts, making an adjustment between principal and income under Prob C §16336 (see §10.110), converting an income interest to a unitrust interest under Prob C §16336.4 (see §10.116A), and making tax code elections regarding principal and interest.

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§10.109B 2. Notice Procedure

A trustee who elects to use the procedure must send the notice to all beneficiaries who are receiving, or are entitled to receive, income, including those entitled to receive income at the trustee's discretion, or who would receive a distribution of principal if the trust were to terminate at the time the notice is given. Prob C §16501(a). Notice need not be given to a beneficiary who consents in writing to the proposed action, or to any beneficiary who is unknown to the trustee or who is known but cannot be located after reasonable diligence. Prob C §16501(b)-(c). See form of notice in §10.109C.

The notice must include the following information (Prob C §16502):

- The name and mailing address of the trustee;
- The name and telephone number of a person who may be contacted for additional information;
- A description of the proposed action and an explanation of the reasons for the action;
- The time within which objections to the proposed action can be made, which must be at least 45 days after the notice is mailed; and
- The date when the proposed action may be taken or may become effective.

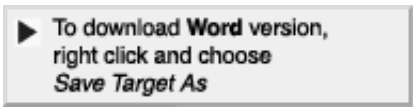
A beneficiary may object to the proposed action by mailing a written objection to the trustee within the time specified in the notice of proposed action. Prob C §16503(b). A trustee is not liable to any beneficiary for taking the proposed action if the trustee does not receive a timely written objection. If no beneficiary entitled to notice objects, the trustee is not liable to any current or future beneficiary with respect to the action, provided that notice has been given to the guardian or conservator of the estate of any beneficiary who is a minor or incompetent adult. Prob C §16503(b).

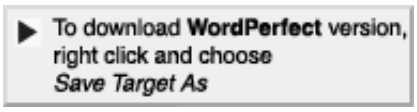
If the trustee receives a timely objection, a beneficiary or the trustee may petition the court to have the proposed action taken as proposed, taken with modifications, or denied. Prob C §16503(c). A trustee who decides not to implement the proposed action must notify the beneficiaries of the decision and the reasons for it. A beneficiary may petition the court to have the action taken. Prob C §16503(d). The beneficiary has the burden of proof, both in objecting to a proposed action and in petitioning to have an action taken. Prob C §16503(c)-(d).

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.109C 3. Form: Notice of Proposed Action

§10.109C 3. Form: Notice of Proposed Action





NOTICE OF PROPOSED ACTION

Probate Code §16500 et seq.

TO THE BENEFICIARIES OF THE _ _[*NAME*]_ _ TRUST

Pursuant to Probate Code §§16500-16504, the trustee hereby gives notice to all beneficiaries of the above referenced trust that s/he intends to take the following proposed action:

On or after _ _[*date*]_ _, the trustee will take the following action: Convert the trust to a unitrust pursuant to Probate Code §§16336.4-16336.6. _ _[*Description of converted unitrust.*]_ _

¨ See attachment for additional details (check if applicable)

NOTICE

THIS NOTICE IS BEING GIVEN PURSUANT TO PROBATE CODE SECTION 16502. If you do not object in writing or obtain a court order preventing the action described above, you will be treated as if you consented to the proposed action and you may not object after the proposed action is taken. If the trustee receives a written objection within the applicable period, either the trustee or a beneficiary may petition the court to have the proposed action taken as proposed, taken with modifications, or denied. Probate Code §16501(d) lists certain actions for which this notice <u>may not</u> be used.

1. The name and address of the trustee:

Name _ _[*name*]_ _

Address _ _[*address*]_ _

2. If you need additional information concerning the proposed action, please contact:

Name _ _[*name*]_ _

Address _ _[*address*]_ _

Telephone _ _[*telephone*]_ _

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Attorney for*]_ _ **Trustee**

3. IF YOU OBJECT OR CONSENT TO THE TRANSACTION, YOU MAY INDICATE YOUR OBJECTION OR CONSENT BY SIGNING AND RETURNING THIS FORM TO THE TRUSTEE AT THE ADDRESS LISTED IN ITEM 1 ABOVE NO LATER THAN _ _[*date*]_ _.

YOU MAY SEND YOUR OWN WRITTEN OBJECTION OR CONSENT. BE SURE TO IDENTIFY THE PROPOSED ACTION AND STATE THAT YOU OBJECT OR CONSENT TO IT.

OBJECTION TO PROPOSED ACTION

¨ **I OBJECT to the proposed action described above.**

Date: _ _ _ _ _ _ __[*Signature of objector*]__
_ _[*Typed name*]_ _
_ _[*Address*]_ _
_ _[*Telephone*]_ _

CONSENT TO PROPOSED ACTION

¨ **I CONSENT to the proposed action described above.**

Notice: You may indicate your consent by signing and returning this form (both pages) to the trustee at the address in item 1. If you do not object or obtain a court order before the date specified above, you will be treated as if you consented to the proposed action.

Date: _ _ _ _ _ _ __[*Signature of consentor*]__
_ _[*Typed name*]_ _
_ _[*Address*]_ _
_ _[*Telephone*]_ _

Comment: The attachment may describe the terms of the proposed unitrust conversion. For a preprinted notice and consent form for a notice of proposed action under Prob C §§16500-16504 similar to the Notice of Proposed Action—Independent Administration of Estates Act (Judicial Council Form DE-165), see the members-only page of the Trusts and Estates Section of the State Bar of California at http://www.calbar.org.

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V. POWERS RELATING TO PRINCIPAL AND INCOME

§10.110 A. Purpose of Clauses

If the trust instrument provides for payments of income to one or more beneficiaries for a term of years or measuring lives and for subsequent distribution of principal to other beneficiaries (usually referred to as remainder beneficiaries), the allocation of receipts and disbursements to principal and income will have an important effect on the interests of the beneficiaries.

PRACTICE TIP: The traditional practice of defining distribution rights in terms of rights to income and rights to principal can have a negative impact on trust investment performance. Generally, the trustee should try to obtain a high total return on investment, taking into account both regular income and capital appreciation. Historically, investments that have produced high regular income, such as bonds, have produced an inferior total return compared to common stocks and other investments having capital appreciation potential. It is now recognized that making distribution rights dependent on whether property is classified as income or principal may force the trustee to make inferior investments to produce the distributions needed by the income beneficiary. The negative impact on total return eventually hurts both the income beneficiary and the remaindermen. As a result of these considerations, many modern trust drafters now seek alternative ways of defining distribution rights unless a traditional income interest is required to qualify a transfer for a marital deduction under IRC §2056 or §2523. For example, the lead beneficiary may be given the right to a "unitrust" payment of a fixed percentage of the value to the trust estate each year, or that beneficiary may be given a right to receive payments of fixed amounts each year, with or without cost-of-living adjustments. For further discussion, see California Estate Planning, chap 24A (Cal CEB 2002); Hoisington, *Modern Trust Distribution Design and Implementing Investment Strategies*, Estate Planning 1998 §5.13 (Cal CEB 1998); and Dennis-Strathmeyer, *You're Not Writing Noncharitable Unitrusts? Neither Am I*, 21 CEB Est Plan Rep 5 (June 2000). Fortunately, it is no longer necessary to use a traditional income interest to qualify a transfer for a marital deduction under IRC §2056 or §2523. Under Treas Reg §1.643(b)-1, trust drafters can use a unitrust interest to satisfy the requirement of a qualifying life income interest for the spouse. See §2.39A.

Allocation between principal and income is made in accordance with the terms of the trust instrument. Prob C §16335(a)(1). If the particular allocation is not covered in the trust instrument, the allocation may be made by the exercise of a discretionary power provided by the instrument. Prob C §16335(a)(2). If the allocation is not covered in the instrument and a discretionary power is not provided by the instrument, then the allocation is made in accordance with the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). Prob C §16335(a)(3).

The trustee also has the power to make an adjustment between principal and income to the extent the trustee considers necessary to satisfy the duty of impartiality between income and remainder beneficiaries under Prob C §16003, subject to certain conditions. Prob C §16336. See §19.37A. The trustee may use the notice of proposed action in Prob C §§16500-16504 to obtain beneficiary consent to use the adjustment power. See §§10.109A-10.109B. Alternatively, the problem can be avoided by giving the beneficiary a unitrust interest with a payout percentage (no less than 3 percent and no more than 5 percent) that satisfies the alternative definition of net income in Prob C §16328. To preserve flexibility, the trust can be drafted to give the beneficiary a traditional income interest, and the trustee can convert the income interest to a unitrust interest with the consent of all the beneficiaries or court approval if the trustee later determines that conversion is desirable. Prob C §§16336.4-16336.7. See §10.116A.

CAUTION: The trustee generally cannot use the adjustment power if the trustee is a beneficiary of the trust. Prob C §16336(b)(7). However, this restriction does not apply to the power to convert an income interest to a unitrust interest under Prob C §§16336.4-16336.7. There is also no restriction on drafting a trust giving a trustee-beneficiary a unitrust interest in place of an income interest under Prob C §16328. For this reason, a unitrust interest may be especially useful in a QTIP trust (see §2.39C) or QDOT trust (see §2.81F) where it is expected

that the beneficiary spouse will be the trustee or cotrustee of the trust.

Because the UPAIA provides a reasonably comprehensive and equitable set of rules for allocating receipts and expenditures between principal and income, many trust instruments do not include extensive clauses addressing these issues. For a sample clause, see form 10.112-1.

Form 10.112A-1 gives the trustee broad discretion to make allocations contrary to the UPAIA. Although this discretion may be important if the trustee will operate a closely held business, it places the trustee between the competing interests of the income and remainder beneficiaries. It may be preferable for the trust to include specific directives about potentially controversial holdings or when the allocation in the UPAIA is contrary to the settlor's intent. See, *e.g., Getty v Getty* (1972) 28 CA3d 996, 105 CR 259, in which the court held, contrary to the allocation rules then in effect, that stock dividends of a closely held corporation were appropriately allocated to principal because of the settlor's intent to maintain control of the corporation through the trust.

In addition, the UPAIA does not adequately provide for every allocation situation. If the trust assets include encumbered property or an S corporation, the UPAIA should be reviewed to ensure that the settlor's desired allocation will be achieved under the statute. If an issue is not addressed by the UPAIA or the UPAIA handles it in a manner contrary to the settlor's intent, the drafter should include a clause that resolves the issue consistent with the settlor's desires. When the trustee is given discretion, no inference of impropriety arises if the trustee exercises that discretion in a manner contrary to the UPAIA. Prob C §16335(a)(2). See §§19.38, 19.51-19.52, 19.113.

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§10.111 B. Tax Considerations

The drafter must consider the possible effect of allocation clauses on a settlor's estate tax liability when a settlor is trustee. The tax risks in this area have been reduced since *State St. Trust Co. v U.S.* (1st Cir 1959) 263 F2d 635 was overruled by *Old Colony Trust Co. v U.S.* (1st Cir 1970) 423 F2d 601. See also *Estate of Ralph Budd* (1968) 49 TC 468, acq 1973-2 Cum Bull 1, and *Estate of Marvin L. Pardee* (1967) 49 TC 140, acq 1973-2 Cum Bull 3, in which the Tax Court held that the settlor-trustee's power to allocate between principal and income, together with broad administrative powers, did not cause the trust to be included in the settlor's estate. See §§10.3-10.6.

The power to allocate receipts and disbursements, exercisable in a fiduciary capacity, is not in itself a power of appointment. Treas Reg §20.2041-1(b)(1). See form 10.112-1, giving the trustee "reasonable discretion" to determine the characterization if the UPAIA is silent on the issue.

Nor will the settlor's retention of the power to make allocations between principal and income in a fiduciary capacity (or, by extension, the power to adjust between principal and income under Prob C §16336 or the power to convert the income interest to a unitrust interest under Prob C §16336.4) ordinarily cause the trust's income to be taxed to the settlor. See IRC §674(b)(8).

As an alternative to restricting the power to allocate receipts and disbursements, the dispositive clauses of the trust instrument can be adjusted. For instance, allocation between principal and income accounts is irrelevant if all income is added to principal, because all receipts and disbursements are then credited or charged to principal. Distributions can then be related to something other than trust income. For example, the beneficiary may be given a fixed amount annually, adjusted for cost-of-living changes, coupled with a power of invasion (with an ascertainable standard if the trustee is not independent). See §9.14. Such adjustments are highly recommended. See the "Practice Tip" in §10.110.

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§10.112 C. Allocation Clauses

Alternative form 10.112A-1 leaves determination of allocation to income and principal to the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). If the settlor is concerned about a particular allocation situation that the UPAIA does not address, the drafter should create specific allocation clauses.

Alternative form 10.112B-1 gives the trustee much broader power than the clauses in forms 10.112A-1 and 10.112C-1. Although this discretion may be extremely important if the trustee will operate a closely held business, a tax-sensitive trustee should not be given such broad powers. See §§10.110-10.111.

Form 10.112A-1 may be used when there is or may be a tax-sensitive trustee. For discussion of avoiding adverse tax consequences to the tax-sensitive settlor or beneficiary, see §10.99.

Note the language empowering the trustee to amortize bond premiums. Under the UPAIA, the trustee will not have this power unless it is expressly authorized. See Prob C §16357. See also §19.27.

For discussion of allocating depreciation and depletion, see §19.19. For clauses requiring the trustee to establish a depreciation reserve, see §19.18.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.112A 1. Form: Uniform Principal and Income Act to Govern

§10.112A 1. Form: Uniform Principal and Income Act to Govern

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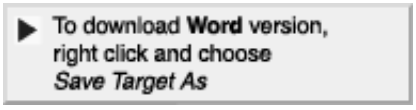
10.112A-1 Uniform Principal and Income Act to govern

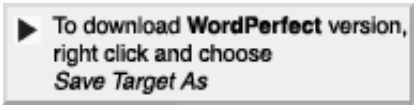
***Uniform Principal and Income Act*. Except when this trust specifically provides otherwise, the trustee shall determine principal and income of the trust estate and from time to time apportion and allocate receipts, expenses, and other charges between those accounts according to the provisions of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375). If this trust or the UPAIA does not provide for allocation of an income or expense item, the trustee has reasonable discretion to determine the characterization.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.112B 2. Form: Broad Power to Determine Principal and Income (Standard Clause)

§10.112B 2. Form: Broad Power to Determine Principal and Income (Standard Clause)





10.112B-1 Broad power to determine principal and income (standard clause)

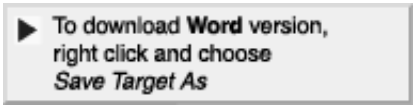
***Power to Determine Principal and Income*. Except when this trust specifically provides otherwise, the trustee shall have the power, exercisable in the trustee's discretion, to determine principal and income of the trust estate and from time to time apportion and allocate receipts, expenses, and other charges between those accounts, including the power to charge in whole or in part against principal, or to amortize out of or charge forthwith to income, premiums paid on the purchase of bonds or other obligations. The trustee is not required to establish a reserve for depreciation against income but may do so if the trustee, in the trustee's discretion, so determines. The reserve and charges shall be established on the assumptions and in the amounts determined by the trustee.**

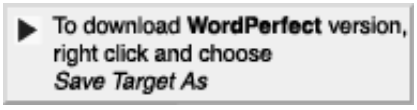
If the trust is a member of a partnership or limited liability company (LLC), the trustee may accept, for the partnership or LLC interest, any accounting methods used by the partnership or LLC, despite (1) the inclusion of depreciation reserves by the accounting methods and the assumptions on which any reserve is based and (2) any inconsistencies with the accounting methods used by the trustee for other property of the trust estate.

No inference of imprudence or partiality shall arise if the trustee, in exercising the discretion conferred on the trustee, has allocated a receipt or expenditure in a manner contrary to any provision of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375). Except as the trustee exercises the discretion conferred on the trustee or as otherwise provided in this instrument, matters relating to principal and income shall be governed by the provisions of the UPAIA, as amended from time to time.

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§10.112C 3. Form: Power to Make Allocations Between Principal and Income With Limited Discretion (Tax-Sensitive Trustee)





10.112C-1 Power to make allocations between principal and income with limited discretion (tax-sensitive trustee)

***Power to Allocate Between Principal and Income*. Allocations between principal and income shall be determined as follows:**

(1) Subject to subparagraph (2) of this clause and to any contrary clause in this trust, the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375) shall govern beneficiaries' rights among themselves in matters concerning principal and income. If the UPAIA contains no provision concerning a particular item, the trustee shall determine what is income or principal and apportion and allocate, in the trustee's discretion, receipts and expenses between these accounts. Income accrued or unpaid on trust property when received into any trust shall be treated as any other income.

(2) All of the powers in this clause are subject to the trustee's duties to treat equitably both the income beneficiaries and remainder beneficiaries of any trust. In this connection, the trustee shall observe the following:

(a) A reasonable reserve for depreciation of all income-producing depreciable real property, capital improvements, and extraordinary repairs to the property (*e.g.,* new roof, new plumbing system) shall be charged to income.

(b) A reasonable reserve for depletion of all depletable natural resources (including oil, gas, mineral, and timber property) shall be charged to income.

(c) A reasonable reserve for amortization of all intangible property having a limited economic life (including patents and copyrights) shall be charged to income.

(d) All distributions by mutual funds and similar entities of gains from the sale or other disposition of property shall be credited to principal.

(e) All premiums paid and all discounts received in connection with the purchase of any bond or other obligation shall be amortized by making an appropriate charge or credit to income.

(f) If the trust is a member of a partnership or limited liability company (LLC), the trustee shall accept, for the partnership or LLC interest, any accounting methods used by the partnership or LLC, despite the inclusion of depreciation reserves by the accounting methods and the assumptions on which any reserve is based and despite any inconsistencies with the accounting methods used by the trustee for other property of the trust estate.

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D. Allocation of Income and Expenses Among Successive Beneficiaries

§10.113 1. Allocation of Income

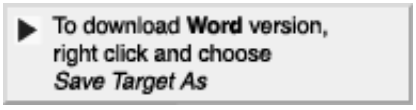
The rights of successive beneficiaries are also governed by the UPAIA. In general, an income beneficiary is entitled to income from the date specified in the trust instrument. Prob C §16345(a). If an income beneficiary's right to income terminates by death or in any other manner, all income paid to the income beneficiary and all income actually received by the trustee before the termination belong to the income beneficiary or his or her personal representative. Prob C §16345(d). All income received by the trustee after termination belongs to the person next entitled to income by the trust's terms.

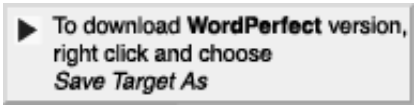
The trust instrument may direct a different allocation of income. Prob C §16335(a)(1). Most trusts that have a beneficiary who is entitled to receive trust income contain a clause directing the disposition of income that is undistributed before the income beneficiary's death. Many settlors prefer to add undistributed income to trust principal to eliminate the need to have the unpaid income administered and potentially taxed in the deceased beneficiary's estate. Doing so also ensures that the income will be distributed to persons whom the settlor wishes to benefit rather than to the deceased income beneficiary's successors or heirs.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.114 2. Form: Undistributed Income Payable to Successive Beneficiaries

§10.114 2. Form: Undistributed Income Payable to Successive Beneficiaries





10.114-1 Undistributed income payable to successive beneficiaries

***Distribution of Accrued Income*. Income accrued or unpaid on trust property when received into the trust shall be treated as any other income.**

[*Add one of the following alternatives*]

[*Alternative 1: Undistributed income payable to next beneficiaries*]

Income accrued or held undistributed by the trustee at the termination of any trust created under this instrument shall go to the next beneficiaries of the trust in proportion to their interest in it.

[*Alternative 2: Undistributed income payable to beneficiary of trust immediately before termination*]

Income accrued or held undistributed by the trustee at the termination of any trust created under this instrument shall go to the beneficiary of that trust immediately before the termination or to his or her estate.

Comment: Alternative 1 may not be appropriate in unusual cases, *e.g.,* gifts of preferred stock with arrearages of large dividends.

Alternative 2 is appropriate when the "income" beneficiary has fixed rights to all or a portion of the income. Alternative 2 should not be included in a trust without considering the potential income tax and generation-skipping transfer tax effects.

Alternative 2 was previously essential for a qualified terminable interest property (QTIP) trust, but it is no longer required. A QTIP trust can qualify for the marital deduction even if income accrued but undistributed between the last distribution date and the date of the spouse's death is not required to be distributed to the spouse or the spouse's estate. Treas Reg §§20.2056(b)-7(d)(4), 25.2523(f)-1(c)(1)(ii). Such undistributed income will, however, be included in the spouse's gross estate for estate tax purposes. Treas Reg §20.2044-1(d)(2).

Neither alternative is appropriate if all "income" beneficiaries receive income at the trustee's discretion.

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§10.115 3. Allocation of Expense Items

The UPAIA also allows the settlor to provide in the trust instrument for allocation of expenses between principal and income. Prob C §16335(a)(1). If the instrument does not provide for allocation of expenses, the expenses may be allocated under a discretionary power of administration provided by the instrument. Prob C §16335(a)(2). In the absence of a contrary clause in the trust instrument or a discretionary power of administration provided by the instrument, expenses are charged according to the provisions of the UPAIA. Prob C §16335(a)(3). If neither the trust instrument nor the UPAIA applies or provides a discretionary power of administration, expenses must be charged to principal. Prob C §16335(a)(4).

In selecting between the alternative clauses in §10.116, the settlor must consider how income will be allocated—especially if expenses will be offset against income. Alternative 2 will always achieve a fair result; Alternative 1 will facilitate simple administration and may be appropriate for trusts in which the amounts in question are not substantial. Alternative 1 permits allocation of expenses to the time when they became due or to the time when they were paid, depending on the settlor's preferences.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.116 4. Form: Allocation of Expenses Among Successive Beneficiaries

§10.116 4. Form: Allocation of Expenses Among Successive Beneficiaries

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10.116-1 Allocation of expenses among successive beneficiaries

[*Use one of the following alternatives*]

[*Alternative 1: Proration not required*]

***Allocation of Expenses*. The trustee need not prorate taxes and current expenses among successive beneficiaries on a daily basis but shall consider all taxes and other current expenses to have been paid and charged to the period in which they _ _**[*first become due and payable/were paid*]**_ _.**

[*Alternative 2: Proration required*]

***Allocation of Expenses*. The trustee shall prorate all taxes and current expenses among successive beneficiaries on a daily basis over the period to which these expenses relate.**

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§10.116A E. Conversion of Income Interest to Unitrust Interest

Treasury regulations permit the trustee to treat as income of the trust a unitrust amount of no less than 3 percent and no more than 5 percent of the fair market value of trust assets, whether determined annually or averaged on a multiple-year basis, if provided by state law. Treas Reg §1.643(b)-1. Under Prob C §16328, a unitrust amount of between 3 and 5 percent will be treated as net income during any accounting period in which the trust is administered as a unitrust under the powers conferred by Prob C §§16336.4-16336.7, or under the terms of the governing instrument. However, income of an income-only charitable remainder unitrust may not be defined using a unitrust amount. Treas Reg §1.664-3(a)(1)(i)(b)(3).

Unless expressly prohibited by the governing instrument, the trustee may convert a trust providing for distribution of income into a unitrust. Prob C §16336.4. The term "income" in a converted trust means an annual distribution of a unitrust amount of 4 percent of the net fair market value of trust assets, except as otherwise agreed by the parties or ordered by the court under Prob C §16336.5. Prob C §16336.4(e). However, the value of residential property is not included in determining the unitrust amount if at least one current beneficiary has the right to occupy that property. Prob C §16336.4(e)(4)(A).

Under Prob C §16336.5(a), the trustee may adopt a payout percentage of not less than 3 percent and not more than 5 percent without court order if all beneficiaries consent. Under Prob C §16336.5(b), the court may order a unitrust conversion with a payout percentage of between 3 and 5 percent if a beneficiary objects, or a beneficiary may petition the court to order the conversion. The trustee may use the notice of proposed action procedure in Prob C §§16500-16504 (see §§10.109A-10.109B) to obtain beneficiary consent to the unitrust conversion. Prob C §16336.4(b)(3).

The trustee may reconvert the trust from a unitrust or change the payout percentage without court order after 3 years if the trustee determines that reconversion or change in payout percentage would enable the trustee to better satisfy the duty to administer the trust impartially under Prob C §16335(b) and specified notice requirements are met, or the court may order the reconversion or change in payout percentage. Prob C §16336.6. The trustee has no duty to convert or reconvert the trust or to consider a conversion or reconversion. Prob C §16336.7. However, the trustee may not use the conversion power to convert a drafted unitrust to a traditional income trust or change the payout percentage, unless otherwise provided by the trust document. Prob C §16336.4(h)(1). To preserve flexibility when drafting a trust that must have an income interest, the drafter can either draft the trust with a traditional income interest or draft the trust with a unitrust interest meeting the requirements of Treas Reg §1.643(b)-1 and Prob C §16328 and include a clause authorizing the trustee to convert the unitrust interest to a traditional income interest. For further discussion, see California Estate Planning, chap 24A (Cal CEB 2002); Skootsky & Temple, *The New Unitrust Statute: Drafting and Administration Consequences for Trusts That Distribute "Income"*, 27 CEB Est Plan Rep 37 (Oct. 2005).

NOTE: A switch between methods of determining trust income authorized by state statute will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. See Treas Reg §1.643(b)-1.

In a proceeding concerning the trustee's exercise or nonexercise of the unitrust conversion power, as is the case in proceedings concerning the exercise or nonexercise of the Prob C §16336 adjustment power (see §10.110), the sole remedy is to direct the trustee to convert the trust to a unitrust, to reconvert from a unitrust, to change the payout percentage, or to order any other necessary or helpful administrative procedures. Prob C §16338. As, again, is the case with the adjustment power, the Probate Code does not impose a duty on the trustee to convert or reconvert a trust or to consider a conversion or reconversion. Prob C §16336.7(a).

See form 9.43-1 for a general unitrust clause. See form 2.39C-1 for a unitrust clause designed for a marital deduction qualifying trust.

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VI. ACCOUNTING BY TRUSTEE

§10.117 A. Purpose of Accounting

Accounts serve two purposes:

- They protect the beneficiary by disclosing errors in the trust administration so that corrective action can be taken in a timely fashion; and
- They protect the trustee by providing a mechanism for discharging the trustee from liability for previous actions.

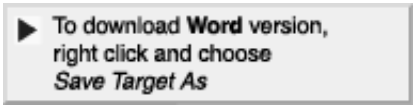
The trustee must account at least annually, at the trust's termination, and when trustees change. Prob C §16062(a). This obligation can be waived or modified by the trust instrument (Prob C §16064(a)) or the beneficiary (Prob C §16064(c)), but a waiver is void for any sole trustee who was involved with drafting the instrument or is closely related to such a person (Prob C §16062(e)).

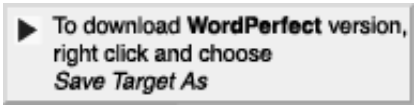
For discussion of accounts, see California Trust Administration, chap 7 (2d ed Cal CEB 2001).

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§10.118 B. Form: Accounting by Trustee





10.118-1 Accounting by trustee

[*Use one of the following alternatives*]

[*Alternative 1: Account required*]

***Accounting by Trustee*. The trustee shall render, besides any account required by a court under Probate Code §17200, an account, from time to time, but not less frequently than every _ _**[*number*]**_ _ _ _**[*year(s)/months*]**_ _ after any prior account, regarding the transactions of any trust created under this instrument. _ _**[*Accounts shall also be rendered by any trustee or the trustee's representative within a reasonable time after the trustee's resignation, death, disability, or removal by a court of competent jurisdiction.*]**_ _**

Accounts shall be made by delivering a written account to each beneficiary _ _[*entitled to current income distribution*]**_ _ or, if there are no current income beneficiaries, to each beneficiary entitled to current distribution from income or principal in the trustee's discretion _ _**[*and to each remainder interest*]**_ _. If any person entitled to receive an account is a minor or is disabled, the account shall be delivered to his or her parents or the guardian of his or her person, if a minor, or to the guardian or conservator of his or her estate, if disabled.**

Unless any beneficiary (including parents, guardians, or conservators of beneficiaries) delivers a written objection to the trustee within 90 days after receipt of the trustee's account, the account shall be final and conclusive concerning transactions disclosed in the account and shall be binding on all beneficiaries of the trust, including unborn, unascertained, and contingent beneficiaries.

After settlement of the account by agreement of the parties objecting to it or by expiration of the 90-day period, the trustee shall no longer be liable to any beneficiary of the trust, including unborn, unascertained, and contingent beneficiaries, for transactions disclosed in the account, except for the trustee's intentional wrongdoing or fraud.

[*Alternative 2: Accounting to adult beneficiaries only*]

The trustee shall account to the adult beneficiaries of the trust created under this instrument and, to the extent permitted by law, the written approval of the adult beneficiaries shall bind minor and contingent remainder interests.

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VII. MISCELLANEOUS ADMINISTRATIVE CLAUSES

A. Notice of Births, Deaths, and Other Events Affecting Interests

§10.119 1. Purpose of Clause

Beneficial interests in a trust are frequently affected by events such as a birth, a death, or dissolution of a marriage. The trustee may not be able or willing to keep track of these events. To encourage the trustee to make regular distributions, without fear that an event may have occurred that would reduce or extinguish a beneficiary's interest (*e.g.,* remarriage), the trust may protect the trustee from liability for distributions made in ignorance of the event. See form 10.120-1.

Unless the optional clause in form 10.120-1 is included, however, the trustee may be relieved of liability for failure to pay estate taxes or generation-skipping transfer taxes that may be payable by the trust on a beneficiary's death or some other event. The settlor may wish to include the optional clause when a professional trustee will serve as trustee but not when a friend or family member will do so. The optional clause can have the effect of removing much of the exculpatory effect of form 10.120-1.

The clauses in §10.120 should be coordinated with the exculpatory clauses in §10.39.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.120 2. Form: Notice to Trustee of Births, Deaths, and Other Events Affecting Interests

§10.120 2. Form: Notice to Trustee of Births, Deaths, and Other Events Affecting Interests

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10.120-1 Notice to trustee of births, deaths, and other events affecting interests

***Notice to Trustee*. Unless the trustee has received actual _ _[*written*]_ _ notice of the occurrence of an event affecting the beneficial interests of this trust, the trustee shall not be liable to any beneficiary of this trust for proceeding as though the event had not occurred.**

[*If appropriate, add the following option*]

[*Option: Trustee not relieved from liability for nonpayment of certain taxes*]

This clause shall not exculpate the trustee from liability arising from nonpayment of estate taxes or generation-skipping transfer taxes that may be payable by the trust on the occurrence of an event affecting the beneficial interests in this trust.

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B. Additions to Trust

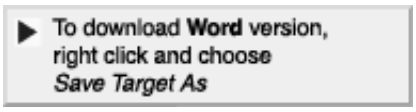
§10.121 1. Purpose of Clause

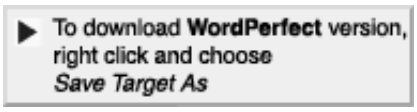
This clause may be used by a settlor who wishes to add to the trust from time to time, *e.g.,* a charitable remainder unitrust or an "annual exclusion" trust. A person other than an original settlor who adds property to a trust becomes the settlor of the trust for purposes of income, estate, and generation-skipping transfer taxes to the extent of the addition to the trust. The drafter should consider these potential tax issues in determining whether persons other than the settlor should be permitted to make additions to the trust. See IRC §§671-677, 2035-2038.

Applicable tax regulations may prohibit making additions to certain charitable trusts and retained interest trusts. See §18.72.

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§10.122 2. Form: Clause Authorizing Additions to Trust





10.122-1 Authorization of additions to trust

***Additions to Trust*. Other property acceptable to the trustee may be added to _ _[*this/these*]_ _ trust(s) by any person, by the will or codicil of _ _[*the/either*]_ _ settlor, by the proceeds of any life insurance, or otherwise.**

[*If appropriate, add the following option*]

[*Option 1: Additions when trust has been subdivided or partially or wholly distributed*]

Unless otherwise specified in this trust or in any instrument of transfer, any addition to any trust that has been subdivided into multiple trusts shall augment proportionately the trusts into which that trust has been divided. Any addition to a trust that at such time has been wholly distributed shall be distributed to the beneficiary of that trust or, if he or she is no longer living, to his or her then-living issue by right of representation. Any addition to a trust that at such time has been partially distributed shall augment proportionately the distributed and undistributed portions of that trust. Any addition to a trust over which a power of appointment has been exercised shall be held in a separate trust or distributed as if the power had not been exercised, unless the instrument exercising that power specifies the manner in which a subsequent addition to the trust shall be distributed.

[*Continue*]

[*If appropriate, add the following option to Option 1*]

[*Option 2: Definition of "proportionately"*]

As used in this trust, the term "proportionately" shall mean equally with respect to all trusts set aside for the _ _[*settlor's/settlors'*]_ _ children and, with respect to the trusts for grandchildren into which a trust for a deceased child has been divided, shall refer to a fractional part of the trust set aside for that child, the numerator of which shall be one, and the denominator of which shall be the number of trusts into which the deceased child's trust shall be divided from time to time. Comparable principles shall apply with respect to other beneficiaries.

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C. Spendthrift Clause

§10.123 1. Purpose of Clause

A trust instrument may provide that a beneficiary's interest in income, principal, or both is not subject to (a) voluntary or involuntary transfer and (b) enforcement of a money judgment until it is paid to the beneficiary. A court may issue an order, however, directing the trustee to satisfy a money judgment out of trust principal that has become due and payable to the beneficiary. Prob C §§15300-15301.

A spendthrift clause protects trust funds against the beneficiary's creditors only before distribution to the beneficiary. The clause protects funds after distribution only up to the amount needed for the beneficiary's support and education; all excess amounts required to be distributed or that are distributed are subject to the claims of the beneficiary's creditors. See Prob C §15307. See also *Estate of Lawrence* (1968) 267 CA2d 77, 72 CR 851 (when trust directs accumulation of surplus income, creditor may reach only mandatory payments exceeding beneficiary's needs for education and support). Further, funds distributed to a bankruptcy debtor within 180 days after filing the petition may be included in the bankruptcy estate under 11 USC §541(a)(5)(A) to the extent that distributions are made from trust income. See *Birdsell v Coumbe (In re Coumbe)* (BAP 9th Cir 2003) 304 BR 378 (testamentary trust).

A spendthrift clause should not be used indiscriminately, because it prevents the beneficiary from assigning his or her interest even if assignment might be advantageous for estate planning or other purposes.

A spendthrift clause may provide less protection with respect to claims involving a beneficiary's obligations to pay child support or spousal support. The extent of protection is now uncertain because of the decision in *Ventura County Dep't of Child Support Servs. v Brown* (2004) 117 CA4th 144, 11 CR3d 489, in which the court compelled the trustee to make a distribution satisfying a beneficiary's obligation of $140,000 for past-due child support. In *Young v McCoy* (2007) 147 CA4th 1078, 54 CR3d 847, however, the court declined to compel the trustee of a discretionary trust to make distributions to a beneficiary who was serving a life sentence in prison for attempted murder, for the purpose of paying civil damages to the victim. The court noted that the child in *Ventura County* was also a named beneficiary of the trust, unlike the victim in *Young*.

If the long-form spendthrift clause (optional addition in form 10.124-1) is used, the language making it inapplicable to any marital deduction trust (other than an estate-type marital deduction trust), qualified subchapter S trust (QSST), or charitable remainder trust should be included because the long form provides for an accumulation of income. See *Virginia Nat'l Bank v U.S.* (4th Cir 1971) 443 F2d 1030. The short-form spendthrift clause (see form 10.124-1) may be used without endangering the marital deduction. See Treas Reg §§20.2056(b)-5(f)(7), 25.2523(e)-1(f)(7). Similarly, use of the short form should not cause a QSST to lose its qualified status. For discussion of marital trusts and QSSTs, see Drafting California Revocable Trusts §7.43, chap 13 (4th ed Cal CEB 2003). On charitable remainder trusts, see chap 18.

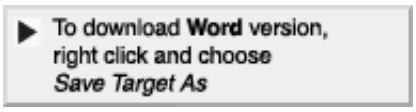
For trusts other than a marital deduction trust, a QSST, or a charitable remainder trust that require that all income be paid out currently, the long form is probably more effective. By permitting accumulation of income and providing no mandatory distributions, the long-form spendthrift clause prevents attachments by creditors and deters action by them against the beneficiary or the trust.

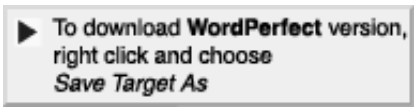
For full discussion of spendthrift protection, see California Will Drafting, chap 27 (3d ed Cal CEB 1992).

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§10.124 2. Form: Spendthrift Clause





10.124-1 Spendthrift clause

***Spendthrift Clause*. No interest in the income or principal of any trust created under this instrument shall be voluntarily or involuntarily anticipated, assigned, encumbered, or subjected to creditor's claim or legal process before actual receipt by the beneficiary.**

[*If appropriate, add the following option*]

[*Option: Long-form spendthrift clause*]

_ _[*The following clause shall not apply to the marital trust, any trust that is a qualified subchapter S trust, or any charitable remainder trust.*]_ _ **If the creditor of any beneficiary who is entitled to any distributions from a trust established under this trust attempts by any means to subject to the satisfaction of his or her claim that beneficiary's interest in any distribution, then, despite any other clause in this trust, until the release of the writ of attachment or garnishment or other process, the distribution directed to be made to that beneficiary shall be disposed of as follows:**

(1) The trustee shall pay to or apply for the benefit of the beneficiary all sums that the trustee determines to be necessary for the reasonable health, education, and support of the beneficiary according to his or her accustomed mode of life; and

(2) The portion of the distribution that the trustee determines to exceed the amount necessary for the reasonable health, education (including study at an institution of higher learning or vocational school), and support shall _ _[*be added to principal/, in the trustee's discretion, either be added to and become principal in whole or in part or be paid to or applied for the benefit of the other beneficiaries then entitled to receive payments from any trust established under this trust, in proportion to their respective interests in the trust estate or, if there are no other beneficiaries, the excess income may be paid to or applied for the benefit of the person or persons presumptively entitled to the next eventual interest, in proportion to their respective interests in the trust*]_ _**.**

Comment: The first bracketed option in paragraph (2) of the long-form spendthrift clause should be used if there is a tax-sensitive trustee.

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D. Choice-of-Law Clause

§10.125 1. Enforceability and Desirability

A choice-of-law clause removes doubt about the law that applies to the validity of the trust and construction of its clauses by specifying the law that will govern. Such a clause will be honored if the jurisdiction specified has some contact with the trust and the clause does not violate public policy. See, *e.g., Frame v Merrill Lynch, Pierce, Fenner & Smith* (1971) 20 CA3d 668, 673, 97 CR 811.

A choice-of-law clause may not be honored with regard to the administration of real property located outside California, because the law of the situs generally governs real property held in a trust. See CC §755. However, the court of the state in which the real property is located may recognize the choice-of-law clause. See *Rudow v Fogel* (Mass App Ct 1981) 426 NE2d 155, 159. If the settlor has not included a choice-of-law clause in the trust instrument, the courts ordinarily apply the law of the settlor's domicile if the trust's corpus is personal property. See CC §946. For further details of conflict of laws as it affects trusts, see chap 20.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.126 2. Form: Specifying Law to Govern Validity, Construction, and Administration of Trust

§10.126 2. Form: Specifying Law to Govern Validity, Construction, and Administration of Trust

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10.126-1 Specifying law to govern validity, construction, and administration of trust

***Governing Law*. The internal laws (and not the law of conflicts) of the State of California _ _[*in force*]_ _ _ _[*on the date of execution of this trust/from time to time*]_ _ shall govern the validity, construction, interpretation, and administration of _ _[*this trust/any trust created under this instrument*]_ _, except that all matters relating to real property shall be governed by the laws of the situs of the real property.**

[*If appropriate, add the following option*]

[*Option: Administration of trust in another state*]

If any trust created under this instrument is administered outside California, a court with jurisdiction over the trustee of the trust may order that the law of that state governs the trust, as long as the change of governing law will not adversely affect the interests of the trust beneficiaries.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.127 E. Construction of Commonly Used Terms

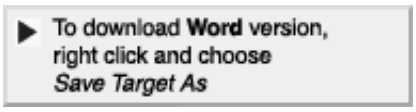
§10.127 E. Construction of Commonly Used Terms

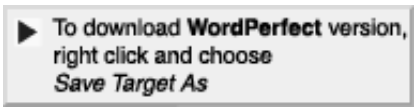
The settlor may provide his or her own definition for any term used in the trust. In any situation in which the meaning of a term significantly affects the trust's interpretation and a misunderstanding may lead to mistake, confusion, or dispute, the drafter may want to include special definition clauses.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.128 1. Form: Gender and Number

§10.128 1. Form: Gender and Number





10.128-1 Gender and number

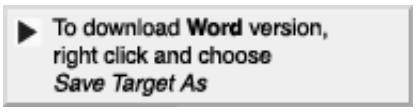
***Gender and Number*. In all matters of interpretation necessary to give effect to any clause of this trust, the masculine includes the feminine and neuter, the singular includes the plural, and the plural includes the singular.**

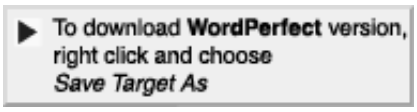
Comment: Even if the drafter prefers to provide proper gender and number designations throughout the trust, this clause will cover any errors or oversights.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.129 2. Form: Trustees and Fiduciaries

§10.129 2. Form: Trustees and Fiduciaries





10.129-1 Trustees and fiduciaries

All references in this trust to trustees, special trustees, or any other fiduciary shall refer to the individuals or institutions serving from time to time in that capacity under this trust.

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§10.130 3. Form: Distribution Among Beneficiaries

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10.130-1 Distribution among beneficiaries

[*Use one of the following alternatives*]

[*Alternative 1: Distribution by representation*]

***Right of Representation*. Distribution of property to or division of property among the issue of a person by "right of representation" means to divide the property into as many equal shares as there are living children of that person and deceased children of that person who leave then-living issue. Each living child of that person shall be allocated one share, and the share of each deceased child who leaves then-living issue shall be allocated in the same manner.**

[*Alternative 2: Distribution per capita*]

***Per Capita at Each Generation*. Distribution of property to or division of property among the issue of a person "per capita at each generation" means to divide the property into as many equal shares as there are living members of the nearest generation of issue then living and deceased members of that generation who leave issue then living. Each living member of the nearest generation of issue then living is allocated one share, and the remaining shares, if any are combined and then divided and allocated in the same manner among the remaining issue as if the issue already allocated a share and their descendants were then deceased.**

Comment: Alternative 1 is based on Prob C §246. It is the consulting editor's experience that clients prefer this language to the language in Prob C §240.

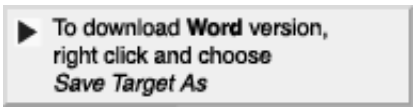
Alternative 2 is based on the language in Prob C §247. This language should be used if the settlor wants each grandchild to receive an equal share, regardless of whether he or she is an only child or one of several children of the settlor's children.

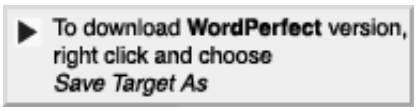
On different types of distribution plans for gifts to issue, see Drafting California Revocable Trusts, chap 8 (4th ed Cal CEB 2003); California Will Drafting §12.32 (3d ed Cal CEB 1992). See chap 9.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.131 4. Form: 'Shall' and 'May'

§10.131 4. Form: "Shall" and "May"





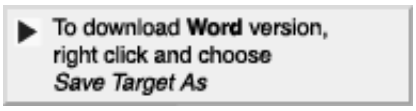
10.131-1 "Shall" and "may"

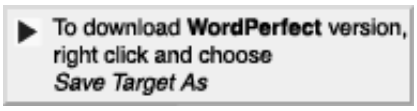
"Shall" and "May." **All references in this trust to the word "shall" indicate a mandatory direction. All references to the word "may" indicate a permissive, but not mandatory, grant of authority.**

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F. Commonly Included Definitions

§10.132 1. Form: Education





10.132-1 Education

Definition of "Education." **Whenever provision is made in this trust to pay for the education of a beneficiary, the term "education" shall include tuition for vocational school, college, and postgraduate study _ _**[*if the trustee determines that the beneficiary pursues this study to his or her advantage*]**_ _ at an institution of the beneficiary's choice. Payments for "education" shall also include expenses for books, supplies, and tutors.**

[*If appropriate, add the following option*]

[*Option: Related living and travel expenses*]

In determining payments to be made to the beneficiary for education, the trustee shall consider the beneficiary's reasonably related living and traveling expenses.

Comment: The settlor may wish to expand the definition to include other study, *e.g.,* the study of music or art under a particular artist or instructor. For a narrower definition of education, see California Will Drafting §22.30 (3d ed Cal CEB 1992).

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2. Issue and Children

§10.133 a. Defining "Issue" and "Children"

Settlors frequently wish to make gifts to "children" or "issue." Because the ambiguity of these terms may lead to litigation after the settlor's death, the settlor may wish to define these terms. Specifically, the trust may indicate whether adopted children, children born out of wedlock, halfbloods, stepchildren, and foster children should be included in the definition of "children."

The statute provides that a "child" is any individual entitled to take as a child under the Probate Code by intestate succession from the parent whose relationship is involved. See Prob C §26. "Issue" of a person is defined in Prob C §50 as all the person's lineal descendants of all generations, with the relationship of parent and child at each generation being determined by the definitions of child and parent. See California Will Drafting §§12.29-12.34B (3d ed Cal CEB 1992).

Under Prob C §21115, halfbloods, adopted persons, persons born out of wedlock, stepchildren, foster children, and the issue of these persons are *included* in the terms of class gifts in accordance with the rules of intestate succession. Probate Code §§6450-6455 provide rules defining parent-child relationships for purposes of intestate succession.

For purposes of inheritance, an adopted child is, with certain exceptions, considered to be a descendant of the adopting parent but *not* the child of his or her natural parent. Prob C §6451. Children born out of wedlock may inherit from their natural parents (see §10.133A) as determined under Prob C §6453, regardless of the marital status of the natural parents. Probate Code §6454 defines the parent-child relationship for purposes of intestate succession to include foster children and stepchildren in certain situations. See *Estate of Sanders* (1992) 2 CA4th 462, 3 CR2d 536, for a discussion prohibiting the use of DNA testing to establish paternity under former Prob C §6408 (now Prob C §6453). See also *Estate of Burden* (2007) 146 CA4th 1021, 53 CR3d 390 (paternity established by clear and convincing evidence that decedent openly held out child as his own). See *Weir v Ferreira* (1997) 59 CA4th 1509, 70 CR2d 33, concerning the binding effect of a dissolution of marriage decree determining a person to be a child of the marriage as discussed in §10.133B.

On the meaning of the term "descendants," see Prob C §6205. See also *Estate of Joslyn* (1995) 38 CA4th 1428, 45 CR2d 616 (class of permitted appointees under testamentary power of appointment limited to "descendants" included person who became stepchild after testator's death and was later adopted as adult); *Estate of Huntington* (1976) 58 CA3d 197, 129 CR 787 ("descendants" as used in will creating testamentary trust included children adopted by daughter beneficiary after execution of decedent's will).

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§10.133A (1) Natural Parent-Child Relationship Under Uniform Parentage Act

The existence of a natural parent-child relationship is generally determined under the Uniform Parentage Act (UPA) (Fam C §§7600-7730). See Prob C §6453. The natural children of a deceased beneficiary may include posthumously conceived children conceived within 2 years after the decedent's death if the decedent specified in writing that his or her genetic material shall be used for posthumous conception. Fam C §7611(f); Prob C §§249.5-249.8, 6453(c). Natural children also may include children who have no genetic connection to presumed parents who received the children into their homes and openly held them out as their natural children under Fam C §7611(d). See *In re Nicholas H.* (2002) 28 C4th 56, 120 CR2d 146 (presumed father met mother when she was pregnant and provided home for mother and child for several years). Such presumed parents may include a second parent of the same sex as the biological parent or other natural parent. See *Elisa B. v Superior Court* (2005) 37 C4th 108, 33 CR3d 46 (presumed mother lived with and supported biological mother and child; "[i]nsofar as practicable," provisions applicable to father and child relationship apply in determining existence of mother and child relationship under Fam C §7650(a)). See also *Kristine H. v Lisa R.* (2005 37 C4th 156, 33 CR3d 81 (biological mother estopped from challenging validity of stipulated judgment declaring that her female partner was second parent of child). In some cases, the determination may depend on presumptions concerning the paternity of a child born during a marriage, as discussed in §10.133B. See Fam C §§7540-7547.

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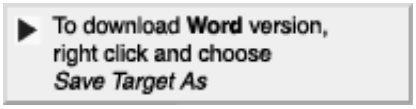
§10.133B (2) Conclusive Marital Presumption for Children of Spouses or Registered Domestic Partners

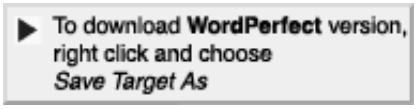
The child of a woman cohabiting with a spouse or registered domestic partner is conclusively presumed to be a child of the marriage or domestic partnership under Fam C §7540, obviating application of parentage presumptions under the Uniform Parentage Act (UPA) (Fam C §§7600-7730) as discussed in §10.133A. (Despite language in Fam C §§7540-7541 limiting the application of the presumption that the child of a wife cohabiting with her husband is the child of the husband when there is evidence demonstrating the biological impossibility of the husband's paternity, the California Supreme Court has stated that "the conclusive marital presumption in section 7540 is not really a presumption at all but is instead 'a rule of substantive law.'" *In re Jesusa V.* (2004) 32 C4th 588, 614, 10 CR3d 205, quoting *Kusior v Silver* (1960) 54 C2d 603, 619, 7 CR 129.) Such a child of a domestic partnership also would be considered the natural child of the partner for purposes of intestate succession under Prob C §6453 because a presumed parent under Fam C §7540 is considered a natural parent under the UPA. Fam C §7611. The same principle should apply to the child of a man cohabiting with a male spouse or registered domestic partner. See Fam C §297.5(d). But see *Amy G. v M.W.* (2006) 142 CA4th 1, 47 CR3d 297 (child with biological mother and father cannot have presumed mother who was married to father as additional parent).

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.134 b. Form: Issue and Children (California Law of Intestate Succession Applies)

§10.134 b. Form: Issue and Children (California Law of Intestate Succession Applies)





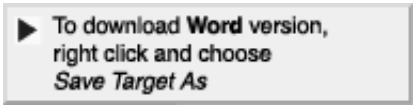
10.134-1 Issue and children (California law of intestate succession applies)

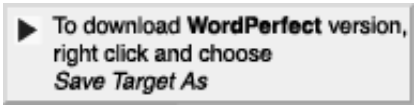
Definition of "Children" and "Issue." **The terms "child" and "children" refer to individuals entitled to take as such from a parent under the California law of intestate succession in effect on the date of this instrument. The term "issue" refers to lineal descendants of all generations, with the relationship of parent and child at each generation being determined in the same manner.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.134A c. Form: Issue and Children (Lineal Descendants)

§10.134A c. Form: Issue and Children (Lineal Descendants)





10.134A-1 Issue and children (lineal descendants)

Definition of "Children" and "Issue." **All references in this trust to the term "issue" refer to lineal descendants of all degrees. The terms "child," "children," and "issue" _ _[*do not*]_ _ include _ _[*e.g., stepchildren/foster children/adopted children who _ _[were/need not have been*]_ _ *minors at the date of adoption*]_ _.**

[*Add one of the following alternatives*]

[*Alternative 1: Issue and children include those born out of wedlock if parent-child relationship exists*]

All references to the terms "issue," "child," and "children" include a child born out of wedlock if a parent-child relationship existed between the child and his or her deceased parent. Except as otherwise expressly provided in this trust, for purposes of this trust the existence of a parent-child relationship shall be determined by California law.

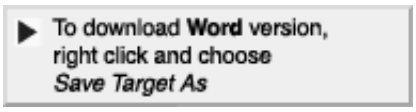
[*Alternative 2: Exclusion of children born out of wedlock*]

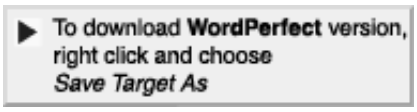
All references to the terms "issue," "child," and "children" refer only to children conceived, born, or adopted during a valid marriage _ _[*or adopted by a single parent*]_ _ and do not include children born out of wedlock, regardless of whether a parent-child relationship existed between a child and his or her deceased parent.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.135 3. Form: Spouse, Husband, or Wife

§10.135 3. Form: Spouse, Husband, or Wife





10.135-1 Spouse, husband, or wife

Definition of "Spouse." **All references in this trust to a person's spouse, husband, or wife shall mean any individual who is that person's then lawfully married spouse (determined by the laws of the jurisdiction in which the person then resides). An individual shall not be considered a spouse, husband, or wife unless that individual is actually residing with the person as husband or wife (disregarding temporary absences due to vacation, illness, or other emergency) when it is necessary to determine the individual's status as a spouse, husband, or wife. The term "spouse," "husband," or "wife" also shall include a widow or widower if that individual was residing at the time of the deceased person's death with the deceased person as husband or wife (disregarding temporary absences due to vacation, illness, or other emergency). This determination shall be made in the trustee's discretion.**

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§10.135A 4. Form: Spouse or Registered Domestic Partner

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10.135A-1 Spouse or registered domestic partner

Definition of "Spouse" and "Registered Domestic Partner." **All references in this trust to a person's spouse shall mean any individual who is that person's then lawfully married spouse or registered domestic partner as provided in California Family Code §297 or in a legal relationship with that person in another jurisdiction with substantially the same rights as a spouse (determined by the laws of the jurisdiction in which the person then resides). An individual shall not be considered a spouse unless that individual is actually residing with the person (disregarding temporary absences due to vacation, illness, or other emergency) when it is necessary to determine the individual's status as a spouse under this paragraph. The term "spouse" also shall include a surviving spouse if that individual was residing at the time of the deceased person's death with the deceased person (disregarding temporary absences due to vacation, illness, or other emergency). This determination shall be made in the trustee's discretion.**

Comment: This form extends the traditional definition of "spouse" in §10.135 to include California registered domestic partners and other individuals with substantially similar rights under the laws of other states or foreign countries. See Fam C §297.5. The revised definition also avoids any question as to whether a person's lawfully married spouse in a jurisdiction that permits same-sex marriage is residing with that person as husband or wife despite any statute providing that the marriage is not recognized in California. See Fam C §308.5.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.136 G. Form: No-Contest Clause

§10.136 G. Form: No-Contest Clause

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10.136-1 No-contest clause

***No-Contest Clause*. If any beneficiary under this trust, singly or in conjunction with any other person or persons, contests in any court the validity of this trust, or seeks to obtain an adjudication in any proceeding in any court that this trust or any of its clauses is void, or seeks otherwise to void, nullify, or set aside this trust or any of its clauses, then that person's right to take any interest given to him or her by this trust shall be determined as it would have been determined if the person had predeceased the execution of this trust instrument _ _[*without surviving issue*]_ _. This clause shall not apply to any disclaimer by any person of any benefit under this trust.**

[*If appropriate, add the following option*]

[*Option: Trustee authorized to defend contest*]

The trustee is authorized to defend, at the expense of the trust estate, any contest or other attack of any nature on this trust or any of its provisions.

Comment: A no-contest clause must be used with extreme caution in an irrevocable trust; a contest by a beneficiary that causes the beneficiary's interest to terminate could have adverse tax consequences. Also note that the enforceability of no-contest clauses is limited by Prob C §§21300-21322 (and will be further limited by Prob C §§21310-21315, effective January 1, 2010).

The settlor should give careful consideration to whether he or she wishes to penalize only a beneficiary whose actions fall within the scope of the no-contest clause or whether he or she wishes instead to penalize that beneficiary along with any of the beneficiary's issue. If the former is the case, the optional language "without surviving issue" should be omitted.

Some drafters may want to encourage the trustee to defend the trust. In that event, the drafter may use the optional clause. Without such a clause, the trustee might be hesitant to defend the trust because a court may rule that an attorney who represents the trustee in an unsuccessful defense of a contest is not entitled to have fees paid from the trust. In *Whittlesey v Aiello* (2002) 104 CA4th 1221, 128 CR2d 742, for example, the court found that an undue-influence contest of a decedent's trust was essentially a dispute between beneficiaries and it would be inequitable to effectively charge the prevailing party with the loser's expenses. Of course, using such language runs the risk of depleting the trust in unforeseen circumstances when a defense of the trust would be undesirable.

On no-contest clauses generally, see California Will Drafting §§35.9-35.10 (3d ed Cal CEB 1992); Drafting California Revocable Trusts, chap 19 (4th ed Cal CEB 2003).

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.137 H. Form: Annual Distributions of Income

§10.137 H. Form: Annual Distributions of Income

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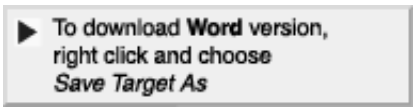
10.137-1 Annual distributions of income

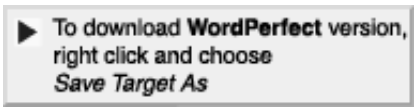
***Annual Distributions of Income*. All required distributions of income shall be made at least annually.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.138 I. Form: Distribution of Disclaimed Property

§10.138 I. Form: Distribution of Disclaimed Property





10.138-1 Distribution of disclaimed property

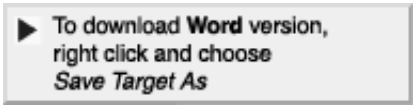
***Distribution of Disclaimed Property*. Any beneficiary shall have the right to disclaim all or part of any interest in property to which he or she may be entitled under this trust. Except as otherwise provided in this trust, any interest so disclaimed shall be distributed as if the beneficiary had died immediately before disclaiming that interest. No other interest of the beneficiary shall be affected by the disclaimer, unless that interest shall also be disclaimed.**

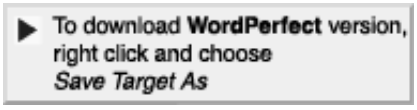
Comment: See §10.91.

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Source: Estate Planning/Drafting California Irrevocable Trusts/10 Trust Administration and Trustee's Powers/§10.139 J. Form: Power to Distribute if Power of Appointment Not Exercised

§10.139 J. Form: Power to Distribute if Power of Appointment Not Exercised





10.139-1 Power to distribute if power of appointment not exercised

***Distribution if Power of Appointment Not Exercised*. Except as otherwise provided in this trust, all clauses of this instrument regarding distribution of any trust shall be subject to the exercise of any power of appointment over the trust given under this instrument.**

If, on the expiration of six months after the death of any person holding a power of appointment given to him or her in this trust, no instrument purporting to exercise that power has been brought to the trustee's attention, any property may be distributed according to the terms of this trust as if the power had not been exercised. If a document purporting to exercise the power shall be located later, the trustee(s) shall not be liable to the appointee(s) under the exercise, and the rights of the appointee(s) and the persons receiving property from the trustee shall be governed by applicable law.

Any power of appointment given in this trust may be exercised by the holder or donee of the power even if (1) the assets constituting the trust over which the power is exercised have not been received by the trustee on the date of the death of the beneficiary or (2) the donee of the power is a minor.

[*Add the following paragraphs when beneficiary has lifetime power*]

Any exercise of a lifetime power of appointment shall be implemented immediately on the exercise of the power. A testamentary power shall not apply to any property over which a beneficiary has exercised his or her lifetime power.

A testamentary power shall be considered to have been exercised only if, by specific reference to the power in his or her last will or in a codicil thereto, a beneficiary has expressed an intention to exercise it.

Comment: This clause should be included if the dispositive clauses of the trust grant a power of appointment.

The third paragraph of form 10.139-1, permitting a donee who is a minor to exercise a power of appoint during minority, is authorized by Prob C §625(b). It is designed to ensure that tax-motivated powers of appointment achieve their desired effect.

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§10.140 VIII. IMPLEMENTING THE TRUST

Settlors can create a trust by declaring that they hold particular property as trustees or by conveying that property to a third party as a trustee. As long as the trust document contains a list of trust property and language satisfying the requirement for a declaration or conveyance, the property listed becomes trust property as soon as the document is executed. No further action is necessary. *Estate of Heggstad* (1993) 16 CA4th 943, 20 CR2d 433.

Nevertheless, the great majority of trusts are funded. In this context, "funding" the trust means the process of changing title to property so that the title reflects the existence of the trust and the identity of the trustees. In the case of a grantor trust that does not have a separate identity for tax purposes, the primary purpose of funding the trust is to facilitate property management by trustees other than the settlor. In a trust that names the settlor as the initial trustee, funding the trust will make it easier for the successor trustee to gain control of the trust assets in the event of the settlor's incompetence or death. If the trust is not funded, the successor trustee may be unable to manage the trust estate without obtaining a court decree declaring that the trust property belongs to the trust. For discussion of filing a *Heggstad* petition under Prob C §850(a)(3), see California Trust Administration §§15.39A, 15.40A-15.40B (2d ed Cal CEB 2001).

The procedures for transferring particular types of property to a trust discussed in Drafting California Revocable Trusts, chap 21 (4th ed Cal CEB 2003) also apply to an irrevocable trust. See also Funding a Revocable Trust (Cal CEB Action Guide October 2007).

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11

Life Insurance Trusts

Jon J. Gallo

I. FUNDING TRUSTS WITH LIFE INSURANCE §11.1
- A. Life Insurance Trust Objectives §11.2
- B. Special Considerations §11.3

II. PLANNING AND DRAFTING CONSIDERATIONS
- A. Partitioning Community Property §11.4
- B. Avoiding Application of Reciprocal Trust Doctrine §11.5
- C. Selecting and Changing Trustee §11.6
- D. Transferring Property to Trust
  - 1. Inclusion of Pre-Owned Policy in Insured's Estate Under IRC §2035 §11.7
  - 2. Form: Contingent Marital Deduction Gift §11.8
  - 3. Avoidance of Estate Tax Inclusion of New Policy §11.9
    - a. Insurable Interest Problem §11.9A
    - b. Effect of Substitute Application §11.9B
  - 4. Gift Tax Value §11.10
  - 5. Gift Tax Exclusions §11.11
- E. Removing Policy From Trust §11.12
- F. Choosing Method of Premium Payment §11.13
- G. Holding Sufficient Liquid Assets to Satisfy Crummey Withdrawal Demands §11.14
- H. Addressing Generation-Skipping Transfer Tax Problems §11.15
  - 1. Avoiding ETIP Periods §11.16
  - 2. Planning for Exemption Allocation §11.17
  - 3. Allocating Exemption by Formula §11.18

III. FORMS
- A. Form: Power to Invest in Life Insurance §11.19
- B. Form: Power to Remove and Replace Trustee §11.20

IV. SELECTING APPROPRIATE INSURANCE PRODUCT §11.21
- A. Selecting Company §11.22
- B. Understanding Insurance Products and Illustrations §11.23
  - 1. Risk Factors §11.24
    - a. Mortality Experience §11.25
    - b. Investment Experience §11.26
    - c. Lapse Rates §11.27
    - d. Company Expenses §11.28
  - 2. Insurance Products §11.29
    - a. Term Insurance §11.30
      - (1) Annual Renewable Term §11.31
      - (2) Level Term §11.32
      - (3) Decreasing Term §11.33
      - (4) Modified Term §11.34
    - b. Whole Life Insurance §11.35
      - (1) Limited-Pay Whole Life Insurance §11.36
      - (2) Current Assumption (Interest-Sensitive) Whole Life Insurance §11.37
      - (3) Blended Whole Life/Term Insurance §11.38
      - (4) Joint Lives Life Insurance §11.39
      - (5) Universal Life Insurance §11.40
      - (6) Variable Life Insurance §11.41
      - (7) Variable/Universal Life Insurance §11.42
  - 3. Illustrations §11.43
    - a. Term Insurance §11.44
    - b. Whole Life Insurance §11.45

c. Blended Insurance §11.46
d. Second-to-Die Insurance §11.47
e. Variable Insurance §11.48
4. Obtaining Information §11.49

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.1 I. FUNDING TRUSTS WITH LIFE INSURANCE

§11.1 I. FUNDING TRUSTS WITH LIFE INSURANCE

In many respects, a "life insurance trust" is simply an irrevocable trust that happens to be funded with life insurance. Nevertheless, the use of life insurance as the primary trust asset causes some specific planning, drafting, and administration problems that distinguish these trusts from other trusts. This chapter focuses primarily on those specific problems (see §§11.4-11.20) and concludes with a discussion of life insurance products (see §§11.21-11.49). On life insurance trust objectives, see §11.2. On special considerations in planning and drafting life insurance trusts, see §11.3.

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§11.2 A. Life Insurance Trust Objectives

The primary objective of a life insurance trust is to avoid inclusion of life insurance proceeds in the insured's taxable estate. A related objective is to avoid additional requirements to qualify a trust for the marital deduction under IRC §2056A if the insured's spouse is a noncitizen. These include the requirement that no distributions of trust principal can be made unless a U.S. trustee has the right to withhold estate tax. See §§2.80-2.81G. A life insurance trust can avoid these requirements by removing assets from the insured's gross estate, thus avoiding the need to qualify for the marital deduction. See §2.81H. For further discussion of this and other considerations, see Zeydel, *How to Create and Administer a Successful Irrevocable Life Insurance Trust*, 34 Est Plan 3 (June 2007). If the insured is married, a second objective is to avoid inclusion in the spouse's taxable estate. If these objectives are met, a life insurance trust can produce substantial transfer tax benefits even though the transfers made to the trust to pay policy premiums are subject to gift tax.

If the insured dies while the insurance is in force, the premium payments typically have a much lower transfer tax value than the policy proceeds. Also, it is often possible to avoid gift tax liability on the gifts made to pay premiums by taking advantage of the IRC §2503(b) $13,000 (plus further cost of living adjustments after 2009) per-donee gift tax annual exclusion unless the available exclusions are being used for other transfers. Although similar results can be achieved by making cash gifts outright to individuals (*e.g.,* the insured's children), who can then use these gifts to purchase and maintain insurance on the donor's life, a trust can provide far greater flexibility with respect to asset management and eventual distribution of the trust estate.

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.3 B. Special Considerations

§11.3 B. Special Considerations

A variety of features distinguish irrevocable life insurance trusts from irrevocable trusts funded with other types of assets:

- *Restricted design options.* Design options are somewhat restricted for life insurance trusts because, under IRC §2042, the proceeds of life insurance are included in the insured's estate if proceeds are payable to the insured's executor or the insured possessed any of the "incidents of ownership" of the policy at death. These are broad concepts. For example, if an insurance trust requires a trustee to use the proceeds to pay the insured's estate taxes, debts, or costs of estate administration, the insurance will be deemed to be payable to the insured's estate and includable in the insured's gross estate. Treas Reg §20.2042-1(b)(1). Accordingly, life insurance trusts should not provide for paying such expenses even when the purpose of the trust is to provide liquid assets for those purposes. Instead, the trust should provide for lending money to or purchasing assets from the insured's probate estate or revocable trust. See §§10.88-10.90. Similarly, the insured will often be treated as having incidents of ownership over a life insurance policy if the insured is the trustee, with the result that the insured should not be the trustee or have an unrestricted power to remove and replace the trustee. See §11.6. In IRS Letter Ruling 200123055, the IRS agreed to honor state court reformations of life insurance trusts that eliminated risks that the trusts could be included in the estates of the insured settlors. The now-deceased scrivener had sent the settlors a letter indicating that the trusts would not be included in their estates.
- *Policy owned by corporation or partnership*. Incidents of ownership may be attributed to the insured through a corporation or partnership controlled by the insured, unless the policy proceeds are payable to the entity or payable to a third party for a valid business purpose. Treas Reg §20.2042-1(c)(6); Rev Rul 83-147, 1983-2 Cum Bull 158.
- *Surviving spouse's elective share right*. For insureds residing in states other than California, another potential concern is whether the elective share rights of a surviving spouse in the trust could cause IRC §2042(1) or §2042(2) to apply to insurance proceeds on the death of the insured because the trust assets are available to satisfy an obligation of the insured's estate. The IRS has taken the position that a surviving spouse's elective share right gives the settlor a disqualifying interest in a charitable remainder trust unless a spousal waiver of the election right is obtained. Rev Proc 2005-24, 2005-1 Cum Bull 909. See §18.6B.
- *Application of IRC §2035(a).* Internal Revenue Code §2035(a) applies to transfers of life insurance, with the result that funding a trust with an existing life insurance policy will result in the policy proceeds being included in the donor insured's estate if he or she dies within three years after the transfer. This is typically not the case with trusts funded with other assets.
- *Complication of generation-skipping transfer tax planning.* Planning for generation-skipping transfer tax can be difficult when the primary trust asset is life insurance—especially with term insurance, the value of which can quickly change, depending on whether death is likely to occur during the policy period. See §4.40.

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II. PLANNING AND DRAFTING CONSIDERATIONS

§11.4 A. Partitioning Community Property

The term "settlor" can be used to refer to either the person who creates a trust or the person who transfers assets to the trust. Unless this chapter makes a distinction, readers should assume that any reference to "settlor" includes both meanings.

As a general rule, no beneficiary should be a settlor. If a beneficiary contributes property to a trust, the beneficiary is likely to have made a transfer with a retained interest, which will result in inclusion of the trust or a portion of the trust in the beneficiary's taxable estate under IRC §2036. This rule usually creates a problem only when community property is transferred to a trust that names a spouse as a beneficiary. If this occurs, half of the trust estate is likely to be included in the spouse's taxable estate when the spouse dies.

This undesirable result can usually be avoided if the insured funds the trust with separate property. This often requires an agreement partitioning community property into equal shares of separate property. To avoid a claim by the Internal Revenue Service that the partition is illusory, the noninsured spouse should not later commingle his or her resulting separate property with the remaining community property. Some practitioners are concerned that consumption of such separate property should also be discouraged as this may be viewed as having the same consequence as commingling.

When an existing community property policy is being transferred to the trust, the transaction becomes more complicated if the clients insist that the insured's spouse must be a beneficiary. One possible approach is to partition both the policy and cash of equivalent value. The insured can then use his or her separate-property cash to purchase the noninsured's interest in the policy. Because the policy is transferred to the insured, the IRC §101(a)(2)(B) transfer-for-value rule should not apply. See §11.12. Because the transfer is made between spouses, the transferring spouse will not recognize gain. IRC §1041.

It is theoretically possible to provide the insured with separate property by having the noninsured spouse make a gift to the insured spouse. Unfortunately, if the gift occurs at approximately the same time as the creation of the insurance trust, the IRS may apply the step-transaction doctrine to conclude that the noninsured spouse actually made a transfer to the trust rather than to the insured spouse.

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§11.5 B. Avoiding Application of Reciprocal Trust Doctrine

Married persons sometimes want to set up two trusts: one created by the husband, holding insurance on his life and benefiting his wife and their issue; and another created by the wife, holding insurance on her life and benefiting her husband and their issue. Because of the considerations discussed in §11.4, each trust would be settled and funded with the separate property of the insured.

When this type of arrangement is desired, considerable care must be taken to avoid application of the reciprocal trust doctrine (sometimes referred to as the crossed-trust doctrine), first articulated in *Lehman v Commissioner* (2d Cir 1940) 109 F2d 99. In *Lehman,* the decedent transferred certain stocks and bonds into a trust for his brother in consideration for his brother's transfer of substantially identical stocks and bonds into a trust for the decedent. Each trust provided that the trustee was to pay the income to the beneficiary brother for life, with the remainder going to that brother's issue. The IRS "uncrossed" the trusts, finding that each trust was the quid pro quo for the other, and treated each brother as the settlor of the trust benefiting himself or herself and his or her issue. As a result, the decedent was treated as having created a trust with a retained life interest, which was included in his estate under IRC §2036(a)(1).

Lehman was amplified in *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730. In *Grace,* the decedent transferred substantial assets to his wife over a 23-year period. The decedent then established an irrevocable trust for his wife, with the remainder going to their issue. Two weeks later, at the husband's request, his wife established a substantially identical trust for his benefit, with the remainder going to their issue. In finding that the wife's trust was includable in the husband's estate, the United States Supreme Court held (395 US at 324, 23 L Ed 2d at 338):

> [A]pplication of the reciprocal trust doctrine is not dependent upon a finding that each trust was created as a *quid pro quo* for the other. Such a "consideration" requirement necessarily involves a difficult inquiry into the subjective intent of the settlors. Nor do we think it necessary to prove the existence of a tax-avoidance motive.… Rather, we hold that application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created the trusts naming themselves as life beneficiaries.

The circumstances under which the reciprocal trust doctrine will be applied by the courts are unclear. For example, in *Estate of Green v U.S.* (6th Cir 1995) 68 F3d 151, the IRS sought to apply the doctrine for purposes of applying IRC §2036(a)(2) when a decedent created a trust for the benefit of one grandchild, naming the wife as trustee, and his wife created another trust for another grandchild, naming the decedent as trustee. Even though the decedent and his wife did not possess beneficial interests in either trust, the IRS sought to uncross the trusts so that the trust created by the wife would be treated as created by the decedent, with the result that he would be deemed to have "retained" the powers he held as trustee of the wife's trust. The Sixth Circuit Court of Appeals ruled that the reciprocal trust doctrine did not apply, because the "same economic position" test in *Grace* requires that (1) a settlor have a beneficial interest in the trust established by the other settlor and (2) the settlor's mere control of beneficial interests as trustee is not sufficient. 68 F3d at 153. It is uncertain whether other courts will similarly limit application of the doctrine. See, *e.g., Estate of Schuler v Commissioner* (8th Cir 2002) 282 F3d 575; *Sather v Commissioner* (8th Cir 2001) 251 F3d 1168.

In any event, the reciprocal trust doctrine significantly limits the use of crossing life insurance trusts and introduces an element of uncertainty concerning eventual tax treatment. If such trusts are desired despite their potential risks, their dispositive terms should be as different as possible, and the trusts should be set up at different times. At least one of the trusts should not confer any economic benefits on the other settlor. For further discussion, see §5.12.

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.6 C. Selecting and Changing Trustee

§11.6 C. Selecting and Changing Trustee

Generally, the insured cannot be the trustee or cotrustee of an insurance trust, because this usually results in the insured's possessing incidents of ownership in the insurance policy "alone or in conjunction with any other person," which will cause the insurance proceeds to be included in the insured's gross estate. IRC §2042. Incidents of ownership include any rights to economic benefits from the policy, including the power to change beneficiaries, borrow against the policy, surrender or cancel the policy, and assign or cancel the assignment of the policy. Treas Reg §20.2042-1(c)(2). In IRS Letter Ruling 200518005, the IRS ruled that a trustee-beneficiary who renounced trustee powers in connection with life insurance before the trust acquired life insurance on her life did not possess incidents of ownership in policies acquired after the renunciation. In IRS Letter Ruling 200314009, however, the IRS ruled that the settlor of a life insurance trust did not release incidents of ownership as a result of a court-ordered reformation that resolved an ambiguity concerning the settlor's power to appoint successor trustees by clarifying that the settlor could not name herself as trustee.

These restrictions make it difficult for the insured to change policies or shift benefits, although the insured may be able to remove a policy from the trust (see §11.12) or cause a policy to lapse by failing to make additional gifts to the trust as needed to pay the premiums. The insured can then make gifts to a new trust with different beneficial interests that may be used to pay premiums on a policy with different features. If the trust owns a whole life policy with substantial cash value (see §11.35) and the insured would prefer not to let the policy lapse or purchase the policy from the trust, the insured may need to seek court reformation of the trust as may be permitted even though the insured is not a beneficiary of the trust. See §8.6.

Revenue Ruling 84-179, 1984-2 Cum Bull 195 provides a limited and rarely useful "safe harbor" when the insured holds incidents of ownership in a fiduciary capacity. Under Rev Rul 84-179, incidents of ownership in a policy on the insured's life held by the insured in a fiduciary capacity will not cause inclusion of the proceeds in the insured's estate if:

- The insured may not exercise the powers over the policy to benefit himself or herself or his or her estate;
- The insured never transferred the policy or any of the premiums to the trust; and
- The powers were not bestowed on the insured as part of a prearranged plan in which the insured participated.

See also *Estate of Harry Bloch, Jr.* (1982) 78 TC 850. This safe harbor is not available in the typical insurance trust situation, because the insured usually transfers the policy or policy premiums or there is a prearranged plan.

Although the insured cannot be the trustee, the insured may retain the authority to remove the trustee and appoint a successor as long as the trust instrument states that the successor cannot be the insured, a settlor, or a related or subordinate party to either of them within the meaning of IRC §672(c). Rev Rul 95-58, 1995-2 Cum Bull 191. For a sample clause, see form 11.20-1. Internal Revenue Code §672(c) defines a "related or subordinate" party as any nonadverse party who is:

- The settlor's spouse if living with the settlor;
- The settlor's father, mother, issue, brother, or sister;
- An employee of the settlor;
- A corporation or any employee of a corporation in which the stock holdings of the settlor and the trust are significant from the viewpoint of voting control; or
- A subordinate employee of a corporation in which the settlor is an executive.

A settlor's spouse can be the trustee if the spouse is not a settlor, the trust does not own any insurance on the life of the spouse under a "second to die" policy or otherwise, and the trustee does not have powers that will cause the spouse to have a general power of appointment under IRC §§2041, 2514. Such a power will cause the trust to be included in the spouse's estate at the spouse's death. The spouse will be a settlor if the trust is funded with community property. See §11.4. The spouse will have a general power of appointment if the spouse can make discretionary

distributions to or for the benefit of the spouse not limited by an ascertainable standard as described in Treas Reg §20.2041-1(c)(2) or can make distributions that discharge a support obligation of the spouse. The spouse must also be precluded from causing distributions to the spouse's creditors, the spouse's estate, or the creditors of the spouse's estate.

If the trustee is a related or subordinate party within the meaning of IRC §672(c), the trust will usually be a grantor trust during the lifetime of the settlor with the result that the trust income will be taxed to the settlor. In many cases this is not a significant concern because a typical life insurance trust does not produce significant income before the insured's death. Income of a life insurance trust may be taxable to the grantor in any event under IRC §677(a)(3), if trust income may be used to pay policy premiums. For further discussion of using grantor trusts as life insurance trusts, see Balakrishna, *Defective Grantor Trusts: Greater Flexibility and Income Tax Leverage*, 32 Est Plan 30 (Dec. 2005).

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D. Transferring Property to Trust

§11.7 1. Inclusion of Pre-Owned Policy in Insured's Estate Under IRC §2035

If the insured transfers an existing insurance policy to an insurance trust, the proceeds will be includable in the insured's estate if the insured dies within three years after the transfer. IRC §2035(a). Because this risk is unavoidable in many instances, the trust should specify what will occur if the insured fails to survive the period.

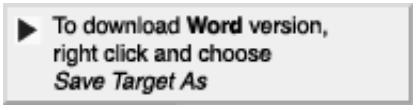
Married persons sometimes provide in the trust that the trust estate will be distributed in a manner qualifying for the marital deduction if the trust is included in the insured's gross estate. If such a tax-postponing strategy is not used, steps should be taken to clarify which funds should be used to pay the extra estate tax. If the trust instrument is silent and the insured's will does not contain a contrary tax apportionment provision, the trust will be liable for a prorata share of the total estate tax. IRC §2206. This amount is usually less than the additional tax caused by inclusion of the trust in the taxable estate and may be less than the amount provided by state law. See, *e.g., Estate of Smith* (Miss 2005) 891 So2d 811.

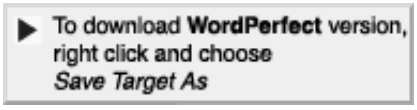
Care should be taken to ensure that the client's will or revocable trust does not contain an ambiguous "pay all death taxes resulting from my death from the residue of my estate [or this trust]" clause. Such a clause may generate considerable disagreement over whether its language is sufficient to override IRC §2206. If the client wishes to override IRC §2206, this intent should be stated in both the will and the insured's revocable trust (if applicable). (Internal Revenue Code §2206 requires a will provision. A provision in the revocable trust is effectively required by Prob C §20110(b)(1) if the revocable trust is funded before death and will provide the funds used to pay the estate taxes.) If the client wants the insurance trust to be liable for all the additional estate taxes caused by inclusion of the trust in the insured's taxable estate, rather than just a prorata share, the insurance trust should direct the trustee to pay the tax. Prob C §20110(b)(1).

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.8 2. Form: Contingent Marital Deduction Gift

§11.8 2. Form: Contingent Marital Deduction Gift





11.8-1 Form: Trust assets includable in settlor's estate distributed to surviving spouse

***Distribution of Insurance to Surviving Spouse*. If proceeds of a life insurance policy owned by this trust are includable for federal estate tax purposes in the estate of a settlor of this trust who was survived by the other settlor for thirty days, the proceeds so includable, and the income from such proceeds earned after the deceased settlor's death, shall not be distributed as otherwise provided in this instrument, but shall instead be distributed to the surviving settlor.**

Comment: This form may be appropriate when an existing insurance policy on a settlor's life is transferred to a trust, thereby creating the risk that the policy proceeds will be included in the insured's estate if the insured fails to survive three years. See §11.7. By causing a transfer that qualifies for the IRC §2056 marital deduction, the clause satisfies the common client desire to avoid death taxes before the death of the surviving spouse. The clause can be modified to provide for disposition to a marital deduction trust. This type of clause should not be used indiscriminately. If, for example, the trust is exempt from GST tax and can be administered so as to provide substantial benefits to skip persons, the benefits of the GST exempt status will be wasted if the trust is distributed to the spouse.

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.9 3. Avoidance of Estate Tax Inclusion of New Policy

§11.9 3. Avoidance of Estate Tax Inclusion of New Policy

The risk that the trust will be included in the insured's taxable estate under IRC §2035 should be avoided when possible. To do so, the practitioner must ensure that the insured never has any incidents of ownership in the policy. See discussion in §11.7. This goal can be easily accomplished if the trust is planned before the client has taken steps to purchase the policy. In such a case, the trust can be established before the original application is submitted to the issuer, and the trustee (rather than the insured) can be the original applicant. However, there is some question as to whether the trustee of a typical life insurance trust has an insurable interest in the life of the settlor. See discussion in §11.9A.

If the insured has already applied for the policy before the trust is created, it may still be possible to avoid application of the IRC §2035 3-year rule if:

- No premium is tendered by the insured;
- The trustee submits a replacement application before the policy is issued; and
- The trustee tenders the premium payment.

See IRS Letter Ruling 9323002. However, the 3-year rule cannot be avoided by using a substitute application dated after the execution of the trust naming the trustee as the applicant. See §11.9B.

To avoid further contentions that creation of a life insurance trust involves a transfer of incidents of ownership, the trustee should not be a mere agent of the insured. Accordingly, the trust agreement should authorize, but not obligate, the trustee to acquire insurance on the settlor's life.

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§11.9A a. Insurable Interest Problem

Under Ins C §280, an insurance contract is void if the insured has no insurable interest. An insurable interest is generally defined as "an interest based upon a reasonable expectation of pecuniary advantage through the continued life … of another person and consequent loss by reason of that person's death" or an interest engendered by love and affection in the case of persons closely related by blood or law. Ins C §10110.1(a). Under Ins C §10110, persons who have an insurable interest in the settlor's life include the settlor, the settlor's dependents, the settlor's creditors or obligees, and a person with a vested estate or interest that depends on the life of the settlor. The Insurance Code does not expressly provide that the trustee of a trust has an insurable interest in the life of a beneficiary. Trusts may not be used to apply for and initiate the issuance of insurance policies for investors where one or more beneficiaries do not have an insurable interest in the life of the insured. Ins C §10110.1(d).

In *Chawla v Transamerica Occidental Life Ins. Co.* (4th Cir 2006) 440 F3d 639, the Fourth Circuit Court of Appeals affirmed a district court decision that an insurance contract owned by a trust created by the insured was void because of misrepresentations regarding the insured's health, but also because the trust had no insurable interest in the settlor's life. The appellate court affirmed the district court decision on the ground that the policy was void and did not address the insurable interest issue. (The district court did not consider that the trust may have had an insurable interest in the life of the settlor because the settlor himself was a beneficiary of the trust. At least one court has held that a trust has an insurable interest in the life of the settlor if the trust beneficiaries have an insurable interest. *Potter Title & Trust Co. v Fidelity Trust Co.* (Pa 1934) 175 A 400. In *Caso v First Colony Life Ins. Co.* (May 7, 2003, G030353) 2003 Cal App Unpub Lexis 4528, 2003 WL 21019625, however, the court held that, in the case of a trust created solely to hold title to real property, the insurable interest of the trust in the life of a particular beneficiary was limited to the amount needed to purchase that beneficiary's interest in the trust under a buy-sell agreement.) In light of the district court decision in *Chawla*, one commentator has suggested that new trusts ideally should be created in and funded with insurance purchased in a state that has a statute giving a trust an insurable interest, such as Delaware; alternatively, the insured should buy the policy before creating the trust and transfer the policy to the trust. The commentator further suggested that one solution to the risk of inclusion under IRC §2035 is to obtain a rider that doubles the payment if the insured dies within 3 years after acquisition of the policy. See Zaritsky, *Irrevocable Life Insurance Trusts and Insurable Interests:* Chawla *Raises Some Nasty Issues for Estate Planners*, 18 Prob Prac Rep 1 (Apr. 2006). Another possibility would be for the settlor to sell the policy to the trust for fair market value. This should avoid application of the 3-year rule. The trust should be a grantor trust to avoid possible recognition of gain under the transfer for value rule of IRC §101(a)(2). See discussion in §11.12. See also Brody & Leimberg, *Avoiding the Tax Trap of the Transfer for Value Rule*, 32 Est Plan 3 (Oct. 2005).

The insurable interest problem also arises in the context of stranger-owned life insurance (SOLI or STOLI or SPIN-Life) arrangements in which elderly clients may receive money in exchange for agreeing to the issuance of life insurance policies on their lives to be held in trust for the benefit of investors who supply the funds to pay the premiums. In *Life Products Clearing, LLC v Angel* (SD NY 2008) 530 F Supp 2d 646, for example, the court denied judgment on the pleadings in an action brought by the transferee of the insured's interest in the trust as initial beneficiary against the personal representative of the insured's estate seeking a judgment declaring that the transferee was the rightful beneficiary of the trust and of the insurance proceeds. The personal representative sought to have the death benefits paid to the insured's estate. The personal representative alleged that the insured obtained the policy with the prior intent to transfer it to a stranger with no insurable interest contrary to applicable state law. See Leimberg & Zaritsky, *New Cases Highlight Insurable Interest Problems with Stranger-Owned Life Insurance*, 20 Prob Prac Rep 1 (Mar. 2008). In California, any "device, scheme, or artifice" designed to give the appearance of an insurable interest where there is none is deemed to violate the insurable interest laws. Ins C §10110.1(e).

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.9B b. Effect of Substitute Application

§11.9B b. Effect of Substitute Application

If the insured has owned the policy for less than 1 year, an insurance agent may suggest using a substitute application dated after execution of the trust agreement, which shows the trustee as the original applicant and owner. Such an application is simply an attempt to change a preexisting paper trail. It does not change the fact that the policy was issued before execution of the trust and appears to have no legal efficacy in avoiding IRC §2035 if the policy was initially issued to the insured.

PRACTICE TIP: It is important to distinguish between substituting applications and backdating a policy to a date before creation of the insurance trust. Life insurance companies compute the age of the insured to his or her nearest birthday. Six months after the insured's birthday, the insured becomes 1 year older for insurance purposes. Backdating makes the effective date of the policy occur before the age change and permits the premium to be calculated on the lower age. Backdating does not subject a policy initially acquired by the trustee to inclusion under IRC §2035.

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§11.10 4. Gift Tax Value

The transfer of an existing life insurance policy to a typical insurance trust without consideration is a gift. If the insured is healthy and insurable, the value of the gift will be the replacement cost of the policy. If the policy is for term insurance, this value will be the value of the unused portion of the premiums already paid. If the policy is for whole life insurance, the value will be the interpolated terminal reserve value (which is similar but not exactly the same as the cash surrender value) at the time of the gift, plus the unused portion of the last premium and dividend accumulations, less outstanding policy loans. Treas Reg §25.2512-6(a). The value of a new policy, however, is its cost. Treas Reg §25.2512-6(a), Example (1).

The gift tax value of a whole life policy may be greater than the "approximation" provided in the regulations if Rev Proc 2005-25, 1983-2 Cum Bull 158, is applied outside the employee benefits area. Revenue Procedure 2005-25 provides safe harbors for determining the fair market value of a life insurance policy distributed from a qualified retirement plan, requiring the use of the greater of (1) the amount determined by the calculation described above plus a reasonable estimate of dividends expected to be paid based on company performance, and (2) a more complex formula based on premiums, earnings, reasonable charges, and a surrender factor. See Zeydel, *How to Create and Administer a Successful Irrevocable Life Insurance Trust*, 34 Est Plan 3, 8 (June 2007).

If the insured is uninsurable at the time of the transfer, the fair market value of the policy may be substantially higher than the amount computed under Treas Reg §25.2512-6(a). See, *e.g., Estate of James Stuart Pritchard* (1944) 4 TC 204, 208, in which the Tax Court held that when death is imminent and the insured is uninsurable, the cash surrender value "would be only helpful as a criterion of the minimum value to be placed on the policies…."

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§11.11 5. Gift Tax Exclusions

The primary means of qualifying transfers to irrevocable trusts for IRC §2503(b) $13,000 (plus further cost of living adjustments after 2009) per-donee gift tax annual exclusions is to provide the beneficiaries with *Crummey* withdrawal powers (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82). Because this technique creates immediately exercisable withdrawal powers, there is no concern that the trust terms will cause the gifts to be gifts of future interests, which do not qualify for the annual gift tax exclusion. Further, the mere fact that the transferred property is life insurance does not cause the gift to be characterized as a transfer of a future interest. Treas Reg §25.2503-3(a); Rev Rul 76-490, 1976-2 Cum Bull 300.

Nevertheless, theoretical concerns arise when insurance is transferred to a trust, the trust has no other assets, the policy has no cash surrender value, and the trustee has no effective way to transfer interests in the policy. In such cases, the *Crummey* withdrawal powers may appear to be illusory. For discussion of this issue, see §11.14. On the use of *Crummey* withdrawal powers and forms, see chap 12 on trusts for minors.

On the desirability of limiting the annual withdrawable amount to the greater of $5000 or 5 percent even when this results in an exclusion of less than the full annual exclusion amount, see §§12.89 (general tax concerns), 4.10, 4.29 (generation-skipping transfer tax concerns). Another approach is to use an IRC §2503(c) trust for the benefit of a beneficiary under age 21. While the beneficiary typically has the right to withdraw the trust assets on attaining age 21, the trust avoids the need for annual withdrawal powers and *Crummey* notices until the beneficiary reaches age 21. See §§12.38-12.63.

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§11.12 E. Removing Policy From Trust

A sale of an existing insurance contract to a trust for adequate and full consideration may be used to avoid the IRC §2035 3-year rule, but this alternative is not practical in most cases because of the IRC §101(a)(2) transfer-for-value rule. Under this rule, life insurance proceeds lose their normal income tax exemption if the transferee of a policy pays consideration. In IRS Letter Rulings 200606027, 200518061, and 200228019, the IRS ruled that the sale or exchange of a life insurance policy from one trust to another does not trigger the transfer-for-value rule if both trusts are grantor trusts owned by the same grantor. In Rev Rul 2007-13, 2007-11 Int Rev Bull 684, the IRS confirmed these rulings and further ruled that the transfer-for-value rule is also not triggered if only the purchasing trust is a grantor trust, because the sale will be treated as a transfer to the insured (see below). However, in the latter case, the transfer may result in a recognition of gain by the selling trust. Rulings in this area generally do not disclose why the transferee trust is a grantor trust, but the objective of creating grantor trust status without causing the insured to have incidents of ownership in the policy under IRC §2042 is often accomplished by giving the grantor's spouse a power that is treated as held by the grantor for grantor trust purposes (IRC §672(e)), but not so treated for IRC §2042 purposes.

The transfer-for-value rule does not apply in the following situations:

- The transferee acquired the policy by gift or through any transaction in which the transferee retains the income tax basis in the policy of the transferor (IRC §101(a)(2)(A)); or
- The transferee is the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or an officer (IRC §101(a)(2)(B)).

The exceptions to the transfer-for-value rule may be useful if it becomes desirable to *remove* a policy from a trust. Because of the exemption for acquisition by the insured, the insured can purchase the policy from the trust. Further, the trust will not recognize gain on the sale of the policy to the insured if the trust is a grantor trust that is deemed owned by the insured for IRC §671 purposes. Deemed ownership probably occurs because the trust will have owned life insurance during the taxable year. See IRC §677(a)(3).

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§11.13 F. Choosing Method of Premium Payment

In trust situations, insurance premiums are generally paid in one of two ways:

- The insured may transfer substantial assets to the trust to fund future premium payments for a prolonged period; or
- The insured may make periodic smaller gifts to the trust.

The first approach produces a funded insurance trust. Although such trusts are rare and require the insured to make a relatively large immediate gift, they offer a potential tax advantage. Under IRC §677(a)(3), *all* the taxable income of a funded insurance trust (not merely the income used to pay the premiums) is taxable to the insured. Because payment of the income tax is presumably not a taxable gift (despite occasional unsupported contrary assertions by the IRS), this arrangement can produce better overall results than having the insured pay the premiums with proceeds of investments held by the insured. For further discussion, see §3.24.

A variation of the first approach is to make a loan to the trust to pay the premiums, represented by a note for the amount in excess of the available annual exclusions in the year in which the policy is obtained, and then forgive the note in a later tax year, resulting in a taxable gift of the balance of the loan after a second round of annual exclusions. See IRS Letter Ruling 200603002 (finding a gift equal to the principal of the note in the first year because the deferred obligation was part of a prearranged plan to forgive the note when no payments on the note were ever made and the note was forgiven within a few months).

Under the more commonly used second approach, the insured pays the premiums by making periodic gifts to the trust. If the trust provides the beneficiaries with *Crummey* withdrawal powers (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) and thereby qualifies the transfers for IRC §2503(b) $13,000 (plus further cost of living adjustments after 2009) per-donee gift tax annual exclusions, this approach usually provides the best gift tax results as long as the insured is not making other exclusion-qualifying gifts to the same beneficiaries each year. But see §11.14.

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§11.14 G. Holding Sufficient Liquid Assets to Satisfy *Crummey* Withdrawal Demands

A life insurance trust typically provides the beneficiaries with *Crummey* withdrawal powers (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) to qualify transfers to the trust for the IRC §2503(b) $13,000 (plus cost of living adjustments after 2009) per-donee gift tax annual exclusion. This grant of an immediate right of withdrawal is necessary because the annual gift tax exclusion is not available for gifts of future interests. Even if the trust instrument confers the necessary withdrawal power, what happens when the trustee has no way of distributing property to satisfy an exercise of the power? Does this tend to show that the withdrawal power is illusory and therefore ineffective?

This issue may arise in several contexts:

- A trustee pays the insurance premium while the withdrawal right is outstanding, and insufficient cash assets remain on hand to satisfy the withdrawal right;
- The settlor has transferred his or her interest under a group term policy to the insurance trust, and the premiums are paid by the employer; or
- The insurance trust owns a policy subject to a noncontributory split-dollar plan.

(Under the latter two circumstances, the insured is deemed to make a gift when the employer pays the premium.) The issue may also arise when an existing policy is transferred to a multibeneficiary trust if the policy has no cash surrender value and the policy cannot be divided in kind.

In these situations, a court could argue that the net result is the same as that in *Ryerson v U.S.* (1941) 312 US 405, 85 L Ed 917, 61 S Ct 656, in which a gift of property to two or more persons was not considered to be a gift of a present interest because all owners had to join to exercise ownership rights. One or all of the beneficiaries may try to exercise their withdrawal rights, but if there is nothing to give them but a tenant-in-common interest in a policy and the rights to the policy cannot be exercised without the other owners' consent, the beneficiary arguably still has not received a present interest gift. Counterarguments can be made (particularly if the trustee has any ability to borrow money or liquidate the policy interest), but the issue is nevertheless troublesome even though the IRS has shown little inclination to raise the issue.

The IRS, however, ordinarily will not issue an advance ruling on whether a *Crummey* withdrawal power would result in a present interest if the trust is intended to consist primarily of life insurance policies. Rev Proc 2010-3, §4.01(48), 2010-1 Int Rev Bull 110.

PRACTICE TIP: As a safety precaution, the practitioner should ensure that a trust always has sufficient liquid assets to satisfy any exercises of *Crummey* powers. This can be accomplished by making cash gifts to the trust long enough in advance of the premium due date that the withdrawal powers will expire before the premium must be paid. The *Crummey* clause should expressly permit the trustee to satisfy the beneficiary's withdrawal right through recourse to trust assets other than those contributed to the trust at the time. Alternatively, the trust may authorize the trustee to distribute fractional interests in the life insurance policies by providing for discretionary distribution of fractional interests in trust assets. See Zaritzky & Leimberg, Tax Planning With Life Insurance ¶5.03[3][g] (2d ed 1998).

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.15 H. Addressing Generation-Skipping Transfer Tax Problems

§11.15 H. Addressing Generation-Skipping Transfer Tax Problems

The generation-skipping transfer (GST) tax issues related to irrevocable trusts are discussed in chap 4, but several of these deserve additional comment in the context of life insurance trusts. See §§11.16-11.18. See also Blanton & Balakrishna, *Dynasty Trusts and Life Insurance: New Opportunities for Leverage*, 30 Est Plan 407 (Aug. 2003).

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§11.16 1. Avoiding ETIP Periods

If a life insurance trust may make generation-skipping transfers (GSTs), the trust usually must be drafted in a manner that avoids creation of an estate tax inclusion period (ETIP). If the trust becomes subject to an ETIP, an allocation of GST tax exemption by the transferor (including an automatic allocation) is effective no earlier than the termination of the ETIP. Treas Reg §26.2632-1(c).

The practical consequence of this rule is to delay the date for valuing the trust for purposes of determining how much exemption must be allocated to the trust to exempt it from GST tax. For a life insurance trust, the result can be unfortunate because the value of the trust may increase dramatically when the insured dies (or even earlier if the insured becomes terminally ill). Unless precautions are taken to avoid creation of an ETIP, the amount of GST tax exemption needed to exempt the trust may greatly increase (or complete exemption may become impossible).

The ETIP rule is discussed in §4.29. As noted there, IRC §2642(f) defines the ETIP as the period during which the value of the transferred property would be includable (other than by reason of IRC §2035) in the transferor's gross estate under IRC Chapter 11 if he or she died immediately after making the transfer. Under Treas Reg §26.2632-1(c)(1), if any part of a trust is subject to an ETIP, the entire trust is subject to an ETIP.

In the context of the standard life insurance trust, the most likely way of inadvertently creating an undesired ETIP is to give the insured's spouse a general power of appointment in the form of either a standard "five-or-five" annual withdrawal power or a *Crummey* withdrawal power that does not satisfy one of the limitations of Treas Reg §26.2632-1(c)(2)(ii). Generally, any withdrawal power that is a general power of appointment under IRC §2041 will cause an ETIP, but this regulation provides that, for ETIP purposes, property is not considered to be subject to inclusion in the estate of the transferor's spouse:

> if the spouse possesses with respect to any transfer to the trust, a right to withdraw no more than the greater of $5000 or 5 percent of the trust corpus, and such withdrawal right terminates no later than 60 days after the transfer to the trust.

See Treas Reg §26.2632-1(c)(2)(ii)(B). A $10,000 withdrawal power will fail the test whenever that amount is more than 5 percent of the trust corpus. Similarly, a standard five-or-five withdrawal power that permits annual withdrawals by the holder regardless of whether there have been any new transfers to the trust will fail the "not later than 60 days after the transfer" requirement. See Grassi, *Key Issues to Consider When Drafting Life Insurance Trusts*, 28 Est Plan 217 (2001).

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§11.17 2. Planning for Exemption Allocation

As noted in chap 4, the planning of an irrevocable trust requires making some basic decisions regarding the GST tax. If the trust will permit GSTs, it is typically advisable to have a plan for allocating the transferor's IRC §2631 GST exemption to the transfers to the trust, keeping in mind that the IRC §2503(b) annual gift tax exclusion is not available for GST tax purposes if a transfer is made to a trust with more than one beneficiary. IRC §2642(c). See IRS Letter Ruling 200227017. If such a trust has at least one beneficiary who is not a skip person, allocation is usually accomplished by filing gift tax returns because no automatic allocation of GST exemption to the transfers may be made. Treas Reg §26.2632-1(b)(4)(i). For discussion of IRS Form 709 and the notice of allocation requirements, see §4.23.

NOTE: It is uncertain whether GST exemption can be allocated to annual exclusion gifts in 2010. Under the plain language of IRC §2664, the exemption allocation provisions in IRC §2632 arguably do not apply even retroactively to transfers in that year. Accordingly, settlors may wish to postpone creating trusts until the status of the GST tax is resolved. Settlors of existing trusts should consider making loans to the trust (making sure to comply with the requirements of IRC §7872) as needed to pay insurance premiums. The loans can be forgiven later in the year and GST exemption allocated to the resulting gifts, provided the GST tax is restored before the end of 2010.

Application of these complex rules can become more complicated if a trust is funded with term insurance. On the one hand, it will be important for the trust to be exempt from GST tax if the insured dies within the term. On the other hand, it may seem wasteful to have allocated GST tax exemption to a trust that ended up being worthless if the insured survives the term. Late allocations of exemption may appear particularly appealing, particularly in the first policy year, because the value of the policy typically drops rapidly over the first year of the policy. (A wait-and-see approach to exemption allocation is most appropriate in the first year of the policy. If the insured dies, a timely GST tax exemption allocation can be made, retroactively exempting the policy back to the day on which the trust was funded. If the insured is still alive and healthy when the gift tax return is due, the allocation can intentionally be made a day late.)

PRACTICE TIP: The appropriate allocation strategy will vary, depending on such factors as the insured's health (assuming rights to continue or renew the policy, even a term policy may have significant value), the likelihood of future distributions to skip persons, and the contemplated alternative uses of the insured's GST tax exemption. Decisions regarding allocation strategy should be documented to avoid future misunderstandings. Such decisions can be subject to much second guessing, particularly if the insured dies suddenly and the trust is not exempt.

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§11.18 3. Allocating Exemption by Formula

When a policy is transferred to a trust or there is a late allocation of GST tax exemption to a trust, the amount of GST tax exemption that must be allocated to exempt the trust depends on the value of the policy on the relevant valuation date. Because it is often difficult to precisely value the policy in time to make the exemption allocation, it is often advisable to allocate the exemption using a formula. This approach is expressly authorized by Treas Reg §26.2632-1(b)(4)(i).

This approach is particularly advisable when the tax return allocating the exemption must be filed before the insured can obtain a statement of the interpolated terminal reserve value of the policy from the carrier. It also protects against the risk that, if the insured dies suddenly or is diagnosed with a terminal illness, the IRS will contend that the true value of the policy on the date for determining the inclusion ratio was higher than the amount of GST tax exemption allocated on the return, thereby forcing the use of more GST tax exemption if, indeed, it is still possible to fully exempt the trust. For discussion of formula allocations, see §4.23.

A disadvantage of formula allocations is that they create uncertainty about the amount of the settlor's GST tax exemption that remains available for future transactions. Accordingly, the value of the policy should be established as closely as possible even if this task is not completed until after the returns are filed.

PRACTICE TIP: Valuation problems do not occur when the only property transferred to the trust is cash and there is always a timely allocation of exemption to each transfer.

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/ III. FORMS/§11.19 A. Form: Power to Invest in Life Insurance

III. FORMS

§11.19 A. Form: Power to Invest in Life Insurance

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11.19-1 Power to invest in life insurance (trustee not obligated to pay premium)

***Power to Invest in Life Insurance*. Despite any requirements of prudent investing that otherwise apply, the trustee is authorized, but not required, to invest any or all of the trust estate in insurance on the life of any person. The trustee also has the power to exercise all options, benefits, rights, and privileges of an owner of any insurance owned by the trust, including the right to borrow against and to pledge the insurance, to surrender it for its cash value, to name and change beneficiaries, and to select and change settlement options for the exclusive benefit of the trust estate. The trustee is not obligated to take any action to pay any premium on any life insurance policy unless the trustee has actual notice that the premium has not been paid. No trustee, however, may acquire insurance on the life of that trustee or exercise any incident of ownership with respect to a policy on the trustee's life. If the trust estate includes insurance on the life of a trustee for any reason, the other trustees or, if there are none, the next successor trustee shall exercise all incidents of ownership with respect to that insurance.**

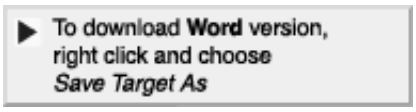
Comment: For the following reasons, the trustee should be authorized, but not required, to own life insurance:

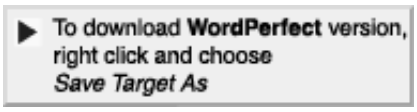
- The trust will own different assets after the insured's death;
- The trust may end up owning other assets even before the insured's death; and
- A requirement to own life insurance will enable the IRS to argue that the settlor is making a transfer of life insurance at the inception of the trust, thereby creating a risk of inclusion in the estate under IRC §2035 if the settlor fails to survive 3 years. See §11.9.

The provision protecting a trustee having no notice that the premium has not been paid is necessary if the settlor or the settlor's employer pays premiums directly despite the *Crummey*-clause liquid asset concerns described in §11.14.

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§11.20 B. Form: Power to Remove and Replace Trustee





11.20-1 Power to remove and replace trustee

***Power to Remove Trustee*. The settlor shall have the power to remove a trustee at any time. When a trustee is removed or at any other time a trustee ceases to act, the settlor may appoint a substitute trustee who shall immediately serve as the trustee, with any otherwise-nominated successor trustee not taking office until the substitute trustee ceases to act. The substitute trustee may not be the settlor or any person or entity related to or subordinate to the settlor within the meaning of Internal Revenue Code §672(c).**

Comment: The settlor usually cannot be the trustee of a life insurance trust. The settlor can, however, retain the limited power to remove and replace the trustee, as set out in this clause. Rev Rul 95-58, 1995-2 Cum Bull 191. See §11.6. When this is desired, this clause may be added to the provisions naming the trustee and providing for successors.

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§11.21 IV. SELECTING APPROPRIATE INSURANCE PRODUCT

As life insurance products become more complex, clients increasingly turn to the estate planner for assistance. The remainder of this chapter provides the reader with an overview of company and product selection. For more detailed discussion, see California Estate Planning, chap 19 (Cal CEB 2002); Zaritsky & Leimberg, Tax Planning With Life Insurance (2d ed 1998). Unfortunately, many life insurance trusts are promoted initially by insurance professionals. Perhaps the most significant problem is that the trustee often has no say in the type of policy, or the amount of the premium, that is to be transferred to or paid by the trustee. If the objective of the trust is to provide a defined death benefit (*e.g.*, to finance an obligation such as buy-sell agreement funding or estate tax liabilities), the trustee must ensure that planned premiums and cash values are adequate to pay future policy expenses until the policy matures at the insured's death. For a discussion of the "ideal" approach (when the trustee has the flexibility to make the appropriate decisions after taking enough time to work up the analysis) versus the "necessary" approach (when the trustee is not able to undertake such due diligence) see Cline, *The Written Investment Plan: Advising Trustees on Investment Planning*, Estate Planning 2008, chap 9 (Cal CEB 2008).

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§11.22 A. Selecting Company

Several services rate life insurance companies, including A.M. Best, Standard & Poor's, Moody's, Duff and Phelps, and Weiss Research. The first four services use information beyond that found in the insurers' annual statements. Weiss Research makes use of additional information when it is available.

Rating reports presented for review should reflect the insurer's current financial condition. If a company's rating has recently been downgraded, the agent should be asked to provide a satisfactory written description of its financial status and the reasons for the reduced rating. Rating reports should help answer the following questions:

- *Does the carrier have adequate surplus?* Surplus is the difference between the carrier's assets and liabilities. The insurance industry uses numerous techniques to compute surplus. The absolute amount of surplus is generally less important than whether the surplus is equal to, less than, or more than the industry average. Both A.M. Best and Moody's publish various industry surplus ratios that can be used for comparison purposes.
- *What quality portfolio does the company hold?* In particular, what percentage of total assets is represented by problem mortgages and junk bonds? Does this percentage exceed industry averages? The answers to these questions are significant because the company's portfolio produces the yield that determines the net cost figures. Many of the rating services take portfolio quality and yield into consideration.

Portfolio analysis is particularly important in the evaluation of companies carrying "second-to-die" insurance. Such companies must perform over a longer period than those carrying single-life policies.

In Belth, Insurance Forum (Sept.-Oct. 1991), former New Jersey Insurance Commissioner Joseph M. Belth recommended that a company be selected if it meets the following two criteria:

- It has a very high rating from at least two of the major rating firms. Very high ratings are A++ from A.M. Best; AAA, AA+, or AA from Standard & Poor's; Aaa, Aa1, Aa2, or Aa3 from Moody's; and AAA or AA+ from Duff and Phelps.
- It does not have a rating below the following from any of the major rating firms: A+ from A.M. Best; AA- from Standard & Poor's; A1 from Moody's; and AA from Duff and Phelps.

For a conservative approach, the author recommends that practitioners add a third criteria: that the company be licensed in the state of New York, which has fairly stringent requirements.

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§11.23 B. Understanding Insurance Products and Illustrations

The material in §§11.24-11.49 is intended to provide the practitioner with basic background information concerning life insurance products and the "illustrations" provided to purchasers. The material is somewhat oversimplified, but present day life insurance policies are so complex and varied that some simplification is necessary.

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§11.24 1. Risk Factors

The goal of every insurance company is to keep premium dollars invested for that period of time and at that rate of return sufficient to permit it to make a profit while maintaining adequate reserves to provide a death benefit when the insured dies.

Policy pricing takes into account four primary risk factors that affect company profitability: (1) "mortality experience" or "claims experience" (see §11.25), (2) "investment experience" (see §11.26), (3) lapse rates (see §11.27), and (4) company expenses (see §11.28). By interacting differently in different policies, these factors determine whether the risks will be retained by the insurance company, shared by the company and the insured, or passed along to the insured.

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§11.25 a. Mortality Experience

Although statisticians cannot determine individual mortality, they can predict group morality with great accuracy. For example, the probability that a 40-year-old male nonsmoker in good health will die within 20 years is 10 percent, while the probability that a 60-year-old male nonsmoker in good health will die within 20 years is 50 percent. Such statistics are often organized into "mortality" or "life expectancy" tables. Insurance companies refer to such statistics as "mortality experience" or "claims experience."

It is important to determine whether the mortality assumptions in the illustration represent the actual mortality experience of the insurance company and, if not, why not? Some insurance illustration software includes an annual decline in mortality experience, based on assumed improvements in medical care. The practitioner should ascertain whether the illustration assumes such future mortality improvements. If so, an alternative illustration should be obtained that does not incorporate such ongoing mortality improvements, so that the effect of such assumptions on the premium will be clearly identified. If two insurers provide illustrations and there is a substantial spread in the mortality assumptions, what facts (*e.g.,* stricter underwriting) justify the assumption that one company will have lower mortality rates than the other? If the insurer claims that strict underwriting is responsible for lower than average mortality experience, does actual experience match the assumed mortality rate?

If mortality is worse than illustrated, the insurer's increased costs are generally passed along to the insured. In term policies, adverse mortality experience is usually passed along by adjusting the illustrated premium up to the guaranteed maximum premium. In most whole life products other than variable insurance, the insurer is able to pass along adverse mortality through a decrease in the crediting rate but not below the guaranteed rate.

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§11.26 b. Investment Experience

The insurer's investment experience directly affects the interest or dividends credited to cash value policies. Whether the insurer's investment experience is a major risk factor depends on the type of policy:

- At one extreme, the typical term policy (lacking in cash values) is not dependent on the insurer's investment experience, except to the extent that investment performance affects the insurer's continued viability.
- At the other extreme, variable policies pass the entire investment risk to the insured.
- In between are all other cash value policies. For these policies, the insurer guarantees a minimum crediting rate, usually between 3 and 5 percent.

Higher crediting rates, however, are almost always used to illustrate policy performance, particularly in vanishing premium illustrations. The insurer bears the risk involved in meeting the guaranteed crediting rates.

Investment risk affects not only the crediting rate but also the safety of the underlying principal. Accordingly, it is necessary to determine the degree of market risk that the insurance company is assuming with invested assets. For more information on this aspect of investment risk, see §11.30.

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§11.27 c. Lapse Rates

Lapse rate is also known as persistency experience. Low lapse rates increase profitability. Insurance companies charge underwriting costs, commissions, and first-year cash values in the year in which the policy is issued rather than amortizing those costs over future years. This practice results in the insurer's losing money in the first year. Insurers with low lapse rates are able to recover first-year costs over the lifetime of the policy. Moreover, most lapses in early years are by persons who are confident of their ability to obtain new insurance; few persons who are uninsurable permit policies to lapse. Companies with low lapse rates also retain a higher proportion of healthy insureds.

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§11.28 d. Company Expenses

The insurer's overhead is the least important of the risk factors. Mortality and investment performance have a greater impact on product performance. Poor management practices may, however, result in a decreased crediting rate. The insurer's expenses are reflected in the discussion of earnings in most rating reports.

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§11.29 2. Insurance Products

Insurance policies may be divided into two fundamental categories: term and whole life. Within each category are numerous variations, caused by product design and/or add-on riders. In reviewing the discussion in §§11.30-11.42, the reader should note how the various risk factors operate in different types of policies.

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§11.30 a. Term Insurance

Term insurance is temporary insurance that provides coverage for a limited period of time or term. It provides pure insurance protection without any buildup of cash value. Term insurance is the least expensive form of insurance in early years. Because it is age based, however, term insurance becomes more expensive with every renewal.

Term insurance tends to be the most sensitive of all insurance products to fluctuations in the risk factors. Most term policies are sold based on a current or illustrated rate schedule and a higher guaranteed schedule of maximum premiums that may be charged. The insurance company may increase the premiums each year to reflect changes in the risk factors (*e.g.,* actual market return and mortality experience of the company) up to the maximum guaranteed premium. Typically, the maximum guaranteed premium is substantially higher than the premium illustrated by the insurance company. If the company's underwriting practices are poor and the company insures many bad risks, the premiums are likely to be increased up to the maximum guaranteed premium.

Term insurance is either renewable or nonrenewable. The extra cost of a renewable term is often offset by the increased flexibility and security of being able to maintain coverage if the insured becomes uninsurable for any reason. Most renewable policies offer a conversion rider, permitting the policy to be converted to whole life without evidence of insurability. Although some term policies renew to age 90, they may become so expensive that they are impractical for long-term estate-planning solutions.

Another variation is return of premium (ROP) term insurance that, for an additional premium, guarantees a 100-percent tax-free return of premiums paid (recovery of basis) at the end of the term period. An ROP term policy may be owned by a life insurance trust, and this will not prevent a return of premiums to the insured at the end of the term period, assuming the insured is still alive. This can be accomplished by making loans to the trust equal to the amount of the annual premiums to be repaid by the trustee who will recover premiums paid by surrender of the policy or by giving an independent person a limited power of appointment to distribute trust assets to the grantor. However, the grantor should not be given a right to recover premiums paid from or secured by the policy that could cause inclusion of policy proceeds in the grantor's estate. See Saks, *Return of Premium Term Insurance Offers Guaranteed Cash Value,* 35 Est Plan 14 (Oct. 2008); Finn, *Avoiding the Potential Catch-22 of Private Non-Equity Split Dollar,* 35 Est Plan 30 (Nov. 2008).

As a general rule, term insurance is not competitive with whole life insurance if it is maintained for more than ten years. On the more popular variations of term insurance, see §§11.31-11.34.

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.31 (1) Annual Renewable Term

§11.31 (1) Annual Renewable Term

An annual renewable term contract provides fixed coverage for the present year and guarantees the right to renew for the following year at a specified rate. It is usually not appropriate for a life insurance trust to own annual renewable term insurance.

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§11.32 (2) Level Term

In a level term contract, the policy is written for a fixed period of years and total premiums for the entire period of coverage are divided into equal installments. Popular types include 5-year convertible and renewable term, 10-year convertible and renewable term, and term to age 65.

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§11.33 (3) Decreasing Term

In decreasing term contracts (also known as declining balance term contracts), premiums remain constant over the period of coverage, but the amount of coverage decreases annually. These policies are usually used to ensure payment for a similarly declining mortgage balance or to provide a fixed monthly income until a specified date.

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§11.34 (4) Modified Term

Modified term contracts are usually set up to function as term insurance for 5 to 10 years and then to automatically convert to whole life or permanent insurance.

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§11.35 b. Whole Life Insurance

Whole life insurance features premiums that are fixed rather than increasing with age. As a general rule, premiums are payable for the life of the insured or until the policy endows (policy reserves equal face amount of the policy), usually at age 100. (Mortality tables commonly assume that all insureds die in the year between ages 99 and 100. The premiums are structured so that the combination of the premium payments and the guaranteed minimum crediting rate will result in the policy reserves equaling the face amount of the policy at that age.)

The level premium system results in the insurer's collecting more in a policy's early years than the company needs to pay claims in those years. In the policy's later years, increased mortality results in less being collected than needed to pay claims, but the shortfall is covered by the earnings on the excess premiums collected in earlier years.

Premium payments are divided between risk protection (mortality) and an investment account. The risk portion represents term insurance, and the investment portion acts as a savings account inside the policy (commonly known as cash value). The cash value is a liquid asset available to the policy owner through borrowing or surrendering the policy. The cash value is usually free from current income taxes while the policy is in force because of tax-favored treatment. When the policy is surrendered for its cash value, income taxes are due only on the amount that exceeds the total premium paid less dividends received.

In ordinary whole life insurance, the company cannot increase the premiums to reflect actual mortality experience. The illustrated premium structure that forms the basis on which many whole life policies are sold usually assumes, however, that the company will credit the cash value of the policy with annual dividends or interest in excess of the minimum guaranteed, with the excess dividends or interest being used to offset the premiums, thereby decreasing the number of years that the premium must be paid by the policy owner. This concept is often described in terms of the number of years that the premium must be paid before it "vanishes."

The vanish date is not guaranteed, however. The company may reduce the amount of dividends or interest credited to the policy to a minimum guaranteed level if it is unable to attain the illustrated investment yield, expenses increase, or it experiences increased mortality. As a result, the number of years that the premium must be paid may increase substantially over the number of years illustrated if the policy is to be kept in force for the insured's lifetime. Moreover, if the product is current assumption (interest-sensitive) whole life, premiums can be adjusted up to a guaranteed maximum. Similarly, poor mortality results or decreased profitability in a blended whole life policy may also result in an increase in the annual premium attributable to the term component, with the result that the premium will once again not be fixed but may increase with age.

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§11.36 (1) Limited-Pay Whole Life Insurance

Level premium whole life insurance features a premium payable for the life of the insured or until the policy endows. In limited-pay whole life insurance, the premium is designed to be payable over a period shorter than the insured's lifetime. Because the insurer must collect the same actuarial amount under either type of policy to create the required reserves, the premiums payable for the same protection under a limited-pay whole life policy are greater than those payable under a level term policy providing the same protection. Single premium insurance is a form of limited-pay whole life insurance.

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.37 (2) Current Assumption (Interest-Sensitive) Whole Life Insurance

§11.37 (2) Current Assumption (Interest-Sensitive) Whole Life Insurance

Current assumption (also known as interest-sensitive) whole life insurance features a level premium that remains fixed for only a specified period of time, usually three to five years. At the end of the specified period, the amount of the premium and possibly the death benefit will be redetermined based on the actual cash value of the policy, which is a function of the crediting rate declared by the insurer during that fixed period.

Because the crediting rate is a function of the investment return of the insurer as well as mortality experience and expenses, an interest-sensitive policy is sensitive not only to investment performance but also to risk factors, including mortality experience and expenses. If investment performance, mortality experiences, and expenses are poor, the insurer may increase the premium up to a guaranteed maximum, represented by the minimum interest guaranty and the maximum mortality charges set forth in the policy.

If the insurer increases the premium, the owner has the option to:

- Continue paying premiums at the old level and reduce the death benefit;
- Pay the increased premium and keep the death benefit level; or
- If there is sufficient cash surrender value, pay premiums at the old level and augment those payments through use of the policy's cash values.

If the insurer reduces the premium, the owner has the option to:

- Continue paying premiums at the old level and increase the death benefit, subject to proof of insurability;
- Continue paying premiums at the old level, keep the death benefit level, and increase the cash value of the policy, effectively creating a vanishing premium once cash values increase to the requisite level; or
- Pay the lower premium and maintain the death benefit at its present level.

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§11.38 (3) Blended Whole Life/Term Insurance

As its name implies, blended whole life/term insurance is a combination of whole life (often referred to as the "base") and term insurance. The policy is designed so that dividends or interest paid on the base will be used to buy paid up additions (additional paid up whole life insurance) that will ultimately replace the term component.

A blended product is substantially more sensitive to the risk factors than an all-base product because many insurers provide that the guaranteed maximum annual premium applicable to the term component is in effect for only a limited number of years. The insured takes the risk that, if the company has poor mortality or investment experience after the guaranty expires, (1) there will be insufficient funds to buy paid up additions and (2) the company will substantially increase the term premium. As a result, the premium in a blended product does not feature the guaranteed level premium found in other whole life products.

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.39 (4) Joint Lives Life Insurance

§11.39 (4) Joint Lives Life Insurance

Joint lives insurance provides "second-to-die" or "first-to-die" coverage:

- Second-to-die contracts are frequently used in irrevocable life insurance trusts and in conjunction with wealth replacement trusts. Some companies issue policies up to the combined insureds' net worth to accommodate the funding of the wealth replacement trust. The joint lives policy is usually less expensive than two separate policies and is appropriate to consider when the practitioner is looking for proceeds at the survivor's death. The policies can be paid up at the first death, or premiums can continue until the second death. Premiums can be paid for life or be structured to vanish. Some companies write these policies on a term basis. Such term policies usually offer a conversion feature. Some companies offer the second-to-die feature as a rider to a primary single insured policy.
- First-to-die contracts also insure joint lives, but the proceeds are payable at the death of the first spouse to die. The total premium cost is usually substantially less than separate policies on both lives because only one death benefit is payable.

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§11.40 (5) Universal Life Insurance

In all forms of whole life insurance other than universal life, premiums are payable for the insured's life (or for a shorter fixed period when limited-pay whole life is involved) in fixed amounts and on a fixed schedule. Universal life, often referred to as "flexible premium adjustable life," features premiums in which both the frequency and amount of premium payments are flexible within prescribed limits. The owner may skip making premium payments as long as the cash value of the policy is sufficient to cover mortality and expenses each month. In other forms of whole life, a skipped premium is treated as a policy loan. If the cash value of a universal life policy is allowed to drop below this level, however, the future contributions that will be required to keep the policy in effect will be substantially similar to the cost of annually increasing term insurance and the cost of maintaining the policy may become prohibitive. Moreover, if the cash value is allowed to drop below the level necessary to keep a universal life policy in force, the policy terminates and a new policy must be purchased, with the premiums based on the insured's increased age.

Thus, universal life does not guarantee any given death benefit beyond the first month or year of the policy unless sufficient premiums are paid to maintain the cash value (known as the accumulation account) at an adequate level. In some universal products, cash values build more rapidly than with other whole life variations as a result of back-end loading. Most whole life policies recover initial policy costs (*e.g.,* commissions, underwriting) from the initial premiums, a practice known as front-end loading. Some universal life policies defer recovery of initial policy costs until the later years of the policy, thereby permitting cash values to increase more rapidly. The policy owner can raise or lower the death benefit without obtaining a new policy. Increases usually require new evidence of insurability.

Universal life policies offer a choice between a level death benefit or a death benefit that automatically adds the current cash value to the regular proceeds. The policy owner has access to the cash values via loans or withdrawals. In traditional whole life, the policy owner has access to the cash values only via loans. Because a universal policy may be viewed as a term policy accompanied by a side fund, it is the most sensitive of all whole life products to the risk factors.

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§11.41 (6) Variable Life Insurance

All the whole life products discussed in §§11.35-11.40 are general account policies, *i.e.*, the investment component (customarily referred to the "cash value") of the policies is represented by assets that are part of the insurer's overall funds. In a variable policy, the cash value of the policy is represented by a separate investment account administered by the insurer but selected by the owner of the policy.

The owner usually has the option to select various mutual-fund-like investments, *e.g.,* stocks—aggressive, stocks—conservative, bonds—long term, bonds—intermediate term, bonds—short term, government securities, total return accounts (*e.g.,* stocks, bonds, cash), money market accounts, guaranteed fixed interest accounts, and real estate accounts. The investment account is legally separate from the insurer's funds and is not subject to the claims of the insurer's creditors. The investment risk is shifted to the insured, and cash values are not guaranteed. Unlike general account policies in which the amount credited to cash values is determined periodically by the insurer, the actual performance of the variable policy investment account passes through to the insured, minus a fixed administrative charge. Thus, the risk of increased mortality or poor general account investment performance is shifted to the company.

The policy may be structured with fixed or (in the case of variable/universal) flexible premiums. The death benefit may fluctuate based on the performance of the underlying investments, but as long as the annual premium is paid, the death benefit will not drop below a guaranteed minimum, which is usually the face amount.

Increased administrative costs tend to make variable policies more expensive than general account policies. In theory, the extra cost is offset by the passthrough of the increased earnings of the investment account. Because the death benefit will usually increase proportionately to the cash value of the policy, variable insurance provides a hedge against inflation. The agent must have a variable annuity license, and all illustrations should be accompanied by a current prospectus.

PRACTICE TIP: Variable insurance is appropriate only if the owner is able to monitor the investments, has a tolerance for investment risk, and intends to hold the policy for at least 10 years. For this reason, variable insurance may be inappropriate for a successor trustee of an irrevocable life insurance trust subject to the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054). In *Stuart Cochran Irrevocable Trust v Keybank* (Ind App 2009) 901 NE2d 1128, for example, the beneficiaries contended that the successor trustee violated the state's version of the UPIA by imprudently delegating certain decision-making authority to the settlor's insurance advisor when the trustee approved an exchange of existing policies providing $4.7 million in death benefits for variable universal life (VUL) policies providing a death benefit of $8 million that were later exchanged for a long-term policy with a guaranteed death benefit of $2.5 million after the VUL mutual fund investments suffered significant losses. Although the court held that the successor trustee had not violated the UPIA in exchanging policies, the decision illustrates the investment risks and hazards of variable life insurance. For further discussion, see Medlin, *Trustee Warnings About ILITs,* 21 Prob Prac Rep 1 (Apr. 2009).

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.42 (7) Variable/Universal Life Insurance

§11.42 (7) Variable/Universal Life Insurance

Variable/universal life insurance is a hybrid that combines the investment flexibility of variable life with the premium and face amount flexibility of universal life.

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§11.43 3. Illustrations

After a life insurance company has been selected, "illustrations" are presented for various policies. A life insurance illustration is a scenario based on a specific set of assumptions involving the company's anticipated mortality experience, investment performance, and expenses.

For example, an illustration showing the performance of a policy based on a 9-percent crediting rate illustrates the cost and performance of that policy if the company's expenses and earnings meet a specified goal each year and the company's mortality or claims experience is at least as good as projected. The insurance company does not, however, guarantee that future claims, investment experience, and expenses will be as shown in the illustration.

If the company's claims, investment experience, and expenses are worse than illustrated, one of two possible scenarios will result:

- The company will reserve the right to increase the premium to be charged for the policy, up to a guaranteed maximum; or
- The premium will remain level, but the number of years that it must be paid will increase.

As a general (but not absolute) rule, increases in the amount of the premium will occur with respect to the term component, while increases in the number of years that the premium must be paid will occur with respect to the whole life component.

Most insurance illustrations contain footnotes or other annotations that divulge whether the premium being illustrated is the guaranteed maximum. If the illustrated premium is not the guaranteed maximum or the illustration does not permit determination of the guaranteed maximum, a new illustration should be prepared that sets forth this information. Typically, the premium illustrated for a term policy is not the guaranteed maximum. The premium illustrated for a whole life policy may or may not be the guaranteed maximum.

When reviewing an illustration, the practitioner should bear in mind that the illustration assumes that the company will attain a specific profit goal and will credit the policy with a certain percentage rate of return for the life of the policy. The practitioner should always ask for an alternative illustration with reductions of 100 basis points or a 1-percent drop in the rate and 200 basis points or a 2-percent drop in the rate.

Using the Best's report for the company in question, the practitioner should take the following steps:

- Determine the company's current net return.
- If the illustration is projecting a higher interest rate being credited than what the company is currently earning, request a written explanation for this optimistic forecast.
- Determine whether the rate of return that the company is earning is being computed using a portfolio or a new money basis. A portfolio approach takes into consideration all assets; a new money approach applies the rate at which the carrier can currently invest assets. If interest rates are declining, the portfolio approach tends to overstate probable future earnings because older assets that are producing a higher rate of return tend to average out the declining interest rates on new investments. If the market is rising, the new money approach tends to exaggerate the company's earnings because new investments will not be burdened with the lower overall return of the company.

On steps to take if the policy being illustrated appears much less expensive than competing policies, see §§11.44-11.49.

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§11.44 a. Term Insurance

The practitioner should ask the following questions if a term insurance policy appears much less expensive than competing policies:

- *Over what period is the illustrated premium guaranteed?* Some term policies guarantee the illustrated premium for only the first year. Other term policies (known as level term policies) guarantee the illustrated premium for the first three, five, ten, fifteen, or twenty years. Once the illustrated premium is no longer guaranteed, the company is free to raise that premium to reflect actual claims, investment experience, and expenses—but not in excess of the guaranteed maximum gross premium.
- *What is the maximum premium that may be charged, and how often may the premium be adjusted?* Some term policies permit the carrier to increase premiums on each anniversary. Adjustments are permitted less frequently for other policies.
- *Can the policy be converted to permanent coverage and up to what age?*
- *Does the policy provide for waiver of premiums in the event of disability?* If so, does coverage continue for life or terminate at the end of the stated term of the policy?

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.45 b. Whole Life Insurance

§11.45 b. Whole Life Insurance

The practitioner should ask the following questions if a whole life insurance policy appears much less expensive than competing policies:

- *If a blended product is illustrated, is the illustrated premium the guaranteed maximum?* If not, what is the guaranteed maximum?
- *If current assumption (interest-sensitive) whole life insurance is illustrated, is the illustrated premium the guaranteed maximum?* If not, what is the guaranteed maximum?
- *What interest or dividend-crediting rate is being assumed in the illustration?*
- *Is the company currently meeting that rate, and has it been meeting it in the past?* For how long? Based on the practitioner's assumptions about the state of the economy, is it reasonable to assume that the insurance company will be able to meet that interest or dividend rate assumption in future years?
- *Is the yield assumption credible?* If two insurers provide illustrations and one is based on a substantially higher yield assumption than the other, what facts justify the assumption that one company will be more profitable than the other?
- *What will be the result if the company is unable to credit the policy with the illustrated yield?* If the product is "pure" whole life and the illustration shows that the premium will "vanish" after a specified number of years, the effect of the company's failure to meet the illustrated interest or dividend rate will result in an increase in the number of years that the premium must be paid before it vanishes, if ever. If the product is blended whole life and the illustrated premium is not the guaranteed maximum for the term component, the company's failure to meet the illustrated rate will result in an increase in the number of years that the premium must be paid, increasing the annual premium up to the guaranteed maximum, or both. The practitioner should have new illustrations prepared showing the effect of decreasing the crediting rate in 1-percent increments.
- *Is the current illustrated crediting rate being credited to existing policies?* Some insurers credit new policies with a higher interest or dividend rate than existing policies. If so, find out why. Do differences in product types justify different crediting rates or is the insurer engaged in a sharp practice of illustrating unreasonably high crediting rates during the first year to attract new business?

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§11.46 c. Blended Insurance

If a blended insurance policy appears much less expensive than competing policies, the practitioner should ask the questions discussed in §11.44 about the term component and the questions discussed in §11.45 about the whole life component.

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.47 d. Second-to-Die Insurance

§11.47 d. Second-to-Die Insurance

In addition to the questions outlined in §§11.44-11.46, second-to-die insurance raises the following special questions:

- *Are nonguaranteed bonus credits or termination dividends included in the illustration?* To induce high persistency (policies that remain in effect for many years), some insurers offer "termination dividends" (a dividend payable at surrender or death) or "bonus" credits (extra interest being credited after the policy has been in effect for a specified number of years) on second-to-die policies. As a general rule, termination dividends are not guaranteed. Some bonus credits may be guaranteed. If the dividends or credits are not guaranteed, the illustration should be resubmitted without the credits and dividends.

PRACTICE TIP: In the author's experience, some insurers tend to exaggerate their mortality, yield, and bonus assumptions for second-to-die insurance.

- *If the first spouse to die passes away considerably earlier than his or her actuarial life expectancy, will otherwise "vanished" premiums reappear?*

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Source: Estate Planning/Drafting California Irrevocable Trusts/11 Life Insurance Trusts/§11.48 e. Variable Insurance

§11.48 e. Variable Insurance

The practitioner should ask the following questions if a variable insurance policy appears much less expensive than competing policies:

- *What investment funds are available, and what has been their performance?* There is substantial diversity in the investment funds made available by different insurers. What has the fund's past performance been? How long has the fund been in existence? Who manages the fund, and what is his or her track record?
- *What are the estimated gross yield and the illustrated costs?* Is the spread between gross and net guaranteed? Is the estimated gross yield reasonable? If the gross yield differs in different illustrated variable products, the practitioner should determine the reason for the difference. The illustration will show costs deducted from the gross yield. Costs include investment advisory fees, fund operating expenses, mortality, and risk charges. Are the illustrated costs guaranteed, or does the insurer reserve the right to increase costs up to a guaranteed maximum?
- *Are the correct investment funds illustrated?* The advisory fees and other costs may differ significantly between funds.
- *Is the death benefit guaranteed?* Will the death benefit be payable even though the investment funds perform significantly below the illustration? Some but not all variable policies guarantee payment of the stated death benefit if a specified minimum level of premiums has been paid or a separate rider is purchased at additional cost.

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§11.49 4. Obtaining Information

The American Society of Chartered Life Underwriters and Chartered Financial Consultants, a national organization of insurance and financial service professionals, has developed the Life Insurance Illustration Questionnaire (IQ) as an educational tool to help professionals and consumers understand the different nonguaranteed performance assumptions used by insurance companies in the design of policies and the creation of illustrations. The IQ consists of 25 questions directed to the insurance company.

According to the introduction to the IQ:

> The purpose of the IQ is to help the student of life insurance understand the different non-guaranteed performance assumptions which insurance companies use to design and create sales illustrations. It has been developed primarily for non-SEC regulated products. Students should understand that sales illustrations are useful in developing the best combination of policy specifications to achieve the buyer's objective. However, illustrations have little value in predicting actual performance or in comparing products and companies.
>
> Most life insurance products sold today have adjustable pricing. This can be accomplished either as a traditional "participating" product or as a product with "non-guaranteed pricing elements" such as changeable interest crediting rates, mortality charges, expense charges, etc. All adjustable pricing products incorporate some guarantees. However, the sales illustrations are usually designed to present potential benefits and costs under a set of non-guaranteed assumptions more optimistic than the guarantees. The insurance company generally limits its responsibility to the guarantees. So the risks associated with the inability of a product to achieve the higher illustrated benefits, or lower illustrated costs, than those generated by the guarantees are borne by the policy holder. A study of the responses to the IQ should help the student better understand those risks.
>
> It is recommended that the IQ be submitted for each company on whose behalf an illustration is presented.

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12

Trusts for Minors

Monica Dell'Osso
Betty J. Orvell

I. TRANSFERS TO MINORS
- A. Scope of Chapter §12.1
- B. Tax Aspects of Gifts to Minors §12.2
  - 1. Gift Tax §12.3
  - 2. Estate Tax §12.4
  - 3. Income Tax §12.5
  - 4. Generation-Skipping Transfer Tax §12.6
- C. Nontax Aspects of Gifts to Minors §12.7
  - 1. Minor's Legal Disability §12.8
  - 2. Child's Ability to Manage Assets §12.9
  - 3. Impact on Child's Incentive §12.10
  - 4. Donor's Loss of Control Over Assets §12.11

II. OUTRIGHT GIFTS AND DIRECT PAYMENTS FOR EDUCATION AND HEALTH
- A. Outright Gifts
  - 1. Legal and Tax Aspects §12.12
  - 2. Advantages and Disadvantages §12.13
- B. Direct Payments for Health and Education (IRC §2503(e)) §12.14
- C. Pay on Death (POD) and Totten Trust Accounts
  - 1. Legal and Tax Aspects §12.15
  - 2. Advantages and Disadvantages §12.16
- D. Joint Tenancy
  - 1. Legal and Tax Aspects §12.17
  - 2. Advantages and Disadvantages §12.18
- E. Guardianships
  - 1. Legal and Tax Aspects §12.19
  - 2. Advantages of Guardianship §12.20
  - 3. Disadvantages of Guardianship
    - a. Termination at Age 18 §12.21
    - b. Transfer of Property if Minor Dies §12.22
- F. Custodianships Under California Uniform Transfers to Minors Act
  - 1. Establishment of Custodianship §12.23
  - 2. Powers of Custodian §12.24
  - 3. Liability of Custodian §12.25
  - 4. Substitute Custodians and Successor Custodians
    - a. Designation of Substitute Custodian §12.26
    - b. Designation of Successor Custodian §12.27
  - 5. Form: Creation of Custodianship by Transferor §12.28
  - 6. Form: Designation of Successor Custodian by Current Custodian §12.29
  - 7. Termination of Custodianship §12.30
    - a. Gift Tax §12.31
    - b. Estate Tax
      - (1) When Donor Is Custodian §12.32
      - (2) Under Reciprocal Trust Doctrine §12.33
    - c. Generation-Skipping Transfer Tax §12.34
    - d. Income Tax §12.35
  - 8. Advantages of Custodianship §12.36
  - 9. Disadvantages of Custodianship §12.37
- G. Qualified Tuition Programs §12.37A
- H. Coverdell Education Savings Accounts §12.37B

III. TRUSTS FULLY QUALIFYING UNDER IRC §2503(c) (MINORS' TRUSTS)

A. Introduction to Minor's Trusts §12.38
B. Requirements for Qualification
1. No Substantial Restriction on Trustees' Power to Distribute Property to Minor §12.39
a. Consideration of Minor's Other Resources §12.40
b. Prohibition Against Use of Property for Legal Support §12.41
c. Discretionary Sprinkling Power §12.42
2. Distribution of Property at Age 21 §12.43
3. Distribution of Property on Minor's Death §12.44
a. Distribution to Minor's Estate §12.45
b. General Power of Appointment §12.46
c. Taker in Default §12.47
d. Limited Power of Appointment §12.48
C. Tax Aspects of §2503(c) Trusts
1. Gift Tax; Need for Separate Trusts §12.49
2. Estate Tax
a. Death of Beneficiary §12.50
b. Death of Settlor
(1) Trust Assets Generally Not Included in Settlor's Estate §12.51
(2) Inclusion When Assets Used to Meet Settlor's Duty of Support §12.52
(3) Risks When Settlor Has Power to Appoint Successor Trustee §12.53
(4) Inclusion When Settlor-Trustee Has Broad Discretion Over Income Distribution §12.54
3. Generation-Skipping Transfer Tax §12.55
4. Income Tax §12.56
5. Trusts Continuing After Age 21 §12.57
D. Distribution of Income and Principal to Living Child
1. Form: Division of Trust Estate §12.58
2. Form: Discretionary Payment of Income and Principal Before Child Attains Age 18 or 21 §12.59
3. Form: Outright Distribution to Living Child at Age 18 or 21 §12.60
4. Form: Child's Power to Terminate Trust After Attaining Specified Age §12.61
E. Form: Distribution When Child Dies
1. Form: Distribution to Child's Estate §12.62
2. Form: Distribution According to Beneficiary's Power of Appointment §12.62A
F. Advantages and Disadvantages §12.63

IV. SECTION 2503(b) TRUSTS (INCOME INTERESTS ONLY QUALIFYING FOR ANNUAL EXCLUSION)
A. Introduction
1. "Income Interest Only" Qualification §12.64
2. Valuing the Income Interest §12.65
3. Tax Benefits Versus Nontax Objectives §12.66
B. Features of §2503(b) Trusts
1. Standard Trust: Current Income Interest Combined With Post-Age-21 Principal Distribution §12.67
2. *Herr* Trusts: Accumulation of Pre-Age-21 Income for Single Beneficiary §12.68
a. Description and Tax Aspects §12.69
b. Qualification of Post-Age-21 Income Interest §12.70
C. Combination of §2503(b) Trust and CUTMA §12.71
D. Tax Aspects of §2503(b) Trusts
1. Gift Tax §12.72
2. Estate Tax §12.73
3. Income Tax §12.74
4. Generation-Skipping Transfer Tax §12.75
E. Form: *Herr* Trust—Distribution of Income by Age 21 §12.76
F. Form: Distribution of Post-Age-21 Income §12.77
G. Form: Distribution of Balance if Beneficiary Dies Before Age 21 §12.78
H. Form: Discretionary Early Distribution of Principal §12.79

V. *CRUMMEY* TRUSTS
A. Introduction and Description §12.80
B. Requirements for Annual Exclusion
1. Minor Beneficiaries §12.81
2. Right of Withdrawal §12.82
a. Notification of Withdrawal Rights
(1) Importance of Written Notice §12.83
(2) Persons Receiving Notice §12.84
(3) Form: Notice to Beneficiary §12.85

b. Period of Withdrawal Right §12.86
c. Amount of Withdrawal Right §12.87
(1) Spouse's *Crummey* Power §12.88
(2) Analyzing Excess Lapse Issues §12.89
(3) Avoiding Excess Lapses §12.90
(4) Multiple Trust Problems §12.91
d. Liquid Assets to Satisfy Withdrawal Power §12.92
e. "Naked" *Crummey* Powers
(1) IRS Disapproval of Naked Powers §12.93
(2) *Cristofani* Ruling: Exclusion Allowed Despite Remote Remainder Interest §12.94
(3) Post-*Cristofani*: IRS Renewed Challenge to Naked *Crummey* Power §12.95
C. Withdrawal Provisions
1. Form: No Excess Lapse Protection §12.96
2. Form: Withdrawal Limited to "5 or 5" §12.97
3. Form: "Hanging" *Crummey* Power §12.98
D. Tax Consequences
1. Income Tax
a. Settlor §12.99
b. Beneficiary §12.100
2. Gift Tax §12.101
a. "5 or 5" Limitation §12.102
b. No Gift if Powerholder Is Beneficiary or Has General Power of Appointment §12.103
c. Avoiding Gift Taxation by Use of "Hanging" *Crummey* Power §12.104
3. Estate Tax
a. Beneficiary §12.105
b. Settlor §12.106
4. Generation-Skipping Transfer Tax
a. Beneficiary §12.107
b. Settlor §12.108
5. Gift Tax; Lapse of Withdrawal Power §12.109
6. Use as Sprinkling Trust §12.110

VI. INCENTIVE TRUSTS (NON-§2503 TRUSTS)
A. Introduction and Description §12.111
B. Nontax Incentive Planning With Trusts for Children §12.112
C. Income Tax Aspects of Non-§2503 Incentive Trusts §12.113
D. Transfer Tax Aspects
1. Gift Tax §12.114
2. Estate Tax §12.115
3. Generation-Skipping Transfer Tax §12.116
E. Incentive Trust Provisions
1. Form: Conditions for Distribution §12.117
2. Form: Distributions for Medical Emergency §12.118
3. Form: Right of Withdrawal at Specified Ages When Child Has Complied With Incentive Provisions §12.119
4. Form: Manner of Distribution to Child Exercising Right of Withdrawal and When Child Dies Without Exercising Right of Withdrawal §12.120
5. Form: Child Not in Compliance With Incentive Provisions at Specified Ages §12.121

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I. TRANSFERS TO MINORS

§12.1 A. Scope of Chapter

This chapter surveys the common planning devices used in making transfers of income and assets to minors. Other chapters in this book are also relevant to structuring gifts to minors, and the planning strategies covered in those chapters are briefly described or referred to here. Although this chapter focuses on the irrevocable trust (primarily the IRC §2503(c) minor's trust and the *Crummey* trust), other wealth-transfer strategies are briefly discussed along with their advantages and disadvantages.

This chapter presents an overview of the tax and nontax aspects of transfers to minors and provides practical advice about implementing such transfers.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.2 B. Tax Aspects of Gifts to Minors

§12.2 B. Tax Aspects of Gifts to Minors

The tax implications of gifts to minors are of major concern. In fact, tax benefits are often the primary factor in the donor's decision to make such a gift.

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§12.3 1. Gift Tax

Gifts in excess of the annual exclusion to any one child during a calendar year, regardless of the form in which the gift is made, are taxable gifts. It is therefore appropriate in structuring transfers to take advantage of the annual exclusion to minimize or eliminate the taxable gifts that would otherwise occur. With limited exceptions, the annual exclusion applies if the donee receives a present interest in the property. IRC §2503(b); Treas Reg §25.2503-3. Outright gifts to children or transfers to custodians on the children's behalf will qualify for the exclusion. If the gift is made in trust, the annual exclusion is available if the beneficiary is given a limited withdrawal right. *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82.

Each taxpayer has a federal estate and gift tax credit that allows transfer of the applicable exclusion amount at death without estate tax and allows transfer of $1 million during the taxpayer's lifetime without gift tax. The estate tax is repealed in 2010 and restored in 2011 with an applicable exclusion amount of $1 million. See IRC §§2010(c), 2210 (estate tax), 2505(a) (gift tax). To the extent that gifts do not qualify for the annual exclusion they will reduce the estate and gift tax credit available, and may consume up to $1 million of the estate tax applicable exclusion amount.

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§12.4 2. Estate Tax

Inter vivos transfers to children can be effective in reducing estate taxes. A common reason for making such gifts is to eliminate from the donor's gross estate any future appreciation in the value of the asset. The future income derived from the asset is also removed from the donor's estate. Only the date of gift value of the asset, less the amount of the allowable gift tax annual exclusion, is included in the donor's tax base when computing the estate tax.

Another advantage of making lifetime gifts is that the amount of any gift tax paid will usually not be included as part of the donor's estate. The fact that the gift tax is not so included can mean a significant savings, particularly in larger estates. An exception to this rule exists, however, for gifts made within 3 years of the donor's death. The gift tax on any gifts made within this period will be included in the donor's gross estate, even though the gift itself is not included. IRC §2035(b).

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§12.5 3. Income Tax

Inter vivos gifts to children, either outright or in trust, are generally ineffective in shifting taxable income because of the "kiddie tax" (see IRC §1(g)) and the compacted income tax rates for trusts (see IRC §1(e)). The kiddie tax applies to the net unearned income of a child who has not reached age 19 (age 24 in the case of a student) and who has at least one living parent, both determined as of the last day of the taxable year. IRC §§1(g)(2), 152(c). However, the kiddie tax does not apply if the child files a joint return for the taxable year. IRC §1(g)(2). Unearned income is all income not attributable to wages, salaries, or other amounts received as compensation for personal services. The net unearned income in excess of an inflation-adjusted amount, reduced by the greater of the child's standard deduction or the itemized deductions allocated to such income, is subject to tax at the parents' top marginal rates. IRC §1(g)(4). For these purposes, distributions from a "qualified disability trust" are considered earned income. IRC §1(g)(4)(C). For further discussion of the kiddie tax, see §§3.19-3.20. For discussion of special needs trusts, see chap 13.

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§12.6 4. Generation-Skipping Transfer Tax

The generation-skipping transfer (GST) tax is imposed whenever a transfer is made to a skip person. A skip person is one who is two or more generations below that of the transferor, unless the transfer qualifies as an outright gift to which the annual exclusion applies or the GST tax is subject to one of several exceptions. See §§4.5, 4.14-4.16.

GST tax considerations applicable to gifts to minors are discussed in §§12.34 (custodianships); 12.55 (IRC §2503(c) trusts); 12.75 (IRC §2503(b) trusts); 12.108-12.109 (*Crummey* trusts); and 12.117 (incentive trusts). For full discussion of GST tax considerations, see chap 4.

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§12.7 C. Nontax Aspects of Gifts to Minors

In certain circumstances, tax considerations may be less critical than issues related to the child's ability to handle the assets, the impact that the gift will have on the child, and the willingness of the transferor to relinquish control of the asset. If the child has particular difficulties (*e.g.,* mental or physical illness or substance abuse), they must clearly be considered in the planning. These factors will influence not only the decision to make the gift but also the manner in which the gift is structured.

It is essential that the attorney review with the client the nontax aspects of the gift. The attorney's task is to ensure that the donor is aware of and examines carefully all ramifications of the proposed gift.

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§12.8 1. Minor's Legal Disability

While the child is a minor, gifts of any significance will usually be made through a trust, custodianship, or guardianship. Aside from the minor's lack of maturity to handle assets, legal limitations on his or her ability to deal with the property make a fiduciary arrangement necessary. See discussion in §12.13.

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§12.9 2. Child's Ability to Manage Assets

Once the child reaches age 18, legal disability ceases to be an issue. There may still be serious questions, however, about the child's mental or emotional maturity with respect to financial matters. The donor's perceptions and opinions on this issue will affect his or her decisions on the size, timing, and structure of the transfer. A donor who lacks confidence in a child's ability to manage his or her finances will be understandably reluctant to make an outright transfer to that child or to provide for termination of a trust at an early age.

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§12.10 3. Impact on Child's Incentive

Related to the issue of a child's ability to manage assets is the overall effect that a transfer of wealth will have on him or her. On the one hand, this event may be an opportunity for the child to develop and mature. If the gift provides financial security, it may create a new sense of independence and responsibility. On the other hand, receipt of significant wealth at a young age may contribute to a loss of incentive and motivation. Because the young person no longer needs to be concerned about earning a living, he or she may become indifferent and irresponsible with respect to financial matters. For further discussion and forms for drafting to maximize the child's incentive, see §§12.112-12.121.

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§12.11 4. Donor's Loss of Control Over Assets

The donor must understand that the tax benefits of lifetime gifts are achieved at the expense of loss of control of the transferred property. An irrevocable gift means a permanent transfer of legal ownership. The donor no longer has the ability to deal with the property as his or her own. Any attempt to exercise rights of ownership may result in inclusion of the property in the donor's estate or donor tax liability with respect to the income derived from the property.

In most circumstances, tax considerations will make it inadvisable for the donor to act as trustee for the child. Unless the trustee's duties and powers are severely limited, the donor's trustee powers will typically result in the trust assets being included in the donor's estate. See §§2.48-2.63. Similarly, the trustee powers may cause the trust income to be taxed to the donor under the grantor trust rules, although this is sometimes desirable. See §§3.22-3.44.

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II. OUTRIGHT GIFTS AND DIRECT PAYMENTS FOR EDUCATION AND HEALTH

A. Outright Gifts

§12.12 1. Legal and Tax Aspects

There are no special legal requirements for making outright gifts to minors. Real property can be conveyed to minors by deed, personal property can be given by physical transfer, and securities can be issued in their names or can be endorsed to the minors and subsequently registered in their names. Outright gifts generate most of the desired tax benefits, including the following:

- Income from the gifted property is taxable to the minor rather than the donor as long as it is not used to satisfy the parent's legal obligation of support. Rev Rul 58-65, 1958-1 Cum Bull 13. See also *Prudence Miller Trust* (1946) 7 TC 1245, acq 1947-1 Cum Bull 3; *Sandifur v U.S.* (ED Wash 1964) 64-2 USTC ¶9817, 14 AFTR2d 5882. If either parent of the child is alive at the close of the taxable year, however, the minor's net unearned income will be taxed at the parent's higher marginal tax rate (the so-called kiddie tax). IRC §1(g). See §12.5.
- The IRC §2503(b) gift tax annual exclusion is available. Rev Rul 54-400, 1954-2 Cum Bull 319. If the outright gift is made to a grandchild and qualifies for the annual exclusion, it will also be exempt from the generation-skipping transfer tax. IRC §2642(c). See §4.15.
- The gifted property is includable in the child's gross estate rather than the donor's. It is includable in the donor's estate, however, if the donor continues to use and control the property or uses it to satisfy a legal obligation of support. See IRC §§2036, 2038.

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§12.13 2. Advantages and Disadvantages

Outright gifts are commonly made and are generally appropriate for small amounts of cash or other assets that require no management. If the minor is almost an adult or the donor has confidence in the minor's judgment, there may be a basis for more significant gift transfers.

There are no special requirements for making outright gifts other than the transfer of title. In most circumstances, however, it is good practice for the donor or his or her attorney to prepare a memorandum of gift so that a record exists that a gift has been made.

Outright gifts have several nontax disadvantages. When donors make an outright gift to a minor, the minor gains control over the property, subject to the limitations of legal incapacity discussed below. The minor may make poor investments or use funds for purposes not approved of by the donor. In addition, substantial outright gifts may damage a minor's sense of values, erode incentive, or have other unfavorable, long-term effects on his or her personality.

A minor who owns property outright usually faces legal obstacles in exercising control over the property. A minor in California (*i.e.,* an unemancipated person under age 18) cannot make a will (Prob C §6100) or delegate a power or make a contract relating to an interest in real property or to any personal property not in his or her immediate possession or control (Fam C §6701). Except as provided in Fam C §6701, a minor may deal with property, but many brokers, banks, issuers of securities, and transfer agents will not enter into transactions with a minor because of the minor's legal right to disaffirm contracts. A minor's contract may be disaffirmed either by the minor before his or her majority or within a reasonable time afterward or, if the minor dies, by his or her heirs or personal representative. Fam C §6710. Thus, unless the minor is emancipated, a guardian may have to be appointed to deal effectively with the minor's property. Fam C §§7000-7110. For discussion of guardianships, see §§12.19-12.22.

An emancipated minor can enter a binding contract, buy and sell real property, and make or revoke a will. Fam C §7050(e). Under Fam C §7002, an emancipated minor is one who:

- Has entered into a valid marriage, whether or not the marriage was terminated by dissolution;
- Is on active duty with any of the armed forces of the United States; or
- Has received a court-ordered declaration of emancipation under Fam C §7122.

When a minor reaches age 18 or becomes emancipated, the legal impediments to the use of property are removed. If the donee's judgment remains immature, however, legal capacity may simply facilitate the dissipation or misuse of property.

If the minor dies at a young age with no testamentary documents, the gifted property may revert to the parent-donor under the laws of intestate succession. That result would be contrary to the purpose of the gift.

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§12.14 B. Direct Payments for Health and Education (IRC §2503(e))

Under IRC §2503(e), direct payments to an educational institution for tuition or to a medical care provider for services rendered to another person are fully excluded from federal gift taxation. They do not trigger gift tax, reduce the annual exclusion, or consume any part of the lifetime unified credit. The payment must be made directly to the educational institution or medical care provider. Treas Reg §25.2503-6(b)(2). The exclusion does not apply to amounts paid to a child or other beneficiary, even if the payment reimburses the beneficiary for tuition or health care costs. A transfer to a trust established to pay tuition or medical costs does not qualify for this exclusion on the theory that use of the trust does not constitute a direct transfer to the educational organization or medical care provider. Treas Reg §25.2503-6(c).

The IRC §2503(e) exclusion applies to tuition for both full-time and part-time students. Amounts paid for books, supplies, dormitory fees or board or other similar expenses do not qualify. Treas Reg §25.2503-6(b)(2). Transfers that would qualify for the exclusion under IRC §2503(e) if made by an individual are not subject to the generation-skipping transfer (GST) tax. IRC §2611(b)(1). See §4.14. They are nontaxable gifts. Direct skips that are nontaxable gifts have an inclusion ratio of zero for GST tax purposes. IRC §2642(c)(1). The amounts covered under IRC §2503(e) and the number of donees are unlimited. The donee need not be a relative of the donor.

Payments for health care or tuition avoid the practical drawbacks of outright gifts to minors because the donor pays only for services of which the donor approves. The payments provide few income tax benefits, however. If the minor is a dependent for income tax purposes, the donor is entitled to any available deduction for educational expenses (in the rare situation in which they qualify as a business expense) or medical care costs. For income tax purposes, the IRS treats the donor's payment for the benefit of a donee who is not the donor's dependent as a gift to the donee, followed by the donee's payment of the potentially tax-deductible expense. See *Litchfield v Commissioner* (1st Cir 1964) 330 F2d 509 (dictum).

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/ C. Pay on Death (POD) and Totten Trust Accounts/§12.15 1. Legal and Tax Aspects

C. Pay on Death (POD) and Totten Trust Accounts

§12.15 1. Legal and Tax Aspects

A pay on death (POD) account is an account that is payable on request to one person during that person's lifetime and to another person or persons on the death of the first person. Prob C §§5140, 5142. A Totten trust account is created when an account is opened in the name of the donor as trustee for one or more beneficiaries. Prob C §80. Fundamentally, these devices are simple will substitutes. Funds on deposit in a POD account pass automatically to the POD payee on the death of the original depositor. Prob C §5140(b). Funds held in a Totten trust account pass to the designated beneficiary or beneficiaries on the trustee's death. Prob C §5302(c).

Neither a POD account nor a Totten trust account has any present income, gift, or estate tax impact. Because the transfer is completely revocable, the income is taxed to the depositor-trustee. Thus, there is no completed gift to the donee when funds are deposited into the account. Treas Reg §25.2511-2(c).

If the beneficiary survives the depositor-trustee, the account becomes the beneficiary's property unless the beneficiary is a former spouse of the depositor-trustee under Prob C §5600, in which case the transfer fails and the account becomes part of the depositor's probate estate. If the beneficiary predeceases the depositor-trustee, the POD arrangement or Totten trust terminates, and the balance of the account is owned by the depositor and becomes part of the depositor's estate.

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§12.16 2. Advantages and Disadvantages

Generally, the depositor retains complete control of the accounts and may withdraw funds for his or her own use. The depositor-donor has no duty to account to the named beneficiary. The funds are automatically transferred to that person on the death of the depositor.

POD and Totten trust accounts are usually an undesirable way to hold funds for a minor. On the death of the depositor, the funds pass outright to the minor who is legally incapable of entering into certain transactions with respect to these funds and may be too immature to manage them. These accounts provide no planning flexibility. There is no provision for an alternative disposition of the funds if the beneficiary predeceases the depositor.

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D. Joint Tenancy

§12.17 1. Legal and Tax Aspects

Property held in joint tenancy is owned by two or more persons in equal undivided shares with right of survivorship. CC §683(a). Joint accounts in financial institutions are subject to special rules. See Prob C §§5130, 5302-5303, 5600.

The primary characteristic of a joint tenancy is the right of survivorship. *Zeigler v Bonnell* (1942) 52 CA2d 217, 126 P2d 118. On the death of a joint tenant, title to the entire asset vests in the surviving joint tenants. Title belongs to the survivors by virtue of the original joint tenancy title and not through inheritance or succession after death. *Goldberg v Goldberg* (1963) 217 CA2d 623, 628, 32 CR 93.

Unless there is equal contribution by the parties, creation of a joint tenancy results in a taxable gift. There are, however, several important exceptions to this rule. When bank accounts, savings bonds, and securities acquired in street name are established as joint tenancies, there is no taxable gift. A gift occurs only when a joint tenant withdraws more than his or her contribution to the property. Treas Reg §25.2511-1(h)(4); Rev Rul 69-148, 1969-1 Cum Bull 226. A second exception is often referred to as a "joint tenancy for convenience." A typical example is the parent who places a child's name on property to facilitate transfer at death, with no intent to create a present interest. Whether there was a transfer of a present interest sufficient to make a gift is a matter of state law.

In California, joint tenancy title creates a rebuttable presumption that the property is, in fact, owned as joint tenancy. *Machado v Machado* (1962) 58 C2d 501, 25 CR 87. Nevertheless, with regard to a joint tenancy bank account, Prob C §5301(a) provides that it is presumed to belong to the parties in proportion to their contributions (while all are alive) unless there is clear and convincing evidence of a different intent. In *Lee v Yang* (2003) 111 CA4th 481, 3 CR3d 819, however, the court held that this presumption applies only while sums remain on deposit. The court concluded that an account owner who withdraws more than that owner's share of account contributions has no duty to account to the other owner.

The entire value of the joint tenancy is includable in the deceased joint tenant's estate, except to the extent that the surviving joint tenant can prove a contribution towards the acquisition of the property. The contribution cannot be made from funds given as a gift to the survivors by the decedent; but instead must be made with the survivor's own funds. IRC §2040(a).

The surviving joint tenant receives a stepped-up basis in that portion of the property that was included in the decedent's estate. IRC §1014(b)(9). The portion of the assets not included in the decedent's estate retains the survivor's basis.

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§12.18 2. Advantages and Disadvantages

The primary advantage of joint tenancy is its simplicity, *i.e.,* the fact that title passes to the surviving joint tenant by operation of law. However, while the donor is alive, there is the danger that creditors of the minor donee joint tenant may seek satisfaction from the joint property, or that the minor will misuse his or her interest in the property for present gain. In *Nikirk v U.S.* (D Ariz 2003) 2003-2 USTC ¶50,701, 92 AFTR2d 6486, in a decision under Arizona law not involving a minor, the court held that a lien for a son's income taxes attached to his joint tenancy interest in real property, even though his mother had paid for the property and created the joint tenancy solely for estate planning purposes. The decision follows *Frederick v Shorman* (Iowa 1966) 147 NW2d 478, in which a mother purchased a residence paying the entire consideration, but took title in joint tenancy with her son. The mother testified that she put the property in both names solely in case something happened to her. The court held that she failed to prove by clear and convincing evidence that she and her son did not hold equal interests in the property. The death of the donor also may result in a minor's having outright ownership of property that he or she has no legal ability to manage. In addition, joint tenancy offers no opportunity for alternate planning in the event that a minor donee predeceases the original joint tenant.

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E. Guardianships

§12.19 1. Legal and Tax Aspects

A guardianship is a court proceeding in which a person or persons are appointed to manage a minor's affairs. The responsibilities of the guardian are bifurcated into those pertaining to the minor's person and those related to the minor's estate. Prob C §§1500, 2108. A single individual can act in both roles, or different individuals or institutions may be appointed. Prob C §1500.

A guardian of a minor's estate performs some of the same functions as the executor of an estate. He or she must file an inventory and appraisal of the estate within 90 days of appointment. Prob C §2610. Thereafter, the guardian must present an accounting of the assets of the estate to the court 1 year after the guardianship has been established and biennially thereafter unless ordered by the court to be more frequent. Prob C §2620(a).

Probate Code §§2450-2467 enumerate the estate management powers of the guardian. Though some routine transactions may be undertaken without court authorization, those of an unusual nature require court approval. Prob C §2450(a). Unless another person (*e.g.,* a surviving parent) is obligated to support the minor, the guardian must use as much of the income and principal of the guardianship estate as is necessary for the care, maintenance, and education of the minor. Prob C §2420(a)-(b). The provisions governing the duties and powers of a guardian of an estate are the same as those for a conservator of an estate. See Prob C §§2400-2595; California Guardianship Practice, chaps 12-13 (Cal CEB Annual).

A guardian is entitled to reasonable compensation as determined by the court. See Prob C §2623(a)(2). As a practical matter, the guardian is often a family member or close friend who does not request a fee. The guardian is entitled to pay from the guardianship estate reasonable attorney fees and other reasonable expenses incurred in the exercise of his or her duties. Prob C §2623(a)(1).

Income derived from property transferred to a guardian is taxed to the minor, whether or not actually distributed. Treas Reg §1.641(b)-2(b). If the minor has a living parent who has a legal obligation of support, guardianship assets used to satisfy that obligation may be taxable to the parent. Rev Rul 58-65, 1958-1 Cum Bull 13.

The transfer of property to a guardian is subject to state and federal gift taxes. The $13,000 (plus cost-of-living adjustments after 2009) IRC §2503(b) gift tax annual exclusion is available for transfers of present interests in property to a minor's guardian. If the transfer is made to a guardian for the benefit of a grandchild of the donor and qualifies for the annual exclusion, it will also be exempt from the generation-skipping transfer tax. IRC §2642(c). Property that is given to a guardian is includable in the minor's gross estate.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.20 2. Advantages of Guardianship

§12.20 2. Advantages of Guardianship

The major advantage of guardianships over alternative mechanisms is that they provide a greater level of judicial oversight and protection. The guardian who obtains court approval for his or her actions is protected against claims of negligence. Requiring the guardian to furnish a bond will add some expense, but the minor will be better protected against loss by defalcation than he or she would be with a custodianship or trust. However, this advantage is usually outweighed by the disadvantages discussed in §§12.21-12.22.

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3. Disadvantages of Guardianship

§12.21 a. Termination at Age 18

The disadvantages of a guardianship almost always outweigh its advantages. Perhaps the greatest of these disadvantages is that the guardianship terminates when the minor reaches age 18. Many donors would rather postpone the time that the minor obtains full control over property until a later age. In addition, the need for court intervention and formal accountings adds expense and inconvenience. Normally, the guardian will need the services of an attorney, whose costs and fees are paid from the minor's estate. Also, court oversight and requirements for court approval to dispose of some types of assets may cause delays that hamper effective management of the minor's property. Custodianships can last until age 21. See §12.30.

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§12.22 b. Transfer of Property if Minor Dies

The estate of a minor who dies before reaching age 18 must be probated and will generally pass to his or her heirs because a minor may not make a will. See Prob C §6100. Absent a disclaimer, the minor's property will go to the minor's parents (if then living) under the laws of intestacy. See Prob C §6402(b). This may be inconsistent with overall family estate planning because the property may be subject to federal estate or gift taxation when it passes from the minor's parents to younger generations.

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F. Custodianships Under California Uniform Transfers to Minors Act

§12.23 1. Establishment of Custodianship

A gift under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) offers an alternative for gifts to minors that avoids the complications of a guardianship or trust. Prob C §§3900-3925. Any individual, trust, or estate may transfer property to a custodian for the benefit of the minor.

Transfers to a custodian may be made by inter vivos gift, by will, by exercise of a power of appointment, by trust, or by designation of a custodian to receive death benefits under a life insurance policy, retirement plan, or pay on death account. Prob C §§3902-3904. Any type of property may be transferred to a custodian under CUTMA. Prob C §§3901(f), 3909(a)(7).

The Probate Code sets forth specific requirements for transfer of various assets. Real property, securities, bank or brokerage accounts, and other assets for which there is evidence of title are transferred by changing title into the name of the custodian. The donor may serve as initial custodian for such transfers. Prob C §3909(a) (but see §12.32 for adverse estate tax consequences of doing so).

Property for which ownership records are not maintained (*i.e.,* unregistered (bearer) securities and certain types of tangible personal property) must be transferred to a trust company or to an adult other than the donor. The donor is precluded from acting as initial custodian for such property. Prob C §3909(a)(7).

If dealing with a transfer agent is difficult, a registered security can be properly endorsed and delivered to a custodian as long as the transfer form under CUTMA (see §12.28) is completed and executed by both the transferor and custodian. Likewise, a certificate of title to an item of tangible personal property issued by a state or the United States may be endorsed and delivered to the custodian if the custodianship form is completed and executed. If form 12.28-1 is used, however, the transferor may not serve as the initial custodian. Prob C §3909.

A trustee or personal representative of an estate may transfer property to a custodianship for a beneficiary who is younger than age 18, even if the instrument does not authorize the transfer and the applicable instrument (or laws of intestate succession) state simply that the property should be distributed to the minor. See Prob C §3906(a). The transfer is permitted, however, only if the trustee or personal representative believes that it is in the minor's best interests and that the transfer is not prohibited by or inconsistent with the applicable governing instrument. Prob C §3906(c)(1)-(2). In addition, the superior court must approve any transfer that exceeds $10,000. This requirement does not apply if the transfer is made to a custodian who is either a trust company or an individual designated as a trustee under a trust instrument that does not require bond. Prob C §3906(c)(3).

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§12.24 2. Powers of Custodian

A custodian has all the rights, powers, and authority over custodial property that ordinary adult owners have over their property, but the custodian may exercise those rights, powers, and authority only in a fiduciary capacity. Prob C §3913. The custodian has discretion to deliver or pay to the minor or expend for the minor's benefit as much of the custodial property as the custodian considers advisable and may do so without court order. Disbursements may also be made without regard to the duty of the custodian or any other person to support the minor and need not take into consideration any other income or property of the minor. Prob C §3914(a). A request by the custodian is not a substitute for, and does not affect, any other person's obligation to support the minor. See Prob C §3914(c).

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§12.25 3. Liability of Custodian

A custodian who is compensated for services is held to the standard of care that must be observed by "a prudent person dealing with the property of another." Prob C §3912(b). In contrast, a custodian who is not compensated is not liable for losses to custodial property unless they result from the custodian's "bad faith, intentional wrongdoing, or gross negligence" or failure to adhere to the standard set forth in Prob C §3912(b). Prob C §3912(b)(1). Both compensated and uncompensated custodians are exempt from liability to the minor if they choose to retain for the custodianship any custodial property received from a donor. Prob C §3912(b)(2).

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4. Substitute Custodians and Successor Custodians

§12.26 a. Designation of Substitute Custodian

A substitute custodian becomes the custodian if the originally named custodian never takes office because of death or declination, disability, or ineligibility to serve. Prob C §3903(a). A gift instrument should designate at least one substitute custodian to serve if the primary custodian is unavailable; if the instrument fails to do so, however, the trustee or personal representative may name the substitute custodian. Prob C §3905(c). It is particularly important for a substitute custodian to be designated when a custodian is designated the recipient of life insurance proceeds. When no custodian can serve, the person who holds property of, or owes a liquidated debt to, a minor (*e.g.,* a life insurance company) may make an irrevocable transfer to a custodian for the minor's benefit. Prob C §3907(a). Under Prob C §3907(c), the custodian can be an adult member of the family, but court approval of the custodianship is required if the proceeds exceed $10,000.

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§12.27 b. Designation of Successor Custodian

In contrast to a substitute custodian, a successor custodian is one who serves if the designated custodian takes office and then becomes unable or unwilling to continue to serve in that capacity. The transferor, acting at the time the transfer establishing the custodianship is made, may designate a successor custodian. See form 12.28-1. In addition, the custodian at any time may designate a successor custodian other than the transferor. Prob C §3918(b). See form 12.29-1.

If a custodian dies or cannot continue as custodian and no successor has been designated, a minor who has attained age 14 may designate a successor custodian in the same manner as a serving custodian would designate a successor. Prob C §3918(d). The Probate Code identifies the parties who may be appointed to serve. See Prob C §3918(d). In considering a petition under Prob C §3918(d) or §3918(f), the court may grant the relief found to be in the minor's best interests. Prob C §3918(g).

A custodian may resign at any time by delivering a written notice to the minor (if the minor has attained age 14) and to the successor custodian and by delivering the custodial property to the successor custodian. Prob C §3918(c). Apparently, a custodian is not entitled to resign unless a successor has been designated and the custodial property transferred to that successor.

The designation form (see form 12.29-1) must be witnessed by a person other than the designated successor custodian or alternative successor custodian(s). The practitioner should consider having the instrument notarized so that it will be more readily accepted by the financial institutions that may hold custodial property. If the custodian holds real property, the instrument should also be designed so that it can be recorded (*i.e.,* space should be left at the top for an indication of the person requesting recording and the address where the instrument should be mailed after it is recorded).

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.28 5. Form: Creation of Custodianship by Transferor

§12.28 5. Form: Creation of Custodianship by Transferor

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12.28-1 Creation of custodianship by transferor

TRANSFER UNDER CALIFORNIA UNIFORM TRANSFERS TO MINORS ACT

I, _ _[*name of transferor and (if a fiduciary) name of representative capacity*]_ _, hereby transfer to _ _[*name of custodian*]_ _, as custodian for _ _[*name of minor*]_ _ until age _ _[*e.g., 21*]_ _ under the California Uniform Transfers to Minors Act (Probate Code §§3900-3925), the following: _ _[*Insert description of custodial property sufficient to identify it*]_ _.

[*If appropriate, add the following option*]

[*Option: Designation of successor custodian*]

I hereby designate _ _[*name*]_ _ to serve as successor custodian for _ _[*name of minor*]_ _ under the California Uniform Transfers to Minors Act (Probate Code §§3900-3925). If _ _[*he/she*]_ _ becomes unable to serve or declines to serve, I nominate _ _[*name*]_ _ in _ _[*his/her*]_ _ place. If that person is ineligible or unable to serve or declines to serve, I nominate _ _[*name*]_ _ to serve as custodian.

This designation shall not become effective unless _ _[*name of original custodian*]_ _ resigns, dies, becomes incapacitated, or is removed by a court of competent jurisdiction.

Date: _ _ _ _ _ _ __[*Signature of transferor*]__
_ _[*Typed name*]_ _

_ _[*Name of custodian*]_ _ **acknowledges receipt of the property described above as custodian for the minor named above under the California Uniform Transfers to Minors Act.**

Date: _ _ _ _ _ _ __[*Signature of custodian*]__
_ _[*Typed name*]_ _

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.29 6. Form: Designation of Successor Custodian by Current Custodian

§12.29 6. Form: Designation of Successor Custodian by Current Custodian

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12.29-1 Designation of successor custodian by current custodian

[*Use one of the following alternatives*]

[*Alternative 1: Immediate resignation of current custodian*]

I, _ _[*name of custodian*]_ _, hereby designate _ _[*name*]_ _ to serve as successor custodian for _ _[*name of minor*]_ _ under the California Uniform Transfers to Minors Act (Probate Code §§3900-3925). If _ _[*he/she*]_ _ is ineligible or unable to serve or declines to serve, I nominate _ _[*name*]_ _ in _ _[*his/her*]_ _ place. If that person is ineligible or unable to serve or declines to serve, I nominate _ _[*name*]_ _ to serve as successor custodian.

I hereby resign as custodian for _ _[*name of minor*]_ _ under the California Uniform Transfers to Minors Act. This resignation shall be effective as soon as the custodial property is transferred to the above-named successor custodian.

[*Alternative 2: Successor custodian to assume duties only in case of future vacancy*]

I, _ _[*name of custodian*]_ _, hereby designate _ _[*name*]_ _ to serve as successor custodian for _ _[*name of minor*]_ _ under the California Uniform Transfers to Minors Act (Probate Code §§3900-3925). If _ _[*he/she*]_ _ is ineligible or unable to serve or declines to serve, I nominate _ _[*name*]_ _ in _ _[*his/her*]_ _ place. If that person is ineligible or unable to serve, or declines to serve, I nominate _ _[*name*]_ _ to serve as successor custodian.

This designation shall not become effective unless I resign, die, become incapacitated, or am removed by a court of competent jurisdiction.

Date: _ _ _ _ _ _ __[*Signature of custodian*]__
_ _[*Typed name*]_ _

Date: _ _ _ _ _ _ __[*Signature of witness*]__
_ _[*Typed name*]_ _

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§12.30 7. Termination of Custodianship

Ordinarily, a custodianship exists until the minor attains age 18, unless the period is extended by the donor or the minor dies. Prob C §3920. By explicit reference in the transfer documents, the donor can extend the period of the custodianship to age 21 for inter vivos gifts. Prob C §3920.5(e). A trustee or personal representative making a transfer may specify the age for termination of the custodianship; however, that age may not be older than 25. Prob C §3920.5(a), (c), (f). The same rule applies to transfers made to a custodian as the result of exercise of an irrevocable power of appointment. Prob C §3920.5(d).

If the transfer document provides that the duration of the custodianship extends beyond the maximum age provided by law, the custodianship must be continued only until the minor attains the maximum age permitted for that particular type of transfer. Prob C §3920.5(g). When the minor reaches the specified age, the custodianship terminates and the property is distributed to him or her. If the minor dies before termination of the custodianship, the property is distributed to the minor's estate. Prob C §3920.

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§12.31 a. Gift Tax

A gift to a minor under the California Uniform Transfers to Minors Act (Prob C §§3900-3925) is a completed gift that qualifies for the $13,000 (plus further cost-of-living adjustments after 2009) IRC §2503(b) gift tax annual exclusion. Because custodial property can only be held until the donee reaches age 21, there is no risk that the gift will extend beyond age 21, which could be considered a gift of a future interest that will not qualify for the annual exclusion. See §12.38.

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b. Estate Tax

§12.32 (1) When Donor Is Custodian

The custodial property is includable in the donor's gross estate if the donor is serving as custodian at the time of his or her death and before the donee reaches age 21. IRC §§2036, 2038; Rev Rul 59-357, 1959-2 Cum Bull 212. The custodian's power to distribute the custodial property and, in effect, terminate the custodianship arrangement makes the property includable under IRC §2038. *Stuit v Commissioner* (7th Cir 1971) 452 F2d 190. The same result occurs if another person was the original custodian but the donor was acting in that capacity at the time of his or her death. Rev Rul 70-348, 1970-2 Cum Bull 193.

A donor-custodian may file an election with the superior court to subject the custodianship to court supervision, under which no custodial property income may be used for any purpose before the custodianship terminates except by order of the superior court on a showing that the expenditure is necessary for the minor's support, maintenance, or education. Prob C §3914(d). This procedure is designed to facilitate the exclusion of the custodial property from the donor-custodian's estate if the donor-custodian dies before the custodianship is terminated. The election imposes substantial restrictions on the custodian's discretion to make distributions. There is no assurance, however, that the IRS will consider this limitation sufficient to deem the property excludable from the donor-custodian's estate.

The right of a donor-custodian who has elected to restrict his or her powers under Prob C §3914(d) to petition the court to order the payment of custodial funds for the minor's support or education is not a general power of appointment that will cause the custodianship property to be included in the donor's estate under IRC §2041. See Rev Rul 77-460, 1977-2 Cum Bull 323.

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§12.33 (2) Under Reciprocal Trust Doctrine

The reciprocal trust doctrine may be applied to bring the custodial property into a deceased donor's estate under IRC §2036 or §2038 if each parent makes a gift of separate property and names the other as custodian. In *Exchange Bank & Trust Co. v U.S.* (Ct Cl 1981) 82-1 USTC ¶13,444, 49 AFTR2d 1446, aff'd (Fed Cir 1982) 694 F2d 1261, a husband and wife made identical gifts of stock under the Uniform Gifts to Minors Act on the same date and named the other as custodian. The court deemed the deceased husband to be the donor of the custodial property nominally transferred by his wife (*i.e.,* the property for which he served as custodian). Because the deceased husband had the power to apply the custodial property in discharge of his own support obligation or to terminate the custodianship by making distributions to the minor, he was considered to have retained sufficient powers to include the custodial property in his estate. For further discussion of the reciprocal trust doctrine, see §5.12.

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§12.34 c. Generation-Skipping Transfer Tax

Certain custodial gifts may have generation-skipping transfer (GST) tax implications. The tax is imposed on direct transfers to a person two or more generations younger than the transferor. IRC §§2611(a)(3), 2612-2613. Transfers to a custodian for the benefit of grandchildren are subject to the tax. As a practical matter, most gifts made to a custodianship will be comparatively small in amount. If the transfer is less than the IRC §2503(b) gift tax annual exclusion amount and otherwise eligible for the IRC §2642(c) GST tax annual exclusion, it will not be subject to the GST tax. Transfers that exceed this amount will usually be covered by the transferor's GST exemption. IRC §2631. On the GST tax, see chap 4.

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§12.35 d. Income Tax

The income from the custodial property is taxable to the minor (*Lawrence Miller* (1943) 2 TC 285, acq 1943 Cum Bull 17; Rev Rul 56-484, 1956-2 Cum Bull 23) and subject to the "kiddie" tax (see §12.5) if the minor is under age 14. Income will be taxed to the minor's parent (or other person who has the legal obligation to support the minor), rather than to the minor, to the extent that the income is used to discharge the parent's (or other person's) legal obligation to support the minor. IRC §677(b); Rev Rul 56-484. The mere fact that custodial property could be used to support the minor will not cause custodianship income to be taxed to the minor's parent. Probate Code §3914(c) specifically states that payments by a custodian are made in addition to, rather than in substitution for, any obligation to support the minor.

The custodianship is not a separate entity for income tax purposes and need not file its own income tax returns. The minor's social security number should be provided in forms that require a property owner to provide a taxpayer identification number.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.36 8. Advantages of Custodianship

§12.36 8. Advantages of Custodianship

Custodianships provide a simple and inexpensive method for making gifts to minors without the need for a guardianship proceeding or the expense of drafting and implementing a trust agreement. The following are some advantages in making gifts under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925):

- A custodial gift is easy to make. Even if the donor fails to fully comply with CUTMA (*e.g.,* the donor designates an ineligible person as custodian, or the person named as custodian refuses to serve), the consummation of the gift is not affected.
- The gift is easier and less costly to administer than a guardianship or trust. A custodian, unlike a trustee, need not file an income tax return, although the minor may have to file a return.
- No court proceedings are required to establish or administer a custodial arrangement. By contrast, such proceedings are required for a guardianship. Thus, there is no court supervision over purchases and sales of property by the custodian.
- No bond is normally required of the custodian unless the court requires one on a petition by an interested party.
- The custodian need not file an accounting with the court unless required by the court on the request of an interested party. See Prob C §3919.
- The transferor of an inter vivos gift may specify that the custodianship may not terminate until the minor reaches age 21. A guardianship must terminate at age 18. See Prob C §3920.5(e).

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§12.37 9. Disadvantages of Custodianship

The disadvantages of a custodianship include the following:

- A custodianship funded by an inter vivos gift must terminate at the earlier of the minor's attaining age 21 or the minor's death. Prob C §3920.5(e).
- A custodianship may have only one custodian, while a trust may have cotrustees. Prob C §3910.
- A custodianship may be established solely for the benefit of one minor, while a trust may have several beneficiaries. Prob C §3910.
- The donor cannot be the custodian without adverse estate tax consequences unless the donor elects to have his or her power and duties governed by Prob C §3914(d), as discussed in §12.32. Even though this election may not be effective for estate tax purposes, the donor may be willing to risk the potential adverse estate tax consequences for greater control because the value of the property in a custodianship may be only a fraction of the donor's estate.
- If the minor dies, the custodial property passes to his or her estate and thus is subject to probate costs and expenses. If the property ultimately passes to the minor's parents, it may be subject to federal estate or gift taxation when they make inter vivos or testamentary transfers of the property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.37A G. Qualified Tuition Programs

§12.37A G. Qualified Tuition Programs

Under IRC §529, gifts to qualified tuition programs (QTPs) receive special tax treatment. QTPs include Prepaid Tuition Plans and more widely used College Savings Accounts. Such gifts will qualify for the annual gift tax exclusion even though such gifts would otherwise fail to qualify because they would be gifts of future interests. The gifts are not treated as gifts of tuition that are subject to the unlimited gift tax exclusion for tuition payments under IRC §2503(e), but the regular annual gift tax exclusion can be claimed in advance subject to specified limitations. Five times the regular IRC §2503(b) exclusion amount ($13,000 plus further cost of living adjustments after 2009) can be claimed in the current year, but this is an "advance" that results in no annual exclusions being available in subsequent years until, in effect, the advance is repaid. If the donor fails to survive that period of time, the amount of the advance remaining "unpaid" is included in the donor's estate. For distributions that are used to pay for qualified higher education expenses, the earnings portion of the distribution is excluded from gross income of both the donor and the beneficiary. Any balance to the credit of the designated beneficiary must be distributed when the beneficiary reaches age 30. In some cases, the donor may change the designated beneficiary to another family member. Nonqualified distributions are subject to income tax and a 10-percent penalty. On investments, see Notice 2009-1, 2009-2 Int Rev Bull 250. For further discussion of college savings accounts, see California Estate Planning, chap 21A (Cal CEB 2002).

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.37B H. Coverdell Education Savings Accounts

§12.37B H. Coverdell Education Savings Accounts

Under IRC §530, a donor can donate $2000 a year to a Coverdell education savings account for the benefit of a person under the age of 18 (or older in the case of a special needs beneficiary). The $2000 limit is a limitation on the donee. The donor can make multiple contributions for the benefit of multiple donees as long as the amount benefiting a particular donee does not exceed $2000. On the other hand, the beneficiary cannot be the beneficiary of IRAs receiving more than the an aggregate of $2000 in contributions, regardless of the number of donors. Contributions can only be made by persons having adjusted gross incomes lower than $110,000, with the allowable maximum contribution being reduced if that income exceeds $95,000. (In the case of a joint return, these amounts are $220,000 and $190,000, respectively.) There is no deduction for the contribution, but income accumulates tax-free until withdrawn. Further, withdrawals are not subject to income tax to the extent they do not exceed the beneficiary's qualified education expenses for the year of withdrawal. Any remaining amounts in the IRA must be withdrawn at age 30. In some cases, the balance can be rolled over for the benefit of another family member. Because the investment income of an education IRA generally is not included in the investment income of a person under age 24 (see §12.5), the IRA income is generally not subject to the IRC §1(g) "kiddie tax." Nonqualified withdrawals are subject to income tax and a 10-percent penalty.

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III. TRUSTS FULLY QUALIFYING UNDER IRC §2503(c) (MINORS' TRUSTS)

§12.38 A. Introduction to Minors' Trusts

An interest in property that does not qualify for the annual exclusion under the regular definition of a present interest (see §2.35) may still qualify for the annual exclusion if that interest meets the requirements of IRC §2503(c). A trust may be designed so that both the income interest and the remainder qualify under §2503(c). Such trusts are referred to in this chapter as §2503(c) trusts. The value of all property transferred to a §2503(c) trust will be treated as a present interest and will qualify for the annual exclusion. A §2503(b) trust may also be designed so that only the income interest qualifies as a present interest. This type of trust is discussed in §§12.64-12.79. Finally, the *Crummey* trust, described in §§12.80-12.111 can also be used as a vehicle for annual exclusion gifts and is not limited by the stringent requirements of §2503(c).

The §2503(c) trust is often called a minor's trust because it is usually established for the benefit of a minor. Although the title to IRC §2503(c) uses the term "minor" (defined in California as any person under age 18; see Fam C §6500), a §2503(c) trust may be established in California or continue in existence for a beneficiary who has attained age 18 but who has not yet attained age 21. The term "minor" is sometimes used in this chapter to refer to the beneficiary of a §2503(c) trust who is between ages 18 and 21.

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B. Requirements for Qualification

§12.39 1. No Substantial Restriction on Trustees' Power to Distribute Property to Minor

Under IRC §2503(c)(1), the trustee must have the power to distribute the property and its income to or for the benefit of the minor until he or she reaches age 21. Note that the Internal Revenue Code does not require any actual distribution to or for the benefit of the beneficiary before age 21. It is sufficient that the trustee has the power to expend the property and income for the minor's benefit. The trustee should be given broad discretion to accumulate or pay out income or principal as the trustee considers appropriate. The trustee may choose not to make distributions in excess of the amount ($1900 in 2009) exempt from the "kiddie tax" under IRC §1(g). See §12.5.

A trust provision directing the trustee to add income to principal ensures that the trustee has discretion to pay both trust principal and trust income for the benefit of the minor, so that both the income interest and the corpus of the trust will qualify for the annual exclusion under IRC §2503(c). See form 12.59-1.

The key statutory requirement is that there must be no "substantial restrictions" under the terms of the trust instrument on the exercise of the trustee's discretion to distribute income or principal to or for the benefit of the minor. Treas Reg §25.2503-4(b)(1); Rev Rul 69-345, 1969-1 Cum Bull 226. See Rev Rul 67-270, 1967-2 Cum Bull 349 (discretion left to trustee to determine purpose and amount of distribution).

In the following cases, the courts held that no substantial restrictions were imposed on the trustee: *Williams v U.S.* (Ct Cl 1967) 378 F2d 693; *Martha J. Heidrich* (1971) 55 TC 746, acq 1974-1 Cum Bull 2; *Upjohn v U.S.* (WD Mich 1972) 72-2 USTC ¶12,888, 30 AFTR2d 5918. In the following cases, the courts held that the trust provisions did impose substantial restrictions on the trustee's discretion: *Faber v U.S.* (6th Cir 1971) 439 F2d 1189 (limitation on use of trust income for minors to provide for "accident, illness or other emergency"); *Illinois Nat'l Bank v U.S.* (CD Ill 1991) 756 F Supp 1117 (trustee's power to expend funds for minor was less than power held by a guardian under state law); *James T. Pettus* (1970) 54 TC 112 (trust principal could be invaded only if trustee determined minor was in need of funds because of illness, infirmity, or disability).

Given the conflict in authorities, a conservative drafter will avoid any restriction on the trustee's discretion to distribute income or principal to or for the benefit of the minor while he or she is under age 21.

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§12.40 a. Consideration of Minor's Other Resources

In Rev Rul 67-270, 1967-2 Cum Bull 349, a distribution power limited to the minor's "support, care, education, comfort, and welfare" was held to qualify because the terms "comfort" and "welfare" broaden the scope of the trustee's powers enough to consider them substantially unlimited. In Rev Rul 69-345, 1969-1 Cum Bull 226, however, the trustee was given discretion to distribute trust property for the minor's "care, support, education, and welfare" but, in exercising this discretion, was required to take into consideration "other resources available to the beneficiary." The IRS ruled that, because both the minor and the minor's parents had other substantial assets, the trustee was not authorized to make distributions under the trust and therefore the trust instrument imposed a substantial restriction on the exercise of the trustee's discretion. Hence, the trust failed to qualify under IRC §2503(c).

Given the conflict in the authorities on the issue, as well as on the issue of whether any substantial restriction has been placed on the trustee's power to distribute trust funds (see §12.39), the trust instrument should explicitly provide that the trustee need not take into consideration other resources available to the minor in exercising the trustee's discretion. See form 12.59-1.

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§12.41 b. Prohibition Against Use of Property for Legal Support

The trustee may be prohibited from using trust principal or income to meet expenses of the minor's support that the minor's parents are legally obligated to provide. Such a restriction is apparently not considered to be a substantial restriction on the trustee's distribution powers. See *Upjohn v U.S.* (WD Mich 1972) 72-2 USTC ¶12,888, 30 AFTR2d 5918.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.42 c. Discretionary Sprinkling Power

§12.42 c. Discretionary Sprinkling Power

The distribution requirement prevents the trustee of an IRC §2503(c) trust from exercising a discretionary power to sprinkle income and principal among a class of beneficiaries. Treas Reg §25.2503-3(c), Example (3). If such a provision is used, no beneficiary has the assurance of a distribution and therefore none has a present interest in the trust. To avoid loss of the annual exclusion, a trust for several beneficiaries must provide for separate shares for each beneficiary.

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§12.43 2. Distribution of Property at Age 21

Unexpended property of an IRC §2503(c) trust must pass to the minor when he or she attains age 21, although the property may pass to the beneficiary before age 21 without affecting the qualification of the trust. IRC §2503(c)(2)(A); Rev Rul 73-287, 1973-2 Cum Bull 321. The reasoning is that such a provision satisfies the requirement of IRC §2503(c)(2)(A) that the property pass to the beneficiary no later than when he or she attains age 21.

In Rev Rul 74-43, 1974-1 Cum Bull 285, the IRS held that a trust not slated to terminate when the beneficiary reaches age 21 still meets the requirements of IRC §2503(c)(2)(A) if either (a) after reaching age 21 the beneficiary has a continuing right to terminate the trust or (b) on reaching age 21 the beneficiary acquires a right to terminate the trust that may be exercisable for a specified period after the beneficiary's 21st birthday. It is immaterial how the trust is extended, whether by positive election by the beneficiary or by the beneficiary's nonexercise of an election to terminate the trust. See IRS Letter Rulings 8507017, 8039023. See also Treas Reg §25.2503-4(b)(2).

In *Martha J. Heidrich* (1971) 55 TC 746, acq 1974-1 Cum Bull 2, the beneficiary had 30 days after reaching age 21 to advise the trustee of his intention to terminate the trust. If the beneficiary did not do so, the trust would remain in force until the beneficiary reached age 25. The court held that the trust met the requirements of IRC §2503(c)(2)(A). Good practice dictates that notice be given to the minor of the termination right, just as the beneficiary of a *Crummey* trust must be given notice of his or her withdrawal right. See §12.83.

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§12.44 3. Distribution of Property on Minor's Death

If the minor dies before age 21, the trust property must either be payable to the minor's estate or be subject to appointment by the minor under a general power of appointment. IRC §2503(c)(2)(B). A trust provision providing that the trust be distributed to the minor's heirs at his or her death is not sufficient; the term "heirs" is deemed to be different from the minor's estate. *Ross v Commissioner* (9th Cir 1981) 652 F2d 1365.

Whether the property passes to the minor's estate or is subject to a testamentary general power of appointment, the property will be included in the minor's gross estate. Such inclusion will often be an advantage. If the property's value exceeds its basis, the trust property will obtain an automatic step-up in basis if the minor dies in 2001-2009. IRC §1014. The trust property may obtain a similar step-up in basis by making an allocation of aggregate basis increase if the minor dies in 2010. IRC §1022. In most cases, the unified credit will shelter the minor's estate from estate taxes. See §12.66.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.45 a. Distribution to Minor's Estate

§12.45 a. Distribution to Minor's Estate

Because an unmarried person under age 18 is generally not able to make a will (see Prob C §6100), a trust provision directing that the property pass to the minor's estate will normally result in the property's passing to the minor's parents by intestate succession. This provision may defeat one aim of the parents' estate planning: to reduce their own taxable estate. The problem may be cured by a qualified disclaimer, in which case the property will pass to the minor's brothers and sisters, if any. If the deceased minor's siblings are under age 18, the amounts may be paid to a custodian under the California Uniform Transfers to Minors Act. Prob C §3906. There will be costs and fees if the trust property must pass through the minor's estate.

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§12.46 b. General Power of Appointment

The preferable method of complying with the requirement of IRC §2503(c)(2)(B) is to give the minor a testamentary general power of appointment. Treasury Regulation §25.2503-4(b) provides:

> [T]he fact that under the local law a minor is under a disability to exercise an inter vivos [general power of appointment] or to execute a will [and thereby exercise a testamentary general power of appointment] does not cause the transfer to fail to satisfy the conditions of [IRC] section 2503(c).

The mere existence of the general power will satisfy the statutory rules. Rev Rul 75-351, 1975-2 Cum Bull 368. If the trust is to terminate at age 21, a California beneficiary may, at any time after attaining age 18, make a will and thereby exercise a testamentary general power of appointment.

The minor's general power of appointment should be unrestricted. Treasury Regulation §25.2503-4(b) provides that "there must be no restrictions of substance (as distinguished from formal restrictions…) by the terms of the instrument of transfer on the exercise of the power by the donee." See also *Gall v U.S.* (5th Cir 1975) 521 F2d 878. Requiring the power to be exercised in a particular form or manner (*e.g.,* requiring that the exercise of the power be in writing or be filed with the trustee or that the writing specifically refer to the power in the trust instrument) are allowable formal restrictions and not prohibited restrictions of substance. See Treas Reg §25.2503-4(b).

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§12.47 c. Taker in Default

In most circumstances, the beneficiary will probably not exercise the general power of appointment; therefore, the trust should name a taker in default of the exercise of the minor's power. Such a provision is approved in Treas Reg §25.2503-4(b)(3). By providing for a taker in default, a probate proceeding may be avoided on the minor's death, and the settlor can specify the taker in default that best fits the settlor's estate planning objectives.

Occasionally, drafters include a gift over to the settlor or a settlor's successors in interest. Such a provision contains potential tax dangers because the actuarial value of the settlor's contingent reversionary interest is includable in the settlor's gross estate. IRC §2037. Also, there is potential income tax liability under IRC §674(b)(6).

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.48 d. Limited Power of Appointment

§12.48 d. Limited Power of Appointment

The requirements of IRC §2503(c)(2)(B) will also be met by a provision that grants the donee a limited power of appointment and provides that any amount not appointed will be payable to the donee's estate. See IRS Letter Ruling 8320007.

In such a situation, the donee would in fact have a general power of appointment, even though not specifically granted one, because the donee's power to refuse to exercise the limited power is itself a general power of appointment. If the donee fails to exercise the power, the property passes to the donee's estate and is included under IRC §2033; if the donee exercises the limited power, the property is included under IRC §2041 because the donee has released a general power of appointment. See Treas Reg §§20.2041-1(b)(1)-(2), 25.2514-1(b)(1)-(2).

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C. Tax Aspects of §2503(c) Trusts

§12.49 1. Gift Tax; Need for Separate Trusts

When property is transferred to an IRC §2503(c) trust, the trust beneficiaries rather than the trust or trustee are the donees. Accordingly, the settlor may use as many annual exclusions for gifts of present interest as there are trust beneficiaries, if each beneficiary's interest qualifies as a present interest. If, however, the trustee is given discretion to pay the income and principal of a single trust to any one or more of several beneficiaries, no single beneficiary is assured of ever receiving any part of the income or principal from the trust. Thus, no beneficiary would be the recipient of a present interest, and no portion of the transfer to the trust would be eligible for the annual exclusion. Treas Reg §25.2503-3(c), Example (3).

For this reason, the settlor should provide that the corpus be divided into separate trusts for each beneficiary. (Undistributed income from the separate trusts may be subject to income tax at lower rates. See §§3.11-3.18.) If a trust complies with the technical requirements of IRC §2503(c), the gift will be considered to be a present-interest gift qualifying for the donor's $13,000 (plus further cost-of-living adjustments after 2009) IRC §2503(b) gift tax annual exclusion. The value of the entire property transferred to a §2503(c) trust is eligible for the annual exclusion.

A spendthrift provision can be included in the trust without losing the annual exclusion. See Rev Rul 54-344, 1954-2 Cum Bull 319.

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2. Estate Tax

§12.50 a. Death of Beneficiary

The property in an IRC §2503(c) trust will be included in the gross estate of a beneficiary who dies before termination of the trust. The trust must provide that the property is to be paid over to the beneficiary's estate at his or her death or be subject to a general power of appointment. The inclusion of the trust assets in the minor's gross estate will be beneficial in most cases. Because the minor's estate will normally not exceed the amount of the unified credit, no estate tax will be payable. For income tax purposes, the assets in the trust will obtain a new basis, equal to their fair market value on the date of the beneficiary's death or on the alternate valuation date if the beneficiary dies in 2001-2009. IRC §1014. The assets in the trust also may obtain a new basis equal to fair market value by making an allocation of aggregate basis increase if the beneficiary dies in 2010. IRC §1022.

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b. Death of Settlor

§12.51 (1) Trust Assets Generally Not Included in Settlor's Estate

In general, if a settlor does not act as trustee, trust assets are subject to estate tax on the settlor's death only in very limited circumstances. Most settlors do not wish the trust assets to be included in their gross estate if they die before the trust terminates. The settlor may have different objectives if the unified credit will completely shield his or her estate from estate taxation. Then, inclusion in a settlor's estate may have a similar effect to inclusion in a minor's estate: There will be no estate tax but a new income tax basis. For California income tax basis rules, see Rev & T C §§18036-18039.

If a settlor serves as a special trustee empowered only to make certain administrative decisions, the trust's assets will not be included in the settlor-special trustee's gross estate. The estate tax rules do not prevent a settlor from appointing his or her accountant, attorney, or close friend or relative as trustee. The settlor's spouse may be made a trustee of the gift of separate property, without adverse estate tax consequences as long as the reciprocal trust doctrine does not apply. The possibility that the settlor might inherit property from the beneficiary does not cause the trust's assets to be included in a settlor's gross estate under IRC §2037. Treas Reg §20.2037-1(c)(2).

If a trust is established with community property, each spouse will be considered to be a settlor of the trust to the extent of his or her one-half interest in the community property. Thus, naming only one spouse as trustee of a §2503(c) trust funded with community property will avoid the estate tax problem for only half of the property. A spouse who consents to split gifts under an IRC §2513 election (see §12.45) is not considered to be a settlor for any portion of the gift of the other spouse's separate property. Rev Rul 54-246, 1954-1 Cum Bull 179.

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§12.52 (2) Inclusion When Assets Used to Meet Settlor's Duty of Support

If a settlor is not the trustee but is the minor's parent and has a duty to support the minor, and if the trust requires that the trust assets be used for the minor's support, the settlor will be regarded as having made a transfer with a retained life estate under IRC §2036 because monetary distributions will discharge the settlor's legal obligation of support. As a result, the trust assets will be included in the settlor's gross estate. Treas Reg §20.2036-1(b)(2); *Estate of Joseph G. Gokey* (1979) 72 TC 721. If a third party trustee, however, is given a discretionary power to apply trust property for the minor's support, this power will not cause assets to be included in the settlor's gross estate under IRC §2036. *Estate of Jack F. Chrysler* (1965) 44 TC 55, rev'd on other grounds (2d Cir 1966) 361 F2d 508. For discussions of the estate tax effect when the trustee owes a duty of support, see §2.53.

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§12.53 (3) Risks When Settlor Has Power to Appoint Successor Trustee

A possible problem area for a nontrustee settlor is the settlor's retention of a power to appoint successor trustees. Generally, a settlor cannot retain the power to remove a trustee and appoint a successor unless the power is limited to designating successors who are not settlors or subordinate parties (within the meaning of IRC §674(c)) of settlors. Rev Rul 95-58, 1995-2 Cum Bull 191. If the settlor retains a replacement power that is not restricted as described, the IRS will contend that the settlor should be deemed to hold the powers of the trustee.

Caution dictates that if a settlor seeks the estate tax benefits of appointing someone other than himself or herself as trustee, the original trust document should list a series of successor trustees (other than the settlor) or the initial trustee should be empowered to designate a successor and should be prohibited from designating the settlor. If a settlor's spouse is to serve as trustee, the drafter must be aware of the reciprocal trust doctrine, which could cause the trust assets to be included in the settlor-trustee's estate. See *Estate of Green v U.S.* (6th Cir 1995) 68 F3d 151, discussed in §5.12, in which the court placed limits on application of the reciprocal trust doctrine.

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§12.54 (4) Inclusion When Settlor-Trustee Has Broad Discretion Over Income Distribution

As discussed in §2.60, if the settlor-trustee has unlimited discretionary power to accumulate or distribute principal or income, and if the settlor dies before the trust terminates, the trust's assets will be included in the settlor's gross estate. Limiting a settlor-trustee's discretion to distribute income or principal by an ascertainable standard may prevent this result. See §2.58. Normally, however, such standards constitute substantial restrictions on the trustee's power to use trust property for the minor, and thus the trust will fail one of the technical requirements of IRC §2503(c). See *Jennings v Smith* (2d Cir 1947) 161 F2d 74. For discussion of substantial restrictions, see §§12.39-12.42. If the settlor of a §2503(b) trust desires to avoid estate taxation on the trust assets at his or her death, he or she should name someone other than the settlor as trustee.

If a settlor-trustee has the power to apply trust income or corpus for the discharge of the settlor's legal obligation to support a minor, the trust's assets will be included in the settlor-trustee's gross estate whether or not that power is exercised. Treas Reg §20.2036-1(b)(2); *Estate of Harry Prudowsky* (1971) 55 TC 890; *Estate of Jack F. Chrysler* (1965) 44 TC 55, rev'd on other grounds (2d Cir 1966) 361 F2d 508; *Estate of Frederick J. McTighe*, TC Memo 1977-410.

If the settlor of a §2503(c) trust is not the trustee, but the trustee owes the minor beneficiary a duty of support (*e.g.,* if a grandparent establishes a trust for a minor grandchild and appoints the grandchild's parent as trustee), the trust may be included in the trustee's gross estate under IRC §2041 and Treas Reg §20.2041-1(c)(1). The trust's assets should not, however, be included in the trustee's gross estate if the trust instrument prohibits the use of trust income or principal to pay expenses for the minor beneficiary's support that the minor's parents are legally obligated to provide. For a form containing such a prohibition, see form 5.27-1.

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§12.55 3. Generation-Skipping Transfer Tax

In general, the generation-skipping transfer (GST) tax will not apply to an IRC §2503(c) trust on a minor's death, because the trust's assets will be included in the minor's gross estate. Thus, there will be neither a taxable distribution nor a taxable termination even if, on the minor's death, the assets pass to a beneficiary in a generation younger than the minor. On the GST tax, see chapter 4.

Moreover, a direct skip transfer to a §2503(c) trust qualifying for present-interest gift tax exclusion is exempt to the same extent from the GST tax. IRC §2642(c)(2). Thus, grandparents may establish a §2503(c) trust for grandchildren and the GST transfer tax will not apply.

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§12.56 4. Income Tax

The settlor of an IRC §2503(c) trust usually seeks to structure the trust so that trust income will not be taxed to the settlor but to the trust, to the minor beneficiary, or partly to each. With the compressed tax rates for trusts (see §3.7), there may be an advantage in shifting the tax liability to the minor (with appropriate consideration of the "kiddie" tax discussed in §12.5) or splitting the liability between the minor and the trust. If the trustee has discretion to distribute or accumulate income until the minor reaches age 21, the trustee can use this power to minimize the aggregate of income taxes paid by both the trust and the minor by distributing some income to or for the benefit of the minor, if the minor is in a lower income tax bracket than the trust.

To meet this objective, the §2503(c) trust must be carefully drafted to avoid problems with the grantor trust provisions of IRC §§671-679. See §§3.22-3.44, 7.4. As discussed in §§3.19-3.20, however, if the minor has not reached age 19 (age 24 in the case of a student) and either parent is alive at the end of the taxable year, the minor's net income will be taxed at the parent's higher marginal rate. IRC §§1(g), 152(c).

Under the grantor trust rules, the settlor may be taxed on the trust income even if he or she does not serve as trustee or cotrustee. Under IRC §674(a), a settlor is taxed on the income of the trust if either a settlor or a nonadverse party has the power to distribute or withhold income or principal without the approval or consent of any adverse party; however, numerous exceptions to this rule are found in IRC §674(b)-(d) (see §§3.22-3.44). Rarely is an adverse party appointed as trustee of a §2503(c) trust, so one or more of the IRC §674(b)-(d) exceptions must be used in the trust for the settlor to avoid having to include taxable income as his or her own. For the definition of "adverse party," see §3.26.

A §2503(c) trust should be drafted to avoid potential problems with administrative powers under IRC §675. For example, if it is contemplated that the settlor may borrow from the trust, either (a) the trustee should not be the settlor or a related or subordinate person subservient to the settlor or (b) all loans should be approved by a special trustee appointed for that purpose who should not be the settlor or a related or subordinate person subservient to the settlor. For the definition of "a related or subordinate person subservient to the settlor," see §3.36.

The trustee of a §2503(c) trust normally has discretion to distribute or accumulate income until the minor reaches age 21. The trust may be empowered to distribute income to a custodian under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) if the custodianship is scheduled to terminate when or before the minor reaches age 21.

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§12.57 5. Trusts Continuing After Age 21

As noted in §12.21, a trust may qualify under IRC §2503(c) if the minor has the right to terminate the trust, exercisable for a specific period after reaching age 21. Two tax questions arise when a beneficiary who possesses a right to terminate the trust at age 21 chooses not to do so:

- How will the post-age-21 income generated by the trust be taxed?
- What are the gift tax aspects if the beneficiary allows the power to terminate the trust to lapse?

These questions have not been directly addressed by the courts or the IRS, but they can probably be answered by referring to authoritative pronouncements dealing with *Crummey* trusts, discussed in §§12.80-12.111.

Apparently, the beneficiary will be taxed on all the trust's post-age-21 income, whether or not that income is actually distributed to the beneficiary, because the beneficiary is viewed as being the substantial owner of the trust if he or she reaches age 21 and allows the trust to continue past age 21. See IRC §678(a)(2); IRS Letter Rulings 8517052, 8142061.

When the beneficiary allows his or her right to terminate the trust to lapse, the beneficiary has made a gift to the extent that the lapse is not covered by the $5000 or 5-percent exclusion of IRC §2514(e), discussed in §12.89. If, however, the trust provides that the beneficiary will eventually receive all the property in the trust and that all trust property is payable to the beneficiary's estate if the beneficiary dies before the termination, then by failing to terminate the trust the beneficiary is simply making a gift to himself or herself. These gifts should not be subject to federal gift tax and should not consume any of the beneficiary's unified credit. See IRS Letter Ruling 8142061. As an alternative to a general power of appointment, a provision giving the beneficiary a limited power of appointment if he or she dies before the trust terminates (thus keeping the property from passing to the beneficiary's estate and possibly to the parents) should also avoid a gift because the beneficiary will not have parted with dominion and control over the trust property. See Treas Reg §25.2511-2(c).

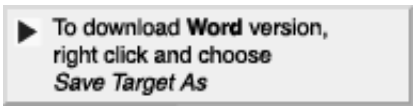
Even to the extent that the lapse of the beneficiary's right to terminate the trust constitutes a taxable gift, the unified credit is available to prevent the actual payment of gift tax. As a result, estate taxes may be increased on the beneficiary's death, but the increase may be insignificant if he or she has a long life expectancy. On the present value of the unified credit, see §12.66.

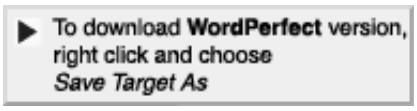
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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/ D. Distribution of Income and Principal to Living Child/§12.58 1. Form: Division of Trust Estate

D. Distribution of Income and Principal to Living Child

§12.58 1. Form: Division of Trust Estate





12.58-1 Division of trust estate

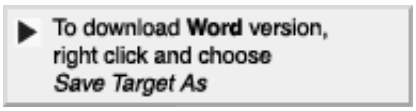
***Division of Trust*. The trustee shall immediately divide the trust estate into _ _[*e.g., two/three*]_ _ equal shares for the benefit of the following _ _[*e.g., two/three*]_ _ children of the settlor(s): _ _[*List names and dates of birth*]_ _. Each share allocated to a child shall be retained and administered by the trustee in a separate trust as follows:**

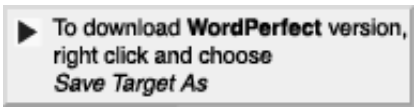
Comment: The minor may not be the settlor's child, in which case the references to "child" should be modified. On the need for separate trusts to qualify for the annual exclusion, see §12.49.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.59 2. Form: Discretionary Payment of Income and Principal Before Child Attains Age 18 or 21

§12.59 2. Form: Discretionary Payment of Income and Principal Before Child Attains Age 18 or 21





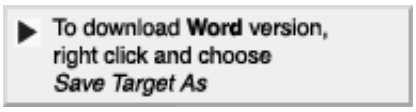
12.59-1 Child under age 18 or 21

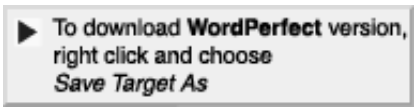
***Discretionary Distributions*. As long as the child for whom the share is set aside is under age _ _[*18/21*]_ _, income of the trust shall be added to principal and the trustee may pay to or apply for the benefit of the child as much of the child's trust as the trustee, in the trustee's discretion, considers necessary for the child's support, care, education, comfort, and welfare. In determining the amount to be paid to a child, the trustee need not consider the child's other income or resources.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.60 3. Form: Outright Distribution to Living Child at Age 18 or 21

§12.60 3. Form: Outright Distribution to Living Child at Age 18 or 21





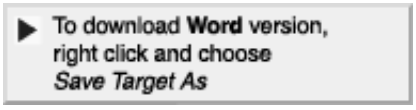
12.60-1 Outright distribution at age 18 or 21

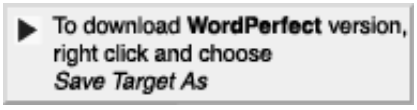
***Distribution of Remainder*. When the child attains age _ _[*18/21*]_ _, the trustee shall distribute to the child the entire undistributed balance of _ _[*his/her*]_ _ trust.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.61 4. Form: Child's Power to Terminate Trust After Attaining Specified Age

§12.61 4. Form: Child's Power to Terminate Trust After Attaining Specified Age





12.61-1 Child's power to terminate trust after attaining specified age

***Beneficiary's Power to Terminate Trust*. The child shall have the power to terminate the trust by a written instrument delivered to the trustee within 60 days after attaining age 21. On receipt of notice of termination, the trustee shall distribute to the child the entire undistributed balance of _ _[*his/her*]_ _ trust. If a child does not exercise this power of termination, the trust shall be held and administered in accordance with the terms of _ _[*article/paragraph*]_ _ _ _[*specify number or letter*]_ _ of this instrument.**

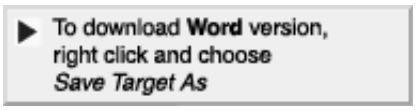
Comment: Form 9.28-1, with appropriate introductory modification, should be used in a trust for minors to provide for disposition when the child chooses not to terminate the trust at age 21. See App B.

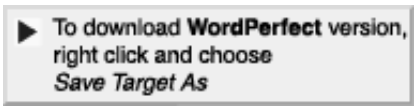
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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/ E. Distribution When Child Dies/ §12.62 1. Form: Distribution to Child's Estate

E. Distribution When Child Dies

§12.62 1. Form: Distribution to Child's Estate





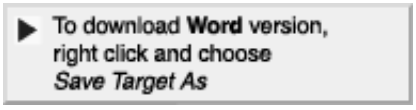
12.62-1 Distribution to child's estate

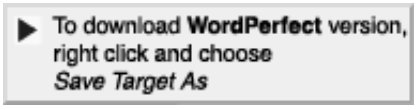
***Distribution of Remainder*. If a child dies before attaining age _ _[*18/21*]_ _ _ _[*or before receiving full distribution of* _ _[*his/her*]_ _ *trust,*]_ _, the undistributed balance of that child's trust (including both principal and any accrued or undistributed income) shall be distributed, free of trust, to the executors or administrators of _ _[*his/her*]_ _ estate.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.62A 2. Form: Distribution According to Beneficiary's Power of Appointment

§12.62A 2. Form: Distribution According to Beneficiary's Power of Appointment





12.62A-1 Distribution according to beneficiary's power of appointment

***Beneficiary's Power of Appointment*. If a child dies before attaining age _ _**[*18/21*]**_ _ _ _**[*or before receiving full distribution of _ _*[*his/her*]*_ _ trust,*]*_ _*, the trustee shall distribute the undistributed balance of that child's trust (including both principal and any accrued or undistributed income) to one or more persons or entities (including the child's own estate) on terms and conditions (either outright or in trust) as the child shall appoint by a will or codicil specifically referring to and exercising this power of appointment. Any part of the child's trust not effectively appointed by the child in this manner shall be distributed, free of trust, to the child's then-living issue by right of representation or, if there is no living issue of the child, to the settlor's then-living issue by right of representation. If any part of that balance, however, would otherwise be distributed to a person for whose benefit a trust is then being administered under this instrument, that part shall instead be added to that trust and shall thereafter be administered according to its terms.**

[*If appropriate, add the following option*]

[*Option: Distribution if all settlor's issue die before full distribution*]

***Distribution if Power of Appointment Not Exercised*. If a child dies before attaining age _ _**[*18/21*]**_ _ _ _**[*or before receiving full distribution of _ _*[*his/her*]*_ _ trust,*]*_ _*, all the settlor's issue are deceased, and no other distribution of the property is directed by this instrument or by the child's exercise of a power of appointment as provided under _ _*[*article/paragraph*]*_ _ _ _*[*specify number or letter*]*_ _*, the trust estate or the portion of it then remaining shall be distributed _ _*[*e.g., in equal shares to _ _*[*name*]*_ _ and _ _*[*name*]*_ _, who are living on the occurrence of the event requiring distribution. If either of them are not then living but leave then-living issue, that issue shall take, by right of representation, the share that their parent would have taken had the parent been then living/to the Regents of the University of California*]*_ _*.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.63 F. Advantages and Disadvantages

§12.63 F. Advantages and Disadvantages

The IRC §2503(c) trust offers all the practical advantages of a custodianship, except that (1) an attorney must be retained to draft the trust instrument and (2) a trust, unlike a custodianship, must file separate income tax returns annually. Creation of a §2503(c) trust is relatively simple, however, and should not be prohibitively expensive.

Most clients making substantial gifts will prefer a §2503(c) trust to a custodianship, despite the additional costs of drafting the trust instrument and preparing annual income tax returns. A §2503(c) trust can be tailored to better meet the settlor's tax and personal objectives. Moreover, a custodianship funded with an inter vivos gift automatically terminates when the beneficiary reaches age 21, whereas a §2503(c) trust can continue beyond the beneficiary's 21st birthday unless he or she elects to terminate the trust within a specified period after attaining age 21. The ability to control the distribution of gifted property if the minor dies before age 21 is another benefit of using a trust rather than a custodianship (which requires distribution to the estate of a deceased minor).

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IV. SECTION 2503(b) TRUSTS (INCOME INTERESTS ONLY QUALIFYING FOR ANNUAL EXCLUSION)

A. Introduction

§12.64 1. "Income Interest Only" Qualification

As discussed in detail in §§12.38-12.63, a gift to a trust established under IRC §2503(c) will qualify for the annual exclusion even though neither the income nor the principal otherwise qualify as present interests. When a gift is made to a trust established under IRC §2503(b), however, only the income interest will qualify for the exclusion. Unlike the principal of a §2503(c) trust, the principal of a §2503(b) trust does not pass to the beneficiary by age 21 but commonly remains under the settlor's control until the beneficiary reaches a specified age or ages.

In determining whether a contribution to a trust qualifies for the annual exclusion, the courts and the IRS examine the contribution as two separate gifts creating two separate legal interests: the income interest and the remainder interest. Accordingly, one of these two gifts may qualify for the annual exclusion as a gift of a present interest in property, while the other does not.

EXAMPLE: A trust provides that *A* is to receive current distributions of all income periodically but is not to receive the principal until age 25. Because *A* receives a stream of income that begins when the trust begins, *A*'s income interest is a present interest that qualifies for the annual exclusion. *A*'s remainder interest, however, is a future interest that does not qualify for the annual exclusion. Among the factors to be considered in determining whether an income interest is a present interest are whether the right to income is immediate and whether it is unrestricted. See Rev Rul 75-415, 1975-2 Cum Bull 374; Treas Reg §25.2503-3(c), Example (1).

To qualify for the annual exclusion, the income interest must also have an ascertainable value. An income interest is not ascertainable if the trustee has the right to invade principal for a beneficiary other than the income beneficiary or has discretion to distribute income disproportionately among multiple income beneficiaries. In addition, the trustee may have broad discretion to make allocations between income and principal that make it impossible to value the income interest. Finally, when the trust is funded with unproductive property (*e.g.,* non-dividend-paying stock, insurance, or artwork), the income interest is unascertainable and does not qualify for the annual exclusion.

NOTE: The annual exclusion may be completely unavailable if the trust is to be funded by nonproductive property, because the IRS may then argue that the right to the income of the trust has no value. See §2.35.

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§12.65 2. Valuing the Income Interest

When property is contributed to a trust, and the gift of the income interest qualifies for the annual exclusion but the remainder interest does not qualify, the value of the contributed property must be divided between its two components: the present value of the income interest and the present value of the remainder. This division depends principally on the interest factor used to value term interests under IRC §7520 for the month in which the gift is made and the number of years that income will be paid to the income beneficiary (normally, the number of years that the remainder beneficiary must wait to receive principal). If the beneficiary's right to receive income during the term of the trust terminates on the beneficiary's death, then the value of the income interest will vary with the income beneficiary's age.

The IRS has published tables to be used in valuing income interests and remainders. See Temp Treas Reg §25.2512-5T(d). The regulations provide for an interest rate or discount factor that is 120 percent of the applicable federal midterm rate (compounded annually) in effect for the month in which the gift is made, rounded to the nearest two-tenths of one percent. IRC §7520; Temp Treas Reg §20.2031-7T(d). See chap 6.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.66 3. Tax Benefits Versus Nontax Objectives

§12.66 3. Tax Benefits Versus Nontax Objectives

A donor or settlor must weigh potential tax benefits (particularly the annual exclusion) against the desire to control when, and to whom, trust property is to be distributed. Guardianships, custodianships, and IRC §2503(c) trusts may all fully qualify for the annual exclusion and allow the donor or settlor, or a fiduciary selected by the settlor, to control the minor's access to funds but only until age 18 (guardianships) or age 21 (custodianships and §2503(c) trusts).

The IRC §2503(b) trust permits more control by the settlor at the expense of some tax benefits. These trusts are designed so that the income interest qualifies for the annual exclusion, while the value of the remainder interest does not. However, only the income must be distributed to the beneficiary by or before the time he or she reaches age 21, and the principal may be held as long as specified in the trust instrument.

When the remainder interest does not qualify for the annual exclusion, that part of the transfer to the trust will be a taxable gift that uses part of the settlor's $1 million IRC §2505 gift tax applicable exclusion amount. If the settlor's applicable exclusion amount has already been exhausted, an actual payment of gift tax will be required. In determining whether this is an important disadvantage, each donor must consider the following:

- Has the annual exclusion been fully used through the transfer of the income interest or through other gifts?
- Is the estate small enough so that the remaining IRC §2010 estate tax applicable exclusion amount will be sufficient to shield the donor's estate from federal estate tax even though the remainder interest consumes a portion of the unified credit?
- In a larger estate, is it likely that the present value of gift tax incurred if the unified credit is exhausted will be insignificant compared to long-term tax savings?

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B. Features of §2503(b) Trusts

§12.67 1. Standard Trust: Current Income Interest Combined With Post-Age-21 Principal Distribution

An IRC §2503(b) trust commonly used for transfers to a child provides for income to be paid to the beneficiary currently and principal to be paid when the beneficiary reaches a mature age or ages (*e.g.,* one third of the principal at age 30, one half of the remaining principal at age 35, and the remaining principal at age 40). This trust strikes a medium position between tax benefits (qualification of income for the annual exclusion) and settlor control.

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§12.68 2. *Herr* Trusts: Accumulation of Pre-Age-21 Income for Single Beneficiary

To avoid the possible disadvantage of paying out all income at least annually to a child, the donor may use a variant of the IRC §2503(b) trust, called a *Herr* trust after the case in which the technique was judicially approved: *Commissioner v Herr* (3d Cir 1962) 303 F2d 780, acq 1968-2 Cum Bull 2. A *Herr* trust provides for accumulation or distribution of income in the discretion of the trustee until the beneficiary reaches age 21. At age 21, all the accumulated and undistributed income must be paid to the beneficiary or, if the beneficiary dies before age 21, must be distributed to the beneficiary's estate or according to the beneficiary's exercise of a general power of appointment.

NOTE: A *Herr* trust may also be a variant of an IRC §2503(c) trust, because the income interest in a *Herr* trust also qualifies for the annual exclusion under §2503(c).

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§12.69 a. Description and Tax Aspects

In a *Herr* trust, the income interest may qualify for the annual exclusion under IRC §2503(c) even though the remainder interest does not, because the right to receive income is considered to be a separate property right. See Rev Rul 68-670, 1968-1 Cum Bull 413. The trustee may therefore have the power to accumulate income before the child attains age 21 and delay distribution of the principal well beyond age 21, but the settlor may still obtain the benefit of the annual exclusion because the income interest satisfies the requirements of IRC §2503(c). In order to achieve this result, accumulated income must be paid to the minor when he or she reaches age 21, although trust principal may be retained in trust for any period fixed by the settlor.

In its simplest form, a *Herr* trust is a trust for the benefit of a person under age 21, which provides the following:

- The trustee has absolute discretion to accumulate or distribute income while the beneficiary is under age 21;
- Accumulated income remaining undistributed on the beneficiary's 21st birthday must be distributed to the beneficiary at that time (or paid to the beneficiary's estate if he or she dies before reaching age 21);
- Income earned by the trust after the beneficiary attains age 21 will be distributed currently (although this provision does not qualify the income interest after age 21 as a present interest eligible for the annual exclusion, as discussed in §12.68); and
- The trust corpus must be distributed to the beneficiary when he or she attains an age or ages set forth in the trust instrument (*e.g.,* 35).

Courts have viewed contributions to *Herr* trusts as gifts of three separate property interests: (1) the income interest before the beneficiary reaches age 21; (2) the income interest generated from age 21 through the termination of the trust; and (3) the remainder interest. In *Herr*, the court ruled that the pre-age-21 income interest was eligible for the annual exclusion under IRC §2503(c). The IRS eventually acquiesced in the tax court opinion in the *Herr* case and allowed the annual exclusion for the pre-age-21 income interest. Rev Rul 68-670, 1968-2 Cum Bull 413.

NOTE: The trustee may be granted full discretion to distribute corpus to the beneficiary before the beneficiary reaches the age at which the trust is slated to terminate. See form 9.42-1. This will allow the settlor to set a comparatively late age for a mandatory full pay-out of trust corpus, because the trustee may make distributions of corpus at any time after the beneficiary reaches age 21.

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§12.70 b. Qualification of Post-Age-21 Income Interest

In a trust that provides for discretionary distribution of income to age 21, distribution of all accumulated income at age 21, and mandatory distribution of income thereafter, the post-age-21 income interest does not qualify for the annual exclusion as a future interest under IRC §2503(b), although the pre-age-21 income interest qualifies under IRC §2503(c). *Estate of Levine v Commissioner* (2d Cir 1975) 526 F2d 717. In Rev Rul 76-179, 1976-1 Cum Bull 290, the IRS indicated its intention to follow *Levine*.

Under *Levine* and the current position of the IRS, there is no gift tax benefit to current distribution of post-age-21 income. The settlor may prefer a trust in which such income is not necessarily distributed currently but is distributed or accumulated at the trustee's discretion. In making distributions, however, the compressed trust income tax brackets under IRC §1(e) should be taken into account.

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§12.71 C. Combination of §2503(b) Trust and CUTMA

A combination of the IRC §2503(b) trust and the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) may allow both pre-age-21 and post-age-21 income interests to qualify for the annual exclusion without requiring all income to be currently distributed from the inception of the trust.

A standard IRC §2503(b) trust provides that income must be paid currently to the beneficiary while corpus may be retained, in the trustee's discretion, past the time when the beneficiary reaches age 21. The income interest qualifies as a present interest because, from the inception of the trust, the beneficiary receives current distributions of income as it is earned or at least annually. Accordingly, both the pre-age-21 income interest and the post-age-21 income interest qualify for the annual exclusion. The value of the remainder interest does not qualify for the annual exclusion.

As noted in §12.68, if the trust provided that pre-age-21 income could be accumulated, and the distribution of such accumulated income could be deferred until the beneficiary reached age 21, then the value of the pre-age-21 income would qualify for the annual exclusion under IRC §2503(c), whereas the value of the post-age-21 income probably would not qualify. *Estate of Levine v Commissioner* (2d Cir 1975) 526 F2d 717.

The settlor may seek the same control and tax benefits sought by the taxpayers in *Levine* by establishing a trust that:

- Requires current (at least annual) distributions of income to the beneficiary from the inception of the trust; and
- Provides that, during the period before the minor reaches age 21, income distributions must be made to a custodian under CUTMA and be held by the custodian until the minor reaches age 21.

Under this arrangement, the settlor could contend that the entire income interest (both pre-age-21 and post-age-21) is eligible for the annual exclusion under IRC §2503(b) because all income is required to be distributed currently. There is a substantial risk, however, that the IRS will apply the *Levine* rationale to these arrangements and determine that the post-age-21 income interest is a future interest that does not qualify for the annual exclusion. See Lischer, *Gifts to Minors*, Tax Management Portfolios 846-2d, A-37 (2005).

Under Prob C §3906, the trustee of a trust can, under some circumstances, distribute amounts payable to the minor to a custodian for the minor's benefit, even if the trust does not mention CUTMA. See §§12.23-12.37. Any such diversion of income from the minor to a custodian that is not authorized by the trust instrument must be approved by the superior court if the amount distributed exceeds $10,000, unless the transfer is to a custodian which is either a trust company or an individual designated as a trustee by a trust instrument that does not require bond. See Prob C §3906(c)(3).

If it is important to the settlors' estate planning goals that both the pre-age-21 and the post-age-21 income interest qualify for the annual exclusion under IRC §2503(b), the trust instrument should specifically state that the amounts that the trust instrument directs to be paid to the beneficiary must be paid directly to the beneficiary and may not be paid to a custodian under CUTMA. Such a direction in a trust instrument is binding on the trustee. Prob C §3906(c)(2).

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D. Tax Aspects of §2503(b) Trusts

§12.72 1. Gift Tax

Although the income interest in an IRC §2503(b) trust will qualify for the annual exclusion, the remainder interest will not. Therefore, the settlor will be required to file a gift tax return. Gift tax must be paid unless the donor has not fully used his or her unified credit.

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§12.73 2. Estate Tax

Creation of an IRC §2503(b) trust ordinarily does not produce any estate tax problems unless the settlor retains rights or powers that would require inclusion in his or her estate, *e.g.,* serving as trustee with discretionary distribution powers. If the beneficiary dies before termination of the trust, the property will not be included in the beneficiary's estate unless he or she has a general power of appointment.

In the case of a *Herr* trust, in which the pre-age-21 income interest qualifies for the annual exclusion under IRC §2503(c), the undistributed income would be included in the beneficiary's estate if the beneficiary died before age 21 because the beneficiary either has a general power of appointment over the accumulated but undistributed income or such income is distributable to the beneficiary's estate.

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§12.74 3. Income Tax

Income of an IRC §2503(b) trust is taxed to the beneficiary because the trust requires its distribution to the beneficiary. If the income is not distributed, it will be taxed to the trust. If the grantor trust rules apply, income that is distributed to discharge the settlor's legal obligation of support will be taxed to the settlor. IRC §677(b). This result can be avoided by trust provisions precluding the trustee from making distributions that will satisfy the settlor's legal obligations, including the obligation to support any person. See Price, Price on Contemporary Estate Planning (2007).

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.75 4. Generation-Skipping Transfer Tax

§12.75 4. Generation-Skipping Transfer Tax

The creation of an IRC §2503(b) trust for a grandchild or other skip person should not be subject to generation-skipping transfer (GST) tax with respect to the income interest, because that interest qualifies for the annual exclusion under §2503(b) and satisfies the requirements of IRC §2642(c). However, the gift of the remainder interest to the grandchild or other skip person will likely result in a taxable termination on the death of the income beneficiary, unless the income beneficiary has a general power of appointment. See chap 4.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.76 E. Form: Herr Trust--Distribution of Income by Age 21

§12.76 E. Form: *Herr* Trust—Distribution of Income by Age 21

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12.76-1 Payment of pre-age-21 income at age 21

***Distribution of Income*. Until the child attains age 21, the trustee may pay to or apply for the benefit of the child as much of the trust income as the trustee, in the trustee's discretion, considers appropriate and shall accumulate any income not so distributed in a separate income account until the child attains age 21 or dies before attaining that age. When the child attains age 21, this accumulated income shall be paid to the child, free of trust, if the child is then living.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.77 F. Form: Distribution of Post-Age-21 Income

§12.77 F. Form: Distribution of Post-Age-21 Income

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12.77-1 Distribution of post-age-21 income

***Distribution of Income*. The trustee shall pay to the child all net income of the trust earned after the date on which the child attains age 21, not less frequently than quarter-annually. The trustee shall distribute to the child the principal of the trust when the child attains age _ _[*e.g., 30*]_ _.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.78 G. Form: Distribution of Balance if Beneficiary Dies Before Age 21

§12.78 G. Form: Distribution of Balance if Beneficiary Dies Before Age 21

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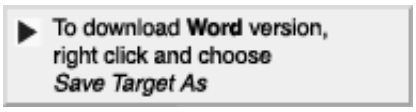
12.78-1 Distribution of balance if beneficiary dies before age 21

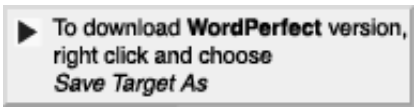
***Distribution of Remainder*. If the child dies before attaining age 21, the trustee shall distribute the undistributed balance of the accumulated income to one or more persons or entities (including the child's own estate) on terms and conditions (either outright or in trust) as the child shall appoint by a will or codicil specifically referring to and exercising this power of appointment. Any part of this accumulated income not effectively appointed by the child in this manner shall be distributed, free of trust, to the child's then-living issue by right of representation or, if there are no living issue, to the settlor's then-living issue by right of representation. If, however, any part of that balance would otherwise be distributed to a person for whose benefit a trust is then being administered under this instrument, that part shall instead be added to that trust and thereafter be administered according to its terms.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.79 H. Form: Discretionary Early Distribution of Principal

§12.79 H. Form: Discretionary Early Distribution of Principal





12.79-1 Discretionary early distribution of principal

***Discretionary Distributions*. The trustee may, but is not required to, distribute some or all trust principal to the child between the date when the child reaches age 21 and the date when the child reaches age _ _**[*e.g., 30*]**_ _.**

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V. *CRUMMEY* TRUSTS

§12.80 A. Introduction and Description

A *Crummey* trust is any trust that uses *Crummey* withdrawal powers as the device for permitting contributions to the trust to qualify for the IRC §2503(b) annual gift tax exclusion. The clauses are named after the case holding that specified withdrawal powers entitled the donor to claim the benefit of the exclusion even though the powerholders were minors. See *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82. A *Crummey* withdrawal power gives a beneficiary a right to withdraw contributions to a trust when contributions are made. This gives the beneficiary an immediate right of enjoyment with respect to the transferred property, thereby circumventing the provision of IRC §2503(b), which does not allow the annual gift tax exclusion for gifts of future interests. Frequently, multiple beneficiaries are each given the right to withdraw shares of each contribution, with the result that the donor may be allowed multiple gift tax exclusions just as if the donor had made outright transfers to multiple donees.

Crummey withdrawal powers normally expire after a very short period of time. Once a power expires, there are no other specific distribution requirements except for the need to address the IRS's contention that no gift tax exclusions are allowed for "naked" powers. See §§12.93-12.95. There is no requirement that the *Crummey* trust terminate when the beneficiary reaches a particular age, or that the beneficiary of the trust must be a minor. The *Crummey* trust achieves the tax benefits of §§2503(b) and 2503(c) trusts but avoids many of their limitations and may thus better accommodate the settlor's nontax objectives.

Clients are sometimes concerned that beneficiaries will actually exercise their withdrawal rights. As a practical matter this usually does not occur. Most beneficiaries realize that if they exercise the right, it will be contrary to the settlor's wishes and the settlor may not make contributions in subsequent years. It is imperative, however, that there not be a prearranged plan that the powers will not be exercised, as this would enable the IRS to contend that the withdrawal power did not really exist. Clients should also be advised that unexercised powers may have income tax consequences (see §12.100) and may raise asset protection concerns (see §1.8) for the beneficiary.

Generally, the courts have judged *Crummey* clauses under standards more lenient than those applied by the IRS. In *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82, the annual exclusion was allowed even though the beneficiaries apparently were not notified of their right of withdrawal. In *Mary Hull Naumoff,* TC Memo 1983-435, the court allowed the annual exclusion even though the trust did not specifically provide that the power of withdrawal could be exercised by a guardian for the minor beneficiary. See also the discussion of naked powers and *Estate of Maria Cristofani* (1991) 97 TC 74, acq 1992-1 Cum Bull 1, acq 1996-2 Cum Bull 1, in §§12.93-12.95. Nevertheless, careful drafters can usually meet the estate planning objectives of a *Crummey* trust while remaining within the limits imposed by the IRS.

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B. Requirements for Annual Exclusion

§12.81 1. Minor Beneficiaries

Following *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82, the IRS ruled that a gift in trust to a minor who had a right of withdrawal was a present interest and therefore qualified for the annual exclusion, even if no guardian was appointed, as long as there was no impediment under the trust or local law to appointment of a guardian before the expiration of the withdrawal period. See Rev Rul 73-405, 1973-2 Cum Bull 321.

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§12.82 2. Right of Withdrawal

Although the IRS has generally accepted the principles behind the *Crummey* decision, it has refused to allow the annual exclusion when the power of withdrawal cannot reasonably be exercised because of limitations under the trust's governing instrument. See Rev Rul 81-7, 1981-1 Cum Bull 474. The IRS is chiefly concerned with two related issues:

- Is the beneficiary (or a guardian for a minor beneficiary) notified of the existence of the withdrawal right and of contributions subject to it?
- Does the right of withdrawal lapse only after there is sufficient time for an adult beneficiary to act or for a guardian to be appointed for a minor beneficiary and for that guardian to take action?

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a. Notification of Withdrawal Rights

§12.83 (1) Importance of Written Notice

Various IRS rulings emphasize the importance of giving notice to the beneficiaries (at least if they are adults) of the annual contributions to the trust that are subject to withdrawal. See Rev Rul 83-108, 1983-2 Cum Bull 167; Rev Rul 81-7, 1981-1 Cum Bull 474. Although the law in this area is not entirely settled (see Dennis-Strathmeyer, *A* Crummey *Action on Decision? Where Are We Now?*, 18 CEB Est Plan Rep 38 (Oct. 1996)), prudence suggests giving beneficiaries written notice of their withdrawal rights each time a contribution is made that creates such a right. This activity should be documented. If the beneficiary is a minor, notice must also be given to any legal guardian or, if none, a natural guardian (parent).If the beneficiary is otherwise under disability, notice should be given to any conservator or authorized agent of that person.

In the view of the IRS, the right to notice cannot be waived by the beneficiary. See IRS Letter Ruling 9532001 in which the IRS concluded an advance waiver would result in loss of the annual exclusion.

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§12.84 (2) Persons Receiving Notice

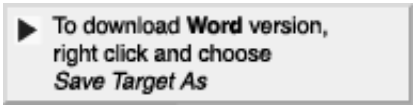
Although some guidance is provided by private letter rulings, which are not binding on the IRS in other cases, there are no formal rules dictating the persons entitled to notice of a withdrawal right. Clearly, notice must be given to a competent adult holder of the right, but questions arise in connection with minors and incompetent adults. In addressing these questions, practitioners should be concerned with the desirability of demonstrating that the withdrawal power was not concealed from the powerholder and the persons most likely to act on behalf of the powerholder's best interests if the powerholder is a minor or incompetent adult. In general, the California Probate Code normally requires sending notice to principals, even infants (on the theory that the notice might find its way into the hands of a concerned person). Although not binding for tax purposes, this is a prudent strategy. In addition, it would be difficult to explain a failure to notify a person having legal capacity to act for the powerholder (guardian, conservator, or attorney in fact under a durable power of attorney.) Finally, unless the parents of a minor or the spouse of an incompetent adult is the settlor, it would similarly be difficult to explain why notice was not given to such a person.

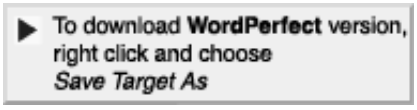
Some practitioners ask the recipients of the notice to sign an acknowledgment of the notice and return it to the trustee. When this practice is followed, it is imperative that the beneficiaries not *release* their withdrawal rights, but merely acknowledge receipt of the notice. A *release* of a withdrawal right can have adverse tax consequences comparable to an excess *lapse* of a withdrawal right. See §12.89.

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§12.85 (3) Form: Notice to Beneficiary





12.85-1 Notice to beneficiary

Dear _ _[*name of beneficiary or interested person*]_ _:

On _ _[*date*]_ _, a _ _[*dollar amount*]_ _ gift was made by _ _[*name of donor*]_ _ to the _ _[*name of trust*]_ _ Trust. Under _ _[*article/paragraph*]_ _ _ _[*specify number or letter*]_ _ of the trust, _ _[*you have/specified beneficiary has*]_ _ the right to withdraw _ _[*dollar amount of withdrawal limit*]_ _ until _ _[*duration of withdrawal period, e.g., until December 31 or for 45 days from date of contribution*]_ _. A request for withdrawal must be in writing and delivered to the trustee before the right expires.

Please indicate your receipt of this letter by dating and signing the enclosed copy and returning it in the enclosed self-addressed envelope.

Very truly yours,
__[*Signature of trustee*]__
Trustee

I acknowledge receipt of this letter.

Date: _ _ _ _ _ _ __[*Signature of recipient*]__
_ _[*Recipient*]_ _

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§12.86 b. Period of Withdrawal Right

The IRS has taken the position that the beneficiary must have sufficient time to exercise the power of withdrawal after receiving notice of the gift, especially if the exercise of the power requires procedural steps such as the appointment of a guardian. Several of the rulings seem to be based on the assumption that the appointment of a guardian might require several weeks. The IRS has never established a fixed minimum period requirement. 45 days is clearly sufficient. That is the time period for the power discussed in Rev Rul 83-108, 1983-2 Cum Bull 167. However, the IRS has frequently not challenged much shorter periods. For example, despite its other objections, the Service did not raise the 15-day period as an issue in *Estate of Maria Cristofani* (1991) 97 TC 74, acq 1992-1 Cum Bull 1, acq 1996-2 Cum Bull 1.

Most rulings regarding sufficiency of time to exercise a right of withdrawal involve a right of withdrawal that lapses at the end of the calendar year and contributions that are made just before the end of the year. In Rev Rul 83-108, the IRS allowed the annual exclusion for a gift to a *Crummey* trust under which the beneficiary's right of withdrawal would not lapse until 45 days after the beneficiary received written notice of a contribution, even though the 45-day period stretched into the calendar year after the year of contribution. The gift was considered to be completed in the calendar year of the contribution even though, as a practical matter, it was unlikely that the beneficiary could exercise the right before January of the following calendar year. If a drafter is going to provide that the withdrawal right will expire at the end of the year, it is normally desirable to provide that this period will be extended if gifts are made late in the year.

Sometimes it is important to avoid having a withdrawal power lapse in a subsequent calendar year, as this may cause lapses in the following year that exceed the greater of $5000-or-5 percent exclusion provided in IRC §2514(e). See §§12.87-12.90. Gifts to the *Crummey* trust should be made soon enough in the current year to assure they will lapse in the current year. Further, as a general rule it is preferable for annual exclusion gifts to be made at the beginning of a calendar year so that the opportunity to make the gift will not be lost in the event of the donor's death midway during that year.

Another strategy sometimes used to address the risk of lapses in excess of the "5 or 5" amount is to provide that withdrawals only lapse with respect to that amount each year and otherwise continue in effect. For a discussion of such "hanging" powers, see §12.105. See also form 12.98-1.

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§12.87 c. Amount of Withdrawal Right

In cases in which it is important to avoid the possibility of a lapse of a withdrawal power that exceeds the $5000-or-5 percent safe harbor under IRC §2514(e), the *Crummey* withdrawal power is normally limited to the lesser of the "5 or 5" amount or the donor's remaining annual gift tax exclusion for gifts that year to the particular beneficiary. See §12.90.

If lapses in excess of the "5 or 5" amount are not a concern, the beneficiary is normally entitled to withdraw the contribution to the extent the transferred property will not be subject to gift tax because of the IRC §2503(b) annual exclusion.

This creates a timing problem for any gift of separate property by a married donor who may wish to split the gift with his or her spouse under IRC §2513 in order to effectively double the available annual exclusion. Usually, the spouses will not formally consent to split-gift treatment until the gift tax return is prepared and filed in the subsequent calendar year. (see §§2.43-2.46). However, *Crummey* clauses must permit withdrawal beginning at the time of the transfer, so it is not possible to wait and see whether the spouse will actually consent. A potential solution to this problem is to provide that the amount withdrawable will be determined on the assumption that a gift by a married person will be split unless the trustee is notified otherwise at the time of the transfer. If the settlor fails to give the notice and the settlor's spouse later declines to split the gift, the settlor will have made a taxable gift, but this would have been the case regardless of the provisions of the withdrawal power. There are two potential drawbacks to this approach. First, if the beneficiary actually exercises the power, the beneficiary will receive twice as much as he or she would have been entitled to receive had the withdrawal right been limited in amount to only the donor's available gift tax annual exclusion. Second, an excessively large withdrawal power will be undesirable in situations in which it is important to avoid a lapse of a power in excess of the $5000-or-5-percent exclusion provided in IRC §2514(e). See §12.89.

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§12.88 (1) Spouse's *Crummey* Power

Sometimes a spouse is given a *Crummey* withdrawal power with respect to a trust funded with separate property. If this is done in connection with a trust that may pay benefits to grandchildren or other skip persons, it is imperative that the amount that can be withdrawn by the spouse not exceed the IRC §2514(e) amount. Otherwise, the power will create an estate tax inclusion period (ETIP) for GST tax purposes. See §4.29. Further, the lapse of a greater power may result in inclusion of a portion of the trust in the spouse's estate under IRC §2041(a)(3)(B) if the spouse has any other interest in the trust. See §12.89. This is rarely desirable. If the spouse does not have any other interest in the trust, the power may be ineffective for gift tax annual exclusion purposes. See the discussion of naked powers at §12.93.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.89 (2) Analyzing Excess Lapse Issues

§12.89 (2) Analyzing Excess Lapse Issues

In some cases, it is critical to avoid lapses of withdrawal powers that will result in a taxable release of a general power of appointment under IRC §2514. Such a release can constitute a taxable gift (although the gift may not be complete at the time of the lapse). In this connection, IRC §2514(e) provides that a *lapse* of a general power is a *release* of the power:

> only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts:
> (1) $5,000, or
> (2) 5 percent of the aggregate value of the assets of which, or the proceeds of which, the exercise of the lapsed power could be satisfied.

The quoted language describes what is known as the "5 or 5" amount. If a single beneficiary's withdrawal powers lapse with respect to an amount greater than the "5 or 5" amount in any calendar year, the beneficiary will generally be treated for transfer tax purposes as removing the excess amount from the trust and then making a gift of the excess amount back to the trust. This transfer tax result can be unfortunate, particularly in the following situations:

- *Power held by a skip person when trust is not exempt from GST tax.* If a grandchild or other skip person has a *Crummey* power to withdraw from a trust that is not exempt from GST tax and the trust has at least one nonskip person beneficiary, any lapse of the skip person's power in excess of the "5 or 5" amount in any calendar year will be treated as a GST taxable distribution to the powerholder, which will be taxed at a flat rate equal to the maximum estate tax rate. Treas Reg §26.2652-1(a)(5), Example 5. CAVEAT: If the trust has any nonskip person beneficiaries, the trust may not be exempt from GST tax unless the donor has filed gift tax returns for transfers to the trust (regardless of whether returns are required for gift tax purposes) and attached the necessary notices of allocation. See §4.17.
- *Power held by a person who retains other interests in the trust.* Just as an actual transfer to a trust may result in the trust estate being included in the estate of the transferor if the transferor retains an interest in the trust, the lapse of a power in excess of the "5 or 5" amount will result in a portion of the trust estate being included in the estate of the powerholder if the powerholder continued to have rights in the trust after the excess lapse. IRC §2041(a)(2). The portion of the trust so included can be substantial because of the method of calculating that portion (see Treas Reg §20.2041-3(d)(4), (5)), particularly in the case of life insurance trusts that may have greatly increased in value at the time of the insured's death. Such inclusion in the powerholder's estate can be particularly unfortunate if, for example, the withdrawal power is held by a child and the trust is a generation-skipping trust that has received an allocation of the grantor's GST tax exemption. Such an exempt trust would otherwise not be subject to transfer tax on the child's death. See also §12.88, concerning problems that occur if the power of a spouse exceeds the "5 or 5" amount.

In sharp contrast, the transfer tax consequences of an excess lapse will be virtually nonexistent if the trust has only one beneficiary, all distributions must be made to or for the benefit of one person during the life of that person, and any trust assets remaining at the beneficiary's death will be included in the in the beneficiary's taxable estate, whether by reason of the beneficiary having a general power of appointment or otherwise. Such trusts are frequently used to make gifts to skip persons so that the annual gift tax exclusion will apply for GST tax purposes. IRC §2642(c)(2). See §§4.15, 4.34. Such a trust is also appropriate for a child if there is little risk that the child will have a taxable estate over the IRC §2010(c) applicable exclusion amount if the child fails to survive until the child is entitled to receive the entire trust free from tax. The requirement of inclusion in the child's taxable estate results in the trust assets receiving a new income tax basis under IRC §1014 when the child dies, if the child dies after 2010, and allows the trust assets to receive a new income tax basis by making an allocation of aggregate basis increase under IRC §1022, if the child dies in 2010.

In cases other than those just described, the consequences of an excess lapse must be carefully examined. If the

consequences are not acceptable, steps must be taken to assure that excess lapses will not occur.

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§12.90 (3) Avoiding Excess Lapses

There are several general approaches to the problem of avoiding *Crummey* withdrawal power lapses in excess of the "5 or 5" amount when this is necessary. One is to limit the withdrawal powers to the "5 or 5" amount in the first place. The second is to provide that withdrawal powers do not lapse except on the last day of the calendar year, at which time they lapse only to the extent of the "5 or 5" amount (a "hanging power"). The drawback of the first approach is that the donor may not be able to make full use of the otherwise available gift tax annual exclusions. There are several disadvantages of hanging powers. The law regarding such powers is uncertain, and unwanted lapses may occur anyway, either because of the death of the powerholder or because of distribution of the trust. A third approach is to provide that the holder of a lapsed power retains a power of appointment over the lapse amount to the extent it exceeds the "5 or 5" amount. This prevents the gift caused by the excess lapse from being a completed gift. This approach presents problems similar to those posed by a hanging power. The gift will become complete if the trust is distributed or the beneficiary dies.

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§12.91 (4) Multiple Trust Problems

The IRS takes the view that any one individual is only entitled to one "5 or 5" exclusion each year regardless of the number of trusts involved. Rev Rul 85-88, 1985-2 Cum Bull 201. Whether this is the case if the different trusts have different settlors is not clearly addressed by the statute or current rulings, but the IRS is likely to take that position, as it is consistent with the concept that the IRC §2514(e) exclusion is a privilege held by the beneficiary.

These positions of the IRS create problems when a beneficiary of a trust has a withdrawal power under more than one instrument. It becomes possible that the lapses of the various powers will result in total lapses exceeding the "5 or 5" amount even if each instrument limits lapses to that amount. In order to address such problems, *Crummey* provisions should enable the donor to reduce or eliminate the withdrawal powers that will be created by a gift by giving notice to the trustee at the time of the gift. If a hanging power is being used, the provision for lapse of the hanging power should provide for reducing the amount otherwise allowed to lapse by the amount of lapses under other instruments.

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§12.92 d. Liquid Assets to Satisfy Withdrawal Power

The IRS has *not* required that a trust have sufficient liquid assets to satisfy the exercise of a withdrawal power. Thus, the annual exclusion has been allowed in a trust that held only interests in a limited partnership. IRS Letter Ruling 8445004. In this ruling, it was important that the trustee had the authority to sell, encumber, loan, or mortgage the trust assets in order to raise the cash necessary to meet withdrawal demands. See also IRS Letter Rulings 8134135, 8103069, 8008040. Nevertheless, the law in this area is uncertain. For further discussion of the issue, see §11.14.

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e. "Naked" *Crummey* Powers

§12.93 (1) IRS Disapproval of Naked Powers

A "naked" *Crummey* power is a *Crummey* power held by a person who has no other substantial rights to receive distributions from the trust. The IRS has long attacked attempts to obtain large numbers of annual gift tax exclusions for transfers to trusts by giving naked powers to a large group of relatives or friends who mysteriously do not exercise them when there is no rational motive not to do so. The IRS views the failure to exercise as evidence of an advance agreement that the powers will not be exercised and therefore concludes that the withdrawal rights stated in the agreement are illusory.

Thus, for example, in IRS Letter Ruling 8727003, the IRS National Office denied annual gift tax exclusions claimed by a married couple whose trusts for their two sons purported to grant naked *Crummey* withdrawal rights to 16 family members. Few of the family members exercised their rights, and those few later revoked their demands. See also, IRS Letter Ruling 9045002 (disallowing gift tax exclusions for withdrawal powers held by contingent remainder beneficiaries who were unlikely to ever receive distributions) and IRS Letter Ruling 9141008 (annual exclusion denied for 32 of 35 withdrawal powers). But see IRS Letter Ruling 9030005 (annual exclusion allowed for contingent remainder beneficiaries because trustee had discretion to sprinkle principal to these beneficiaries).

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§12.94 (2) *Cristofani* Ruling: Exclusion Allowed Despite Remote Remainder Interest

Despite the history of letter rulings disallowing the annual exclusion for naked *Crummey* powers or for *Crummey* powers held by persons with only remote contingent interests, the Tax Court allowed gift tax exclusions because of withdrawal powers held by contingent remainder beneficiaries in *Estate of Maria Cristofani* (1991) 97 TC 74, acq 1992-1 Cum Bull 1, acq 1996-2 Cum Bull 1. In that case, the donor created a trust that was to pay all income to her two children until donor's death, at which time the children would be entitled to outright distribution of the balance of the trust estate. Grandchildren were entitled to discretionary distributions of principal during donor's life, but the trust stated that the children were the primary beneficiaries. The grandchildren were entitled to distributions of income and a share of the trust at the end of the term only if a child failed to survive the donor. The issue presented was whether annual exclusions were allowable for the *Crummey* powers given to the five grandchildren.

In a reviewed decision, the full Tax Court judges ruled unanimously that the annual exclusions were allowable, rejecting the IRS's contention that the facts in the case were distinguishable from those in *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82 because the trust interests of the five grandchildren in *Cristofani* were far less substantial than those of the children in *Crummey.* The court concluded that it was sufficient to show that the grandchildren had in fact been given enforceable withdrawal powers. It should be emphasized that the court found that there was no advance agreement that the powers of the grandchildren would not be exercised. The same finding was made in *Estate of Lieselotte Kohlsaat,* TC Memo 1997-212.

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§12.95 (3) Post-*Cristofani*: IRS Renewed Challenge to Naked *Crummey* Power

In 1992, the IRS acquiesced "in result only" to the Tax Court decision in *Estate of Maria Cristofani* (1991) 97 TC 74, acq 1992-1 Cum Bull 1, acq 1996-2 Cum Bull 1, and indicated that, although it would not appeal, it disagreed with the Tax Court's "sweeping interpretation of *Crummey*" and would continue to challenge naked or contingent remainder beneficiaries' *Crummey* powers, preferably outside the Ninth Circuit. To some extent Action on Decision 1992-09, which announced the acquiescence, established a "safe harbor," stating:

> The Service does not contest annual gift tax exclusions for *Crummey* powers held by current income beneficiaries and persons with vested remainder interests. However, the Service will deny exclusions for powers held by individuals who either have no property interests in the trust except for *Crummey* powers, or hold only contingent remainder interests.

Unfortunately, this language provides little guidance with respect to discretionary income interests in sprinkling trusts, and it is rare that a remainder beneficiary's interest will not be contingent because most trusts contain survival requirements.

In *Estate of Joseph Cidulka,* TC Memo 1996-149 (which did not involve *Crummey* powers), the IRS won a small victory in a case involving a series of annual transfers to both a son and the son's wife. Each year the son's wife immediately retransferred her gift to the son. The court concluded that the gifts to the son's wife were actually gifts to the son, with the result that no annual exclusion was allowed for the transfers to the son's wife. Because the facts are substantively similar to what occurs when the holder of a naked power does not exercise the power, the IRS may attempt to use *Cidulka* as a favorable precedent.

In 1996, the IRS revised its acquiescence in *Cristofani* in what appears to be a retrenchment. Action on Decision 1996-010, which announced the revised acquiescence, states:

> [T]he Service will deny the exclusions for *Crummey* powers, regardless of the powerholders' other interests in the trust, where the withdrawal rights are not in substance what they purport to be in form. If the facts and circumstances of a particular case show that there was a prearranged understanding that the withdrawal right would not be exercised or that doing so would result in adverse consequences to its holder…, the creation of the withdrawal right is not a bona fide gift of a present interest in property.

Calling such withdrawal rights "illusory gifts of present interests," the IRS promised future litigation in cases in which "the substance of the transfers was merely to obtain annual exclusions and that no bona fide gift of a present interest was intended." By omitting any reference to the Ninth Circuit Court of Appeals in its modified acquiescence, the IRS appeared to be signaling a renewed attack on *Crummey* powers nationwide, even in the "home" circuit of *Cristofani* and *Crummey.*

In 1997, the IRS lost a case similar to *Cristofani*. Again, the court concluded that there was no prearranged agreement that the contingent beneficiaries would not exercise their withdrawal powers. *Estate of Lieselotte Kohlsaat,* TC Memo 1997-212.

As a result of this legal history, there is no "bright line" test for determining when the IRS will attack *Crummey* withdrawal powers held by persons who do not have significant mandatory income interests or a substantial probability of eventually receiving a distribution of a remainder interest. Further uncertainty is caused by the fact that in many cases these issues are not raised and contested until the death of the donor, at which time case law may be very different from the time the trust was created.

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C. Withdrawal Provisions

§12.96 1. Form: No Excess Lapse Protection

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12.96-1 *Crummey* clause without excess lapse protection

***Right to Withdraw Annual Exclusion Amount*. At any time a gift is made by any donor to this trust, each beneficiary of the trust shall have the immediate right to demand and receive immediate distribution of an amount equal to the amount specified in a writing signed by the donor and delivered to the trustee no later than the time of the gift. If no such amount is specified, the amount that may be withdrawn shall be the lesser of:**

(1) The amount of the gift divided by the number of persons having a right to demand a distribution with respect to the gift; or

(2) The amount of the Internal Revenue Code §2503(b) annual gift tax exclusion remaining available to the donor at the time of the gift for gifts to the distribution right holder in the calendar year. For purposes of determining the identity of the donor(s) and the amount of available gift tax exclusion remaining, any gift of separate property made by a married person shall be deemed to have been made one-half by that person and one-half by the spouse of that person unless either of those persons is not a citizen of the United States or the gift is accompanied by a statement that this sentence does not apply.

***Notice of Withdrawal Rights*. On receiving any gift to this trust that creates a distribution right under this _ _[*article/section*]_ _, the trustee shall immediately give written notice of the right to each person acquiring the right. If a right is acquired by a minor, notice also shall be given to a parent of the minor and any court appointed guardian of the minor. If a right is acquired by an incompetent adult, notice also shall be given to all of the following then in existence: the adult's spouse, the adult's conservator, and the adult's attorney in fact. The donor may require additional notice by giving written notice to the trustee at the time of the gift.**

***Exercise of Withdrawal Rights*. Each right to demand distribution shall expire unless it is exercised by delivering written notice to the trustee within 45 days following the date of the gift. In the case of a minor or incompetent adult, the right may be exercised on behalf of the holder by the holder's guardian, natural guardian, conservator, or attorney in fact. The trustee may, in the trustee's discretion, satisfy a distribution right holder's demand in cash or in kind using any trust assets. The distribution rights created by this _ _[*article/section*]_ _ are superior to all other distribution rights created in this instrument, and provisions of this document providing for retention in further trust of assets otherwise distributable to persons under a specified age are not applicable.**

Comment: Because this form may create withdrawal powers equal to the annual gift tax exclusion amount multiplied by the number of donors, the clause should only be used when no adverse tax consequences will result if the lapse of all withdrawal powers for the year may exceed the IRC §2514(e) "5 or 5" amount (equal to the greater of $5000 or 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapse powers could be satisfied.) See §12.89. If that condition is satisfied, the clause has the advantages of relative simplicity and assures that the gifts of each donor to the trust (including a donor's spouse if gifts are split under IRC §2513) will qualify for the annual gift tax exclusion. The provisions permitting modification in accordance with notices provided by the donor permit addressing unexpected circumstances. Because it is unlikely that the withdrawal power will ever be exercised, the clause does not address the issue of how the trustee will make the distribution. Probate Code §3906 permits distribution to a custodianship. This clause should not be used to give a withdrawal power to a spouse of a settlor if the IRC §2642(f) ETIP rule is a concern. See §4.29.

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§12.97 2. Form: Withdrawal Limited to "5 or 5"

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12.97-1 *Crummey* clause with "5 or 5" limitations

***Withdrawal Right Limited to $5000 or 5 Percent*. At any time a gift is made by any donor to this trust, _ _[*specify beneficiaries or class of beneficiaries*]_ _ shall each have the immediate right to demand and receive immediate distribution of an amount equal to the amount specified in a writing signed by the donor and delivered to the trustee no later than the time of the gift. If no such amount is specified, the amount that may be withdrawn shall be the lesser of:**

(1) The amount of the gift divided by the number of persons having a right to demand a distribution with respect to the gift; or

(2) The amount of the Internal Revenue Code §2503(b) annual gift tax exclusion remaining available to the donor at the time of the gift for gifts to the distribution right holder in the calendar year. For purposes of determining the identity of the donor(s) and the amount of available gift tax exclusion remaining, any gift of separate property made by a married person shall be deemed to have been made one-half by that person and one-half by the spouse of that person unless either of those persons is not a citizen of the United States or the gift is accompanied by a statement that this sentence does not apply; or

(3) The remaining "5 or 5" amount. The remaining "5 or 5" amount shall be determined by calculating a tentative "5 or 5" amount, which shall be the greater of $5000 or 5 percent of the aggregate value of the assets out of which, or the proceeds of which, an exercise of the withdrawal power could be satisfied, determined as of the date of the gift. The remaining "5 or 5" amount is the tentative "5 or 5" amount reduced by all demand rights held by the demand right holder with respect to this trust at any time during the calendar year to date, which have lapsed or might lapse during the calendar year. If more than one donor makes a gift to the trust at the same time, the remaining "5 or 5" amount shall be calculated based on the aggregate of the gifts, with the sum so determined then being divided by the number of donors making gifts at the same time for purposes of determining the annual gift tax exclusion to be allowed each donor. If, as of the date of the gift, the demand right holder has possessed or continues to possess any withdrawal rights under other trusts that have lapsed or might lapse during the calendar year, this and the other trusts subject to the holder's withdrawal powers shall be aggregated for purposes of computing the remaining "5 or 5" amount.

***Notice of Withdrawal Rights*. On receiving any gift to this trust that creates a distribution right under this _ _[*article/section*]_ _, the trustee shall immediately give written notice of the right to each person acquiring the right. If a right is acquired by a minor, notice also shall be given to a parent of the minor and any court appointed guardian of the minor. If a right is acquired by an incompetent adult, notice also shall be given to all of the following then in existence: the adult's spouse, the adult's conservator, and the adult's attorney in fact. The donor may require additional notice by giving written notice to the trustee at the time of the gift.**

***Withdrawal Rights Cumulative*. The withdrawal rights created by this _ _[*article/section*]_ _ are cumulative. At the end of each calendar year, the withdrawal rights of each holder that have been in existence more than 45 days shall expire as to that portion of such rights that is equal to the "maximum expiration amount." In the case of a demand right holder having no general power of appointment under another instrument that has lapsed during the calendar year, the maximum expiration amount is the greater of (a) $5000, or (b) 5 percent of the aggregate value of the assets out of which the demand right holder's withdrawal rights could be satisfied, determined using the value of the trust estate on the last day of the year. In other cases, the maximum expiration amount shall be calculated as if this trust and all trusts with respect to which the holder has allowed a general power of appointment to lapse during the calendar year were a single trust, and by reducing the result by the amounts of the lapses under the other trusts. The purpose of this provision is to prevent the occurrence of a lapse that would be treated as a release under Internal Revenue Code §2514(e).**

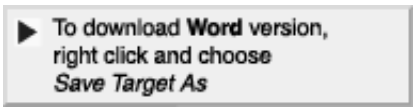
***Exercise of Withdrawal Rights*. A distribution right may only be exercised by delivering written notice to the trustee before the right expires. In the case of a minor or incompetent adult, the right may be exercised on behalf of the holder by the holder's guardian, natural guardian, conservator, or attorney in fact. The trustee may, in the trustee's discretion, satisfy a distribution right holder's demand in cash or in kind using any trust assets. The distribution rights created by this _ _[*article/section*]_ _ are superior to all other distribution rights created in this instrument, and provisions of this document providing for retention in further trust of assets otherwise distributable to persons under a specified age are not applicable.**

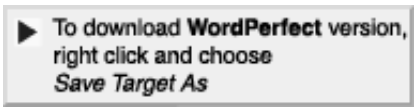
Comment: This clause is intended for use in situations in which it is imperative to avoid giving beneficiaries powers that might result in lapses in excess of the IRC §2514(e) "5 or 5" amount. See §§12.87-12.89. This includes most generation skipping trusts. Although any excess power will hang, this clause is fundamentally different than the one in the next section in that it attempts to prevent creation of an excess withdrawal power in the first place. This will likely reduce the annual gift tax exclusions that can be obtained for gifts to the trust unless 5 percent of the trust corpus is a substantial amount. It is important to note that the possibility of an excess withdrawal power still exists with this clause because the value of the trust estate at the time of the lapse (the end of the year) is not known on the date of the gift.

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§12.98 3. Form: "Hanging" *Crummey* Power





12.98-1 "Hanging" *Crummey* withdrawal power

***Withdrawal Right Limited to $5000 or 5 Percent*. At any time a gift is made by any donor to this trust, _ _[*specify beneficiaries or class of beneficiaries*]_ _ shall each have the immediate right to demand and receive immediate distribution of an amount equal to the amount specified in a writing signed by the donor and delivered to the trustee no later than the time of the gift. If no such amount is specified, the amount that may be withdrawn shall be the lesser of:**

(1) The amount of the gift divided by the number of persons having a right to demand a distribution with respect to the gift; or

(2) The amount of the Internal Revenue Code §2503(b) annual gift tax exclusion remaining available to the donor at the time of the gift for gifts to the distribution right holder in the calendar year. For purposes of determining the identity of the donor(s) and the amount of available gift tax exclusion remaining, any gift of separate property made by a married person shall be deemed to have been made one-half by that person and one-half by the spouse of that person unless either of those persons is not a citizen of the United States or the gift is accompanied by a statement that this sentence does not apply.

***Notice of Withdrawal Rights*. On receiving any gift to this trust that creates a distribution right under this _ _[*article/section*]_ _, the trustee shall immediately give written notice of the right to each person acquiring the right. If a right is acquired by a minor, notice also shall be given to a parent of the minor and any court appointed guardian of the minor. If a right is acquired by an incompetent adult, notice also shall be given to all of the following then in existence: the adult's spouse, the adult's conservator, and the adult's attorney in fact. The donor may require additional notice by giving written notice to the trustee at the time of the gift.**

***Withdrawal Rights Cumulative*. The withdrawal rights created by this _ _[*article/section*]_ _ are cumulative. At the end of each calendar year, the withdrawal rights of each holder that have been in existence more than 45 days shall expire for that portion of such rights that is equal to the "maximum expiration amount." In the case of a demand right holder having no general power of appointment under another instrument that has lapsed during the calendar year, the maximum expiration amount is the greater of (a) $5000, or (b) 5 percent of the aggregate value of the assets out of which the demand right holder's withdrawal rights could be satisfied, determined using the value of the trust estate on the last day of the year. In other cases, the maximum expiration amount shall be calculated as if this trust and all trusts with respect to which the holder has allowed a general power of appointment to lapse during the calendar year were a single trust, and by reducing the result by the amounts of the lapses under the other trusts. The purpose of this provision is to prevent the occurrence of a lapse that would be treated as a release under Internal Revenue Code §2514(e).**

***Exercise of Withdrawal Rights*. A distribution right may be exercised only by delivering written notice to the trustee before the right expires. In the case of a minor or incompetent adult, the right may be exercised on behalf of the holder by the holder's guardian, natural guardian, conservator, or attorney in fact. The trustee may, in the trustee's discretion, satisfy a distribution right holder's demand in cash or in kind using any trust assets. The distribution rights created by this _ _[*article/section*]_ _ are superior to all other distribution rights created in this instrument, and provisions of this document providing for retention in further trust of assets otherwise distributable to persons under a specified age are not applicable.**

Comment: This clause may be useful in the occasional situation in which it is desirable to avoid *Crummey* power lapses in excess of the IRC §2514(e) "5 or 5" amount (see §12.89), but the risk that the beneficiary will die while holding a large withdrawal power is small and significantly outweighed by the benefit of obtaining aggregate gift tax exclusions for all donors exceeding the "5 or 5" amount. The withdrawal powers expire each year only to the extent of

the "5 or 5" amount, with the remaining withdrawal rights being permitted to "hang." If the holder of the withdrawal right dies while a portion of the withdrawal right is still hanging, that portion will be included in the beneficiary's estate under IRC §2041. This clause should not be used to give a withdrawal power to a spouse of a settlor if the IRC §2642(f) ETIP rule is a concern. See §4.29. For a discussion of hanging powers, see §12.105. If any beneficiary of the trust has a withdrawal power under any other trust, it is necessary to modify the lapse provision so that the combined lapses under both trusts do not exceed the "5 or 5" limitation.

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D. Tax Consequences

1. Income Tax

§12.99 a. Settlor

If the settlor retains powers with respect to the trust that would cause him or her to be treated as owner of the trust under the grantor trust rules, income will be taxed to the settlor. IRC §§671-677. See §12.56. In such situations, the beneficiary is not taxed on the trust income. IRC §678(b). Taxation of income to the settlor represents an important planning opportunity because the IRS has ruled that the settlor of a grantor trust does not make an additional gift to the trust when the settlor pays the taxes on trust income without reimbursement by the trust. Rev Rul 2004-64, 2004-2 Cum Bull 7. See §3.24.

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§12.100 b. Beneficiary

The beneficiary is generally taxed on trust income that is distributed to him or her. See §§3.12, 3.15. Will the beneficiary be taxed on some or all of the trust's undistributed income because the trust instrument grants the beneficiary a power of withdrawal?

To the extent that income is attributable to assets over which the beneficiary has a power of withdrawal before the power lapses, the income is generally taxable to the beneficiary because, under IRC §678(a)(1), the beneficiary is considered to be the owner of the assets while the power of withdrawal is exercisable. Rev Rul 67-241, 1967-2 Cum Bull 225. Until the power of withdrawal lapses, the beneficiary could make the property his or her own by simply exercising the withdrawal right. Because the power of withdrawal normally applies only to new contributions, however, and typically lasts for only for a limited period, as a practical matter little income will be generated by the property during the withdrawal period.

The more important question is whether income attributable to property over which the beneficiary once had a power of withdrawal (which has lapsed) is taxable to the beneficiary. The IRS has taken the position in several private letter rulings that if the beneficiary had a power of withdrawal over assets contributed to a trust that has lapsed, the beneficiary is taxable on the income attributable to such assets as long as they remain in the trust. See IRS Letter Rulings 200022035, 9535047, 8701007, 8517052, 8308033 (all citing IRC §678(a)(2)). This limits the opportunity for splitting trust income between the trust and the beneficiary. See discussion in 22 CEB Est Plan Rep 22 (Aug. 2000). See also IRS Letter Rulings 200606006, discussed in 27 CEB Est Plan Rep 136 (Apr. 2006) (grantor trust will continue to be deemed owned by grantor despite lapse of spouse's withdrawal power because of express exception in IRC §678(b)). With a traditional §2503(c) trust, because a minor is taxed on distributed income while the trust is taxed on undistributed income, the trust's taxable income can be split between the minor and the trust so that the income is subject to the lowest income tax rates. See §12.56.

It is unclear whether the IRS's position is correct. Internal Revenue Code §678(a)(2) treats as the owner of a trust any person who has partially *released or modified* a power of appointment over trust property but retains rights in or control over the trust that would cause a grantor to be treated as an owner under IRC §§671-677. The terms of the trust that define the beneficiary's interest will therefore be relevant in determining the applicability of IRC §678(a)(2). Because only *lapses* typically occur under a *Crummey* trust, the IRS letter rulings cited may be based on an overly broad reading of IRC §678(a)(2). See Lischer, *Gifts to Minors*, Tax Management Portfolios 846-2d, A-45 (2005).

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§12.101 2. Gift Tax

A *Crummey* withdrawal power is a general power of appointment under IRC §2514(c) because it can be exercised in favor of the powerholder. An exercise or release of such a power is considered to be a transfer of property by the powerholder. Under IRC §2514(e), a *lapse* of a general power of appointment is treated as a taxable *release* of the power only to the extent the lapse exceeds the "5 or 5" limitation discussed in §12.89.

If the remainder is not certain to vest in the beneficiary, then when the beneficiary allows his or her power of withdrawal to lapse, the beneficiary makes a gift to the remainder beneficiaries if the value of the lapse exceeds the "5 or 5" amount, unless the beneficiary does not part with dominion and control over such excess amount. Treas Reg §25.2511-2. The gift to the remainder beneficiary is not a present interest and does not qualify for the annual exclusion. IRC §2503(b); Treas Reg §25.2503-3(a).

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§12.102 a. "5 or 5" Limitation

As discussed in §12.89, a lapse of a *Crummey* power is treated as a release, and therefore a transfer, only to the extent that the amount subject to the power exceeds the greater or $5000 or 5 percent ("5 or 5") of the aggregate value of the property out of which the exercise of the lapsed power could have been satisfied. IRC §2514(e). If this limit does not apply or is not sufficient to cover the amount of the gift, the beneficiary will be required to use a portion of his or her unified credit against the tax. IRC §2514(e). If a minor beneficiary is likely to live for many years, the consumption of a portion of the unified credit may be of little importance. See §12.66.

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§12.103 b. No Gift if Powerholder Is Beneficiary or Has General Power of Appointment

The terms of the trust may limit the application of IRC §2514(e) when there is a lapse of a right to withdraw an amount in excess of the "5 or 5" limitation. As discussed in §12.110, a gift occurs only if the lapse of the power results in a transfer of property to the trust for ultimate distribution to a beneficiary other than the powerholder. If the trust provides that the powerholder or his or her estate will receive all the trust property, a lapse will not result in a transfer of the property to another person.

Similarly, if the beneficiary has a general power of appointment over the property in the trust, there will not be a gift on the lapse of the *Crummey* power because the existence of the power of appointment makes the transfer incomplete for gift tax purposes. Treas Reg §25.2511-2(b). Therefore, if the trust has only one beneficiary who is entitled to income and principal distributions during his or her lifetime and the beneficiary is given a general power of appointment over the trust, the failure to exercise the power of withdrawal is merely a transfer to the beneficiary.

As a practical matter, the beneficiary is often given a testamentary power of appointment to avoid the gift tax problem created by a lapse of the power in excess of the "5 or 5" limitation. Such a power in the beneficiary ensures that he or she will not have parted with dominion and control over the lapsed property. This technique also requires creating a separate share for each beneficiary so that distributions to other beneficiaries will not be treated as distributions of property subject to the appointment powers of other beneficiaries. For discussion of estate tax consequences when the beneficiary holds a general power of appointment, see §2.65.

Form 12.62A-1 can be used to give the beneficiary a testamentary power of appointment, and the settlor can specify alternative takers who will receive trust assets if the beneficiary dies and fails to exercise the power of appointment.

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§12.104 c. Avoiding Gift Taxation by Use of "Hanging" *Crummey* Power

Adverse tax consequences may also be avoided by use of a "hanging" *Crummey* power, which provides that the power lapses each year only to the extent of the "5 or 5" limitation of IRC §2514(e). To the extent that the withdrawal right for the year exceeds this amount, the right continues ("hangs") and will lapse in future years within the "5 or 5" limitation.

Use of a hanging power may be undesirable because it does not provide that the withdrawal right will lapse at the end of a specified period but instead allows the beneficiary to make withdrawals over a longer period of time. This increases the likelihood that the beneficiary may actually exercise the power, which might be contrary to the settlor's wishes. Also, extension of the withdrawal period may increase the amount of trust income that is taxable to the beneficiary under IRC §678, particularly in the *Cristofani* situation discussed in §12.94. A hanging power is particularly effective in GST planning, however. See chap 4.

For a form of hanging power, see form 12.98-1.

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3. Estate Tax

§12.105 a. Beneficiary

If the beneficiary dies before termination of the trust holding a general power of appointment, the trust assets will be included in the beneficiary's gross estate. IRC §2041(b)(2). The IRS contends that IRC §2041 applies even if the beneficiary is a minor incapable of exercising the power. See Rev Rul 75-351, 1975-2 Cum Bull 368.

It is important to note that §2041 applies only if the beneficiary predeceases the termination of the trust and the instrument provides for distribution of the remaining assets to another beneficiary. In that event, §2041 requires inclusion in the beneficiary's gross estate of the value of the property subject to the power of withdrawal possessed at death and the value of prior year taxable lapses of that power as to which the beneficiary has retained interests. Any withdrawal amount "hanging" at the time of death is includable in the powerholder's gross estate. Lischer, *Gifts to Minors*, Tax Management Portfolios 846-2d, A-50 (2005).

The amount of the inclusion is the excess of the amount subject to the power of appointment over the "5 or 5" limit. The regulations provide a specific formula for computing the estate tax inclusion for pre-death taxable lapses. See Treas Reg §20.2041-3(d)(4).

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§12.106 b. Settlor

If the trust is appropriately structured, no portion of it should be included in the settlor's estate. Use of the trust income to discharge the settlor's legal obligation of support may, however, cause inclusion. See §12.52.

If the settlor is serving as trustee of the trust at the time of his or her death, there may also be adverse estate tax consequences. For example, if the settlor-trustee has discretion to distribute income to one or more trust beneficiaries, and the power is not limited to an ascertainable standard, the assets may be included in the settlor's estate if he or she dies before termination of the trust. See §12.54.

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4. Generation-Skipping Transfer Tax

§12.107 a. Beneficiary

A beneficiary who holds a withdrawal power will be treated as the transferor of the property subject to the power for GST tax purposes to the extent that the lapse of the withdrawal power is a taxable transfer under the gift or estate tax rules. See Treas Reg §26.2652-1(a)(5), Example 5. However, this may not apply in 2010.

If the lapse does not exceed the "5 or 5" limitation, the donor remains the transferor. In the rare case when the lapse results in a completed gift, the beneficiary becomes the transferor for GST tax purposes to the extent of the taxable gift (*i.e.,* amounts in excess of the "5 or 5" limitation).

Fortunately, the trust is usually drafted to prevent lapse of the power from resulting in a completed gift. (As discussed in §§12.104-12.105, this protection can be provided by giving the beneficiary a testamentary power of appointment or a "hanging" power.)

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§12.108 b. Settlor

If the trust qualifies under IRC §2642(c)(2) as a trust for a "skip" person, it will have an inclusion ratio of zero for generation-skipping transfer (GST) tax purposes to the extent the transfer to the trust is exempt from gift tax. A trust qualifies under §2642(c)(2) if there is only one beneficiary entitled to distributions and the property will be included in the beneficiary's estate if he or she dies before termination. The lapse of a withdrawal power over such a trust is not a direct skip, taxable termination, or taxable distribution. See IRC §2652(a); Treas Reg §26.2601-1(b)(1)(v)(A).

Under this rule, nontaxable (annual exclusion) gifts to trusts for grandchildren will be exempt from the GST tax. To qualify for this exemption, a separate trust (or a separate "share" which is treated as a separate trust under Treas Reg §26.2654-1(a)(1)(i), as discussed in §4.15) must be established for each grandchild.

If a grandchild is a contingent beneficiary of a *Crummey* trust established for a child (other than as a taker in default of an exercise of a general power of appointment granted the child), a transfer to the trust will not be exempt from the GST tax because it will not satisfy the requirements of IRC §2642(c)(2). Therefore, the grandparent-settlor should probably file gift tax returns with respect to such transfers to allocate the IRC §2631 GST tax exemption to the transfer. See §4.17.

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§12.109 5. Gift Tax; Lapse of Withdrawal Power

To protect the beneficiary of a *Crummey* trust from the adverse tax consequences of a lapse of a withdrawal power that exceeds the "5 or 5" limitation of IRC §2514(e) (discussed in §12.89), the settlors may have to give up the full amount of the gift tax exclusion.

For example, if the settlor transferred $10,000 to a trust over which the beneficiary had a *Crummey* power limited to the greater of $5,000 or 5 percent of the trust, the available exclusion would be limited to $5000. The settlor would be forced to file a gift tax return and use a portion of his or her unified credit with respect to the balance of the contribution.

As discussed, strategies can be used to allow the full amount of the exclusion and avoid a lapse of the withdrawal power that would result in adverse tax consequences to the beneficiary. See §§12.104 (general power of appointment in beneficiary), 12.105 ("hanging" *Crummey* power).

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§12.110 6. Use as Sprinkling Trust

A *Crummey* trust will sometimes be designed so that contributions that are subject to the withdrawal right can be sprinkled among many beneficiaries. Such an arrangement will appeal to the settlors because it allows the trustee to disburse funds to the most deserving or most needy beneficiaries. The settlors will be taxed, however, on the trust's income if this discretion over distributions is sufficiently broad and can be exercised by a settlor or a related or subordinate party. IRC §674(c). See §§3.26, 3.36.

In addition, if a settlor serves as trustee of such a sprinkling trust, the assets of the trust will be included in the settlors' estate if the settlor dies before the trust terminates and the sprinkling power is not limited by an ascertainable standard. See IRC §2036(a)(2); Treas Reg §20.2038-1(a). See also §2.58. If a guardian or other adult agent of a minor allows a minor's right of withdrawal to lapse, and the trust funds that were once subject to the withdrawal right are eventually diverted to other beneficiaries, the guardian or agent may be legally liable to the minor. See Prob C §§2401.3 (breach of guardian's fiduciary duty), 16002 (duty of loyalty). If trust funds may be sprinkled among several beneficiaries, the minor who allows the power of withdrawal to lapse thereby makes a taxable gift except to the extent that the lapsed withdrawal power falls within the "5 or 5" exclusions provided by IRC §2514(e). See §12.89.

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VI. INCENTIVE TRUSTS (NON-§2503 TRUSTS)

§12.111 A. Introduction and Description

The IRC §2503(b) or §2503(c) trusts share a disadvantage in common: The minor obtains or has the right to obtain income or property at a time mandated under the IRC in order to obtain tax advantages. Sometimes, qualifying or partially qualifying for the annual exclusion does not justify:

- Giving control of the property to the minor at age 18 (outright gifts and guardianships), at age 21 (custodianships and §2503(c) trusts), or at a particular age after 21 (§2503(b) trust); or
- Even giving the minor the right to demand property (*Crummey* trusts).

Trusts for which nontax incentives are the primary concern may be referred to as "incentive trusts" or non-§2503 trusts. These incentives may include attempts to encourage a certain behavior or simply to delay distribution until the beneficiary reaches a particular age that the settlor believes is appropriate.

The simplest incentive trust provides that, during the beneficiary's lifetime and at the trustee's discretion, income or principal may be distributed to or for the benefit of the beneficiary or may be retained in trust. Some age is set for the trust to terminate and for all assets to be distributed to the beneficiary. (If, however, the trust is designed to maximize use of the settlor's IRC §2631 GST tax exemption, the trust may continue for the beneficiary's entire lifetime so that remaining amounts can benefit the next generation.)

If the beneficiary dies before the trust terminates, the assets of the trust are distributed as appointed by the beneficiary if the beneficiary exercises a testamentary power of appointment. Otherwise, the trust assets are distributed to alternative takers listed in the instrument. These alternative takers should not include the settlor or his or her estate.

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§12.112 B. Nontax Incentive Planning With Trusts for Children

Sociologists have identified a phenomenon among American youth known as the "postponed child." Born in the 1960s, this child attains financial and emotional maturity at a delayed age as a result of various cultural trends during that decade. In some cases, this child never becomes fully mature. This syndrome is evident primarily among children of affluent parents. See Gallo & Gallo, *Estate Planning for the Postponed Generation*, Estate Planning 1987 §3.3 (Cal CEB 1987). The phenomenon of the postponed child can, of course, occur in any generation.

Parents confronted with this problem should structure their estate plans appropriately. One approach is to delay distributions to the child by 5 or 10 years to allow additional time for maturation. Thus, if a traditional plan provided for discretionary income and principal distributions and staggered distributions of principal at ages 25, 30, and 35, a plan for the postponed child might retain income and principal distributions as discretionary and postpone the principal distributions until age 30 or 35.

Another strategy is to provide for distributions at certain intervals after the parent's death (*e.g.,* 5, 10, or 15 years). This technique avoids chronological age as a determinant of maturity and provides the child time to assume responsibility after the parent's departure. See Estate Planning 1987 §3.5.

The delay in distribution may be coupled with incentives that encourage productive behavior. Monetary rewards in the form of additional or accelerated distributions can be provided for completion of an education, worthwhile employment, or other achievements. Typically, motherhood and caring for the family on a full-time basis are also taken into account in determining these rewards. See Estate Planning 1987 §3.6.

Forms 12.118-1—12.121-1 set out incentive provisions that are appropriate for many settlors. The types of incentives in trusts may, however, be as varied as the settlor's particular goals. For example, distributions may be keyed to the earnings of the beneficiary. The trustee may be authorized to make distributions based not on specific achievements but rather on a determination that payment reflects the settlor's philosophy regarding an individual's productivity.

Some practitioners recommend that the postponed child act as cotrustee of his or her trust. The theory is that this arrangement will provide the child exposure to and experience with financial management and responsibility.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.113 C. Income Tax Aspects of Non-§2503 Incentive Trusts

§12.113 C. Income Tax Aspects of Non-§2503 Incentive Trusts

One potential tax benefit of a non-§2503 trust is that the income generated by the trust will be taxed to the trust or to the beneficiary but not to the settlor. The settlor will still be taxed on trust income to the extent that it is used to discharge his or her legal support obligations (see §12.52) or if the settlor retains powers with respect to the trust that would cause him or her to be treated as owner of the trust under the grantor trust rules. See IRC §§671-677; see §12.56. The drafter should note, however, that bracket compression (see §3.7) and the "kiddie" tax (see §12.5) may limit income tax benefits.

If the settlor, the settlor's spouse, or any nonadverse party to the settlor retains the ability to control beneficial enjoyment of income and principal without the consent of an adverse party and those persons are not limited as provided in IRC §674(b), the settlor will be treated as owner of the trust and the income is taxable to him or her. IRC §674(a). Internal Revenue Code §672(a) defines an adverse party as a person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power.

The exceptions set forth in IRC §674(b) allow the settlor or any other person to hold various powers over income and principal. From the standpoint of planning for children, the most important exceptions may be found in IRC §674(b)(5)-(8):

- Under IRC §674(b)(5), even a settlor is allowed to hold the power to distribute principal to or for any current beneficiary as long as the distribution will be charged against that beneficiary's proportionate share as if the principal constituted a separate trust. The settlor may distribute principal to a beneficiary or class of beneficiaries if the distribution is limited by a reasonably definite standard set forth in the trust instrument. An example of such a standard would be a directive to pay costs of education. For discussion of "reasonably definite standards," see §3.35.
- Internal Revenue Code §674(b)(6) permits even a settlor to distribute or withhold income from a beneficiary as long as any accumulated income is ultimately paid to the beneficiary, to his or her estate, or his or her appointee or is distributed on termination of the trust to the current income beneficiaries in shares that are irrevocably specified in the trust instrument. Treas Reg §1.674(b)-1(b)(6). Because these requirements are extremely technical and the statute is somewhat ambiguous, the drafter should be cautious in relying on them. For example, a power in the settlor will not qualify for the exception under IRC §674(b)(6) if the substance of the power is to shift income from one beneficiary to another. Nevertheless, the exception may apply when the settlor retains a limited power to shift income among current income beneficiaries. See examples in Treas Reg §1.674(b)-1(b)(6)(ii).
- Under IRC §674(b)(7), even a settlor may withhold income from a beneficiary during his or her incompetency or minority.
- Internal Revenue Code §674(b)(8) allows a trustee to allocate receipts and disbursements between principal and income.

Any trustee, other than the settlor or the settlor's spouse, may shift and allocate income among the beneficiaries. IRC §674(d). The powers allowed under this exception are important when the trustee is not independent and the trust will continue beyond the minority of the beneficiaries, who may have dissimilar or unequal needs. See Price, Price on Contemporary Estate Planning (2007 ed).

An independent trustee who is not related to or subservient to the wishes of the settlor may exercise much broader powers with respect to distribution of income and principal without adverse income tax consequences. An independent trustee can hold the power to distribute, apportion, or accumulate income and pay out principal to or for the beneficiaries. IRC §674(c)(1).

Accordingly, a settlor may design a trust that provides substantial income tax savings and does not make property or property rights available to a beneficiary before the age selected by the settlor.

For a further discussion of IRC §674, see §§3.26-3.37.

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D. Transfer Tax Aspects

§12.114 1. Gift Tax

Gifts to non-§2503 trusts will not qualify for the annual exclusion and will use the settlor's unified credit until the settlor's applicable exclusion amount is reduced by $1 million. The amount of the applicable credit amount is an amount sufficient to avoid any payment of tax on cumulative taxable transfers not exceeding the applicable exclusion amount. The estate tax applicable exclusion amount is $2 million in 2006-2008 and $3.5 million in 2009. The gift tax applicable exclusion amount is $1 million. See IRC §§2010(c) (estate tax), 2505(a) (gift tax). If cumulative transfers exceed $1 million, a transfer to a non-§2503 trust will trigger the payment of gift tax.

The total transfer taxation (the sum of estate and gift taxation) imposed on the settlor and his or her estate will not be increased merely because a particular transfer to a trust does not qualify for the annual exclusion if cumulative transfers do not exceed $1 million and either of the following apply:

- The unified credit available to the settlor is sufficient to cover all inter vivos and testamentary transfers by the settlor; or
- The settlor will exhaust the annual exclusion with other gifts made to the same donee during the same year and, hence, it is irrelevant whether additional gifts made to a trust for the donee qualify for the annual exclusion.

Even if a gift does not qualify for the annual exclusion, the gift may substantially reduce the total amount of transfer taxation imposed on the settlor's inter vivos and testamentary transfers, for the following reasons:

- *Post-transfer appreciation.* Appreciating property that is transferred during the settlor's lifetime will be subject to transfer taxation based on its value at the time of transfer. If that same property were retained until the settlor's death, it would be subject to inclusion in the settlor's gross estate based on its value on the date of death (or alternative valuation date).
- *Post-transfer income*. If the asset were retained by the settlor until his or her death, all accumulated income generated by the property would be includable in the settlor's estate. In contrast, post-transfer income flows to a younger generation, without transfer tax.

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.115 2. Estate Tax

§12.115 2. Estate Tax

If income of a non-§2503 trust is used to discharge the legal obligations of the parent-grantor, the assets will be includable in his or her estate. IRC §§2036, 2038. If any person, whether or not a settlor, has the ability to compel distributions from a trust to discharge his or her legal obligations, that person may be regarded as having a general power of appointment over the trust. IRC §2041.

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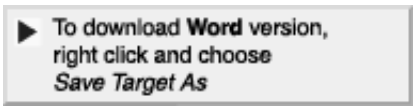
§12.116 3. Generation-Skipping Transfer Tax

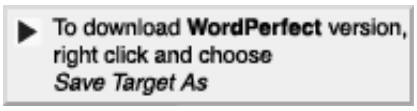
The application of the GST tax must be considered with respect to all irrevocable trusts. IRC §§2601, 2612-2613. A trust for skip persons may be exempt from GST tax if it satisfies the provisions of IRC §2642(c)(2). For discussion of the GST tax, see chap 4.

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E. Incentive Trust Provisions

§12.117 1. Form: Conditions for Distribution





12.117-1 Conditions for distribution

***Discretionary Distributions*. While the settlor's children are living, the trustee may distribute to any one or more of the settlor's children part or all of the net income or principal of their respective trusts as the trustee, in the trustee's discretion, shall determine, without restriction as to purposes or amounts, as long as the child falls within one of the following descriptions:**

(1) The child is a full-time student at an accredited college, university, vocational school, or similar institution and maintains the equivalent of a grade point average of _ _[*e.g., 2.5*]_ _ or better on a scale in which 4.0 is an "A" grade, and the child's course of study is progressing towards the completion of an undergraduate or other degree at the rate of a full time student;

(2) The child is employed full time in an occupation to which the child devotes at least 35-40 hours of work per week, or the child is pursuing a career that is socially productive on a full-time basis, _ _[*such as a career as an artist or a musician, to be determined by the trustee in the trustee's discretion*]_ _;

(3) The child is disabled and this disability prevents him or her from being a productive and self-supporting member of society as determined by the trustee in the trustee's discretion;

(4) The child is pursuing an educational, scientific, or charitable goal that the trustee determines, in the trustee's discretion, is in the best interests of the child and the general public and makes the child a productive member of society as determined by the trustee in the trustee's discretion; or

(5) The child is occupied full time in caring for other family members such as children or other relatives and the trustee determines, in the trustee's discretion, that this obligation reasonably precludes the child from earning a living (an example of such an occupation would include motherhood).

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.118 2. Form: Distributions for Medical Emergency

§12.118 2. Form: Distributions for Medical Emergency

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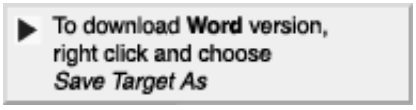
12.118-1 Distributions for medical emergency

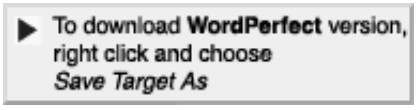
***Emergency Distributions*. It is the settlor's intent that a child not receive distributions of income or principal from the trust if the child is not complying with the provisions of one or more of the foregoing five subparagraphs. The trustee may, however, make distributions of income or principal to any child or his or her lineal descendants in the event of medical (including psychiatric) emergency, as the trustee determines in the trustee's discretion.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.119 3. Form: Right of Withdrawal at Specified Ages When Child Has Complied With Incentive Provisions

§12.119 3. Form: Right of Withdrawal at Specified Ages When Child Has Complied With Incentive Provisions





12.119-1 Right of withdrawals at specified ages when child has complied with incentive provisions

***Contingent Withdrawal Rights*. After a child of the settlor has complied with one or more of the five subparagraphs of the above clause for a period of _ _[*e.g., 5/10/15*]_ _ years and has attained age _ _[*e.g., 40/45/50*]_ _, that child shall have the right to withdraw at any time and from time to time, by specific reference to this right in a written request delivered to the trustee, from the principal and accumulated income, if any, of the respective trust of that child, without restriction as to purposes, all or any part of an amount equal to _ _[*e.g., one fourth/one third*]_ _ of the value of the trust on the date on which the child attained that age, the trust was divided, or the _ _[*e.g., five/ten*]_ _-year compliance requirement is complete, whichever is later.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/12 Trusts for Minors/§12.120 4. Form: Manner of Distribution to Child Exercising Right of Withdrawal and When Child Dies Without Exercising Right of Withdrawal

§12.120 4. Form: Manner of Distribution to Child Exercising Right of Withdrawal and When Child Dies Without Exercising Right of Withdrawal

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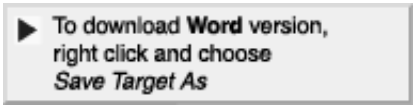
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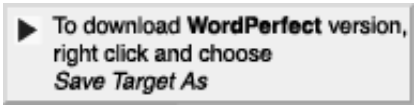
12.120-1 Manner of distribution to child exercising right of withdrawal and when child dies without exercising right of withdrawal

***Exercise of Withdrawal Rights*. The trustee shall distribute to a child exercising his or her rights of withdrawal cash or assets equal in value to the amounts designated in such requests and subject to withdrawal under _ _[*article/paragraph*]_ _ _ _[*specify number or letter*]_ _. If that child dies having qualified to exercise such right of withdrawal but before the right is exercised, the property subject to the right of withdrawal shall be distributed in any manner the child directs by provision in the child's will expressly referring to this trust. This power of appointment is a general power of appointment, which may be exercised in favor of the child's estate. In the event the power is not exercised, the property subject to the power shall be distributed to _ _[*specify*]_ _.**

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§12.121 5. Form: Child Not in Compliance With Incentive Provisions at Specified Ages





12.121-1 Child not in compliance with incentive provisions at specified ages

***Trustee Power to Delay Distributions*. If a child attains any of the ages of withdrawal described in** _ _[*article/paragraph*]_ _ _ _[*specify number or letter*]_ _ **and has not complied with the trust provisions sufficiently to enable him or her to make a withdrawal, but is making a good-faith effort to do so as determined by the trustee in the trustee's discretion, the trustee may delay the ages at which the child may make such withdrawals. If, however, the child has not qualified for all such withdrawals by the time that the child attains age** _ _[*e.g., 60*]_ _**, these assets shall no longer be subject to withdrawal by the child but shall be held by the trustee for the benefit of that child and the child's lineal descendants. The trustee shall distribute to that child or any of his or her lineal descendants part or all of the income or principal as the trustee determines necessary for the maintenance of those beneficiaries.**

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13

Special Needs Trusts

Sterling L. Ross, Jr.
Ruth A. Phelps

I. PLANNING AND DRAFTING SNTs
- A. Purpose of Special Needs Trust (SNT) §13.1
- B. Types of SNTs §13.2
  - 1. Third Party SNT §13.3
  - 2. Litigation Special Needs Trust (LSNT) §13.4
  - 3. First Party SNT §13.5
- C. Public Benefits
  - 1. Overview of SSI and Medi-Cal §13.6
  - 2. SSI Benefits §13.7
    - a. Eligibility for Disabled and Aged Poor §13.8
    - b. Limitation on Resources §13.9
    - c. SSI Benefits Reduced by Income §13.10
    - d. Reduction for In-Kind Support and Maintenance §13.11
    - e. SSI Transfer Rules §13.12
  - 3. Medi-Cal Benefits §13.13
    - a. Eligibility for Medi-Cal Benefits §13.14
    - b. Medi-Cal Transfer and Recovery Rules §13.15
  - 4. Social Security and Medicare Distinguished §13.16
- D. SSI Special Needs Trust Rules
  - 1. Third Party SNTs §13.17
  - 2. First Party SNTs §13.18
    - a. Need for Irrevocability Clause §13.19
    - b. Avoiding Attack on Irrevocability Clause §13.20
- E. Medi-Cal Special Needs Trust Rules
  - 1. Federal Medicaid Law §13.21
  - 2. Medi-Cal Trust Regulations §13.22
    - a. Third Party Trusts §13.23
    - b. First Party Trusts §13.24
- F. Statutory "Spendthrift" Protection §13.25
- G. Income Taxation of SNTs §13.26
- H. Chart: Summary of SNTs §13.27

II. ESTABLISHING LSNTs
- A. Overview of LSNTs §13.28
  - 1. Substantial Impairment §13.29
  - 2. Unmet Special Needs §13.30
  - 3. Amount Reasonably Necessary §13.31
- B. Procedure for Obtaining Court Approval §13.32
- C. Petition to Terminate Trust §13.33
- D. Claims by Government Agencies §13.34
- E. Disabled Adults With Capacity §13.35
- F. Continuing Court Supervision §13.36
- G. Estate and Gift Tax Consequences of Funding and Termination of LSNTs §13.37

III. INTER VIVOS THIRD PARTY SNT CLAUSES
- A. Introductory Clauses for Third Party SNT §13.38
  - 1. Form: Title of Third Party SNT §13.39
  - 2. Form: Irrevocability; Limited Power of Amendment for Third Party SNT §13.40
  - 3. Form: Purpose of Third Party SNT §13.41
- B. Distribution Provisions for Third Party SNT §13.42
  - 1. Form: Distribution for Special Needs §13.43
  - 2. Form: Trust Advisory Committee §13.44

3. Form: Requirement to Seek Public Benefits §13.45
4. Form: Trust to Supplement Public Benefits §13.46
C. Termination Provisions for Third Party SNT §13.47
1. Form: Termination of Third Party SNT on Death of Beneficiary §13.48
2. Form: Backstop Termination Clause for Third Party SNT §13.49
3. Form: Payment of Expenses of Third Party SNT §13.50

IV. OTHER INTER VIVOS FIRST PARTY SNT CLAUSES
A. Introductory Clauses for First Party SNT §13.51
B. Distribution Provisions for First Party SNT §13.52
C. Termination of First Party SNT on Death of Beneficiary §13.53
D. Trust Protector Clause §13.54

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I. PLANNING AND DRAFTING SNTs

§13.1 A. Purpose of Special Needs Trust (SNT)

The principal purpose of a special needs trust (SNT) is to preserve public benefits for disabled or aged beneficiaries. The benefits at issue are principally benefits that are "asset sensitive," that is benefits that require the recipient to have resources and income below a certain level to qualify. This chapter provides a basic discussion of SNTs and public benefits with third party SNT forms. For a detailed discussion of SNTs and first party SNT forms, see Special Needs Trusts: Planning, Drafting, and Administration (Cal CEB 2008). On public benefits, see Special Needs Trust, chap 3.

A properly designed and administered trust can provide funds to supplement a disabled or aged beneficiary's public benefits without interfering with those benefits. Wealthy clients may wish to combine SNTs for disabled beneficiaries with more familiar tax-saving irrevocable trust devices such as QPRTs, GRATs, CRTs, or CLATs. See Sandoval, *Tax-Efficient Funding of a Lifetime Special Needs Trust*, 32 Est Plan 32 (Oct. 2005).

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§13.2 B. Types of SNTs

Irrevocable inter vivos SNTs are primarily used in two contexts:

- Estate planning for parents with a disabled son or daughter; and
- Litigation when the proceeds of a settlement or judgment would cause the disabled plaintiff to lose public benefits.

For purposes of this chapter, SNTs are divided into two groups: the first party SNT and the third party SNT. An SNT established to manage litigation proceeds on behalf of a disabled plaintiff, with funds that belong to the disabled plaintiff, is referred to as a litigation special needs trust (LSNT) and is a type of first party SNT. See §§13.4-13.5. An SNT established in traditional estate planning, *i.e.*, by parents for a disabled son or daughter, is referred to as a third party SNT, because the assets that fund the trust belong to a third party. See §13.3.

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§13.3 1. Third Party SNT

A third party SNT is an SNT established and funded by a person other than the beneficiary. It is usually established by a parent for a disabled child. It may also be established by a grandparent, a sibling, or any other third party.

An inter vivos trust is commonly used to receive gifts from several donors. For example, parents may establish an inter vivos SNT for a disabled child and then notify the grandparents of its existence. If the grandparents wish to leave assets to the disabled person, the inter vivos SNT can be used to consolidate asset management in a single entity, preserve public benefits, and alleviate the need for the grandparents to establish a testamentary SNT.

If the inter vivos trust is likely to receive gifts from several sources, practitioners frequently prefer that it be irrevocable. See §§13.38-13.50. Donors may feel more comfortable in transferring assets to a trust that will not be modified later. Also, the power to revoke may cause trust assets to be includable in the settlor's estate if the settlor predeceases the beneficiary. IRC §2038.

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§13.4 2. Litigation Special Needs Trust (LSNT)

The litigation special needs trust (LSNT) is an inter vivos irrevocable trust for the management of litigation proceeds for a disabled plaintiff. See discussion in §§13.28-13.37. An LSNT is a form of first party SNT designed to satisfy the safe-harbor exception of 42 USC §1396p(d)(4)(A). See §13.3.

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§13.5 3. First Party SNT

The types of first party SNTs in current use under the safe-harbor exceptions in 42 USC §1396p(d) are the following:

- Court-established (d)(4)(A) SNT. This is the most commonly used form of first party SNT and includes the LSNT. See §13.4.
- Non-court-approved (d)(4)(A) SNTs. In some situations, court involvement may be unavailable. For example, the disabled person may receive an inheritance and transfer assets to a trust established by a parent or grandparent that meets the other (d)(4)(A) requirements. See §§13.51-13.54. Note, however, SSI policy requires that the person establishing the trust must have legal authority to act with regard to the assets of the individual. This is typically done by having the competent disabled individual execute a power of attorney authorizing the establishment and transfer of assets into the first party SNT.
- The (d)(4)(C) SNT. The (d)(4)(C) exception applies to pooled first party trusts that meet specified conditions. For a detailed discussion of pooled SNTs, see Special Needs Trusts: Planning, Drafting, and Administration, chap 12 (Cal CEB 2008).

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C. Public Benefits

§13.6 1. Overview of SSI and Medi-Cal

Supplemental Security Income (SSI) and Medi-Cal are the most important public benefits available to the disabled and aged. SSI provides a monthly cash subsistence grant to disabled, blind, or aged (65 or older) persons. Medi-Cal (California's version of the Medicaid program) pays for a broad array of medical treatments and is the only government program that pays for long-term nursing home care.

Administration of SSI and Medi-Cal is subject to federal and state guidelines:

- The Social Security Administration's Program Operations Manual System (POMS) governs administration of SSI.
- Medi-Cal is governed by California Department of Health Care Services (DHCS) All-County Welfare Directors (ACWD) Letters. Medi-Cal is also governed by the California guidelines of the federal Centers for Medicare & Medicaid Services (CMS), which administers the Medicaid program, found in the department's State Medicaid Manual.

Both programs are need based and available only to those with minimal financial resources. Persons who are eligible for SSI benefits are eligible for Medi-Cal. Persons not eligible for SSI benefits may be eligible for Medi-Cal only if they are "medically needy." For Medi-Cal eligibility categories, see §13.14.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.7 2. SSI Benefits

§13.7 2. SSI Benefits

SSI provides a monthly stipend to supplement the recipient's income to a maximum amount defined by regulation. The amount of the benefits is determined by guidelines in 20 CFR §§416.401-416.435. These payments are increased by a state supplement administered by the Social Security Administration. The benefit amounts are adjusted annually and published in the Federal Register each February, effective April 1.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.8 a. Eligibility for Disabled and Aged Poor

§13.8 a. Eligibility for Disabled and Aged Poor

SSI eligibility requirements are described in 20 CFR §§416.200-416.269. The applicant must be disabled, blind, or over age 65 and the applicant must not have more than the permitted income and resources to pay for food and shelter. Excess income coming to an SSI recipient will cause the SSI monthly benefits to be reduced dollar for dollar. For resource limits, see §13.9. For income rules, see §§13.10-13.11.

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§13.9 b. Limitation on Resources

An otherwise eligible person is not entitled to SSI if the applicant's own countable resources and those of the applicant's spouse exceed $3000. 42 USC §1382(a)(2)(B), (3)(A). For an otherwise eligible single person, the resource limit is $2000. 42 USC §1382(a)(1)(B), (3)(B). A personal residence owned by the beneficiary is excluded from the beneficiary's resources, regardless of its value. 20 CFR §416.1210(a). Furniture, clothing, and personal care items are excluded to the extent that their total value does not exceed a "reasonable amount." 42 USC §1382b(a)(2)(A); 20 CFR §§416.1210(b), 416.1216. An automobile of any value is also excluded if it is used as transportation. 20 CFR §416.1218.

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§13.10 c. SSI Benefits Reduced by Income

Income is either "earned" or "unearned" and both types of income count against benefits. Gifts, inheritances, and additions to trusts are categories of unearned income. Not all income is counted, however. Some items are specifically excluded from income for policy reasons. For example, the first $20 per month of unearned income and the first $65 per month of earned income are not counted. 20 CFR §416.1124(c)(6), (c)(12). Special rules apply to in-kind support and maintenance. See §13.11.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.11 d. Reduction for In-Kind Support and Maintenance

§13.11 d. Reduction for In-Kind Support and Maintenance

There is a special category of in-kind income called "in-kind support and maintenance" (ISM). This is food or shelter provided directly to the recipient or paid for by a third party.

The provision of ISM reduces SSI, but not dollar for dollar as with cash. The maximum reduction is subject to either the one-third reduction rule or presumed maximum value (PMV) rule. Under the PMV rule, ISM is valued at the lesser of its actual value or at its "presumed" value of one-third of the federal benefit portion of the SSI payment. Any time the beneficiary receives anything that constitutes food or shelter, the beneficiary's SSI will be reduced by the lesser of one-third of the federal benefit portion or the actual value of food or shelter benefits received.

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§13.12 e. SSI Transfer Rules

The purpose of the SSI transfer rules is to disqualify individuals who have made gifts of their assets to qualify for SSI benefits.

If a person disposes of resources for less than fair market value on or after a certain "look-back" date, the person is ineligible for SSI for a number of months, determined by dividing the value of all gift transfers by the SSI benefit rate. The period of ineligibility, however, shall not exceed 36 months. 42 USC §1382b(c).

The SSI transfer rules are similar to the Medi-Cal transfer rules (see §13.15), but with several differences. An important distinction is that the SSI rules apply to transfers of "resources" but not "income." The Medi-Cal rules apply to both resources and income.

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§13.13 3. Medi-Cal Benefits

Medi-Cal provides payment for hospitalization, treatment in medical clinics, doctors' services, lab tests, X-rays, home health care, nursing home care, and a host of related medical services. The program also pays for community mental health and drug abuse services and intermediate care facilities for the developmentally disabled. 42 USC §1396a(a)(10) (requisite provision of "medical assistance" by state plan implementing Medicaid).

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§13.14 a. Eligibility for Medi-Cal Benefits

Two main categories of persons are eligible for Medi-Cal benefits. First, subject to certain limited exceptions, if an individual receives SSI or other public cash grant assistance, he or she automatically qualifies for Medi-Cal. Such an individual is "categorically needy."

Second, an individual whose income level is too high to meet SSI eligibility requirements may nevertheless be eligible for Medi-Cal if medical expenses will deplete the applicant's income to below a "maintenance need" level. Such a person is "medically needy." The maintenance need level is a percentage of the cash grant payable to a person without income or resources. A substantial number of the medically needy are nursing home residents.

The resource limits for Medi-Cal eligibility are similar to the rules for SSI eligibility. See §13.9. (The Medi-Cal regulations use the term "property," while the SSI and federal Medicaid rules both refer to "resources.")

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§13.15 b. Medi-Cal Transfer and Recovery Rules

Like the SSI transfer rules (see §13.12), the purpose of the Medi-Cal transfer rules is to disqualify individuals who have made gifts of their assets so as to qualify for Medi-Cal benefits.

If a person disposes of resources for less than fair market value on or after a certain "look-back" date, the person is ineligible for long-term care (nursing home) Medi-Cal benefits for a number of months, determined by dividing the value of the transferred assets by the statewide average private-pay rate for nursing facility services. However, there is no period of ineligibility for community based Medi-Cal services.

For further discussion of the complex Medi-Cal transfer and estate recovery rules, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chaps 10-12 (Cal CEB 2003).

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§13.16 4. Social Security and Medicare Distinguished

Social Security and Medicare are employment-related, public insurance programs that are neither need based nor means tested. They provide benefits to wage earners who have qualified for the program by payroll tax contributions. Eligibility for Medicare is tied to eligibility for Social Security or Railroad Retirement benefits.

Social Security provides "old age" (retirement) benefits and disability benefits. In addition to disability benefits for a disabled worker, Social Security provides benefits for a disabled adult child of a covered worker who became disabled before age 22. When a covered worker dies, becomes disabled before age 65, or retires, his or her disabled child is eligible for benefits. In *Balian v Balian* (2009) 179 CA4th 1505, 102 CR3d 470, the beneficiary of an irrevocable special needs trust petitioned the court to remove a monthly restriction on distributions that was apparently intended to preserve her eligibility for public benefits. The beneficiary alleged that she was receiving Social Security disability benefits, which were not based on need or financial hardship; that the settlor had not understood the nature of her benefits when the trust was created; and that the continuation of the restrictions defeated or substantially impaired the accomplishment of the express purpose of the trust. The court determined that the petition did not violate the trust's no-contest clause.

A child is considered disabled if he or she is either (1) blind or (2) unable "to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months." 42 USC §§402(d)(1)(B), 423(d); 20 CFR §404.350(a).

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D. SSI Special Needs Trust Rules

§13.17 1. Third Party SNTs

If the beneficiary of a third party SNT cannot control the amount or frequency of trust distributions and cannot revoke the trust and use the funds for the beneficiary's personal benefit, the trust assets are not a countable resource to the beneficiary for SSI eligibility purposes.

The revocability of a trust and the ability to direct the use of the trust principal depend on the terms of the trust agreement and state law. If a trust is irrevocable by its terms and under state law the beneficiary cannot use the trust assets for support and maintenance, the assets are not considered resources of the beneficiary. 20 CFR §416.1201.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.18 2. First Party SNTs

§13.18 2. First Party SNTs

For trusts established by the recipient, trust assets are considered a resource for SSI purposes and an individual who establishes a trust "other than by will" may lose eligibility, unless one of the safe-harbor provisions in 42 USC §1396p(d)(4) applies. Gifts to an inter vivos trust in particular may result in the loss of eligibility. 42 USC §1382b(e)(2). Thus, the following rules apply:

- If the trust is revocable by the grantor, the entire trust is a resource to the grantor, and payments to anyone other than the grantor are considered to be a transfer of resources. 42 USC §1382b(e)(3)(A). See §13.19 on the need for an irrevocability clause.
- If the safe-harbor exceptions do not apply, the portion of the trust from which payments can be made to or for the benefit of the beneficiary or the beneficiary's spouse is a countable resource. 42 USC §1382b(e)(3)(B).

NOTE: If the trust holds title to a house as a home for the beneficiary, the house would not be a resource of the beneficiary regardless of whether the trust is a third party SNT or first party SNT. It would also not be a resource if the beneficiary moved from the house. If the trust purchases the house outright, the house would be income in the form of ISM in the month of purchase only. If the trust does not purchase the house outright, payment of the monthly mortgage is a disbursement from the trust that results in receipt of ISM in the form of shelter. See §13.11.

A trust that satisfies the 42 USC §1396p(d)(4) requirements and was established solely for the benefit of an individual with a disability under the age of 65 is exempt from the transfer rules, which would otherwise cause a period of ineligibility for SSI or long-term care Medi-Cal benefits for an individual who disposes of an asset for less than fair market value. 42 USC §1382b(c).

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.19 a. Need for Irrevocability Clause

§13.19 a. Need for Irrevocability Clause

Under California law, the grantor of an irrevocable trust does not have the unilateral authority to revoke the trust. However, a trust is presumed revocable unless the trust is expressly made irrevocable by the trust instrument. Prob C §15400. For this reason, a first party SNT should include an express irrevocability clause. In some states, it may be necessary to name an individual remainder beneficiary to avoid the common law doctrines of merger and worthier title. See §13.20.

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§13.20 b. Avoiding Attack on Irrevocability Clause

In some cases, the Social Security Administration (SSA) has successfully argued that a special needs trust (SNT) that was irrevocable on its face was revocable and therefore invalid under the common law doctrine of merger and the doctrine of worthier title. However, the doctrine of worthier title is abolished as a rule of construction in California by Prob C §21108, and the application of the doctrine of merger is restricted by Prob C §15209.

PRACTICE TIP: To avoid any SSA argument along these lines, it is advisable to name an individual remainder beneficiary for the SNT rather than leaving it "to the beneficiary's estate" or "to the beneficiary's legal heirs." For example, the SNT could provide: "On the death of the beneficiary, the trustee shall pay $100 to the beneficiary's brother, John Smith, and the remainder to the beneficiary's heirs at law."

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E. Medi-Cal Special Needs Trust Rules

§13.21 1. Federal Medicaid Law

Extremely restrictive rules apply to trusts that are "established" by the applicant, *i.e.*, funded with the applicant's money. These rules do not apply to third party trusts.

If the trust established by the applicant is revocable, the corpus is considered to be an available resource, payments to or for the beneficiary are considered to be income, and payments to anyone else are considered to be transfers. 42 USC §1396p(d)(3)(A).

If the trust is irrevocable, any portion of the income or principal from which payment could be made to or for the applicant is considered to be an available resource. 42 USC §1396p(d)(3)(B).

The following trusts are exempt from these rules:

- A trust that contains the assets of a disabled individual under age 65, established by a parent, a grandparent, a "legal guardian," or the court. 42 USC §1396p(d)(4)(A). The statute is unclear, but the trust remains protected even after the beneficiary reaches 65. These trusts are commonly known as (d)(4)(A) trusts.
- A trust that is composed only of pension, Social Security, and other income in a state that does not allow income "spend down" (*i.e.,* not California). 42 USC §1396p(d)(4)(B).
- A trust that contains the assets of a disabled individual if the trust is established and managed by a nonprofit corporation and uses separate accounts of pooled assets. 42 USC §1396p(d)(4)(C). These trusts are commonly known as pooled SNTs.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.22 2. Medi-Cal Trust Regulations

§13.22 2. Medi-Cal Trust Regulations

The California Department of Health Services (DHCS) has adopted regulations complying with the Medicaid trust rules described in §13.21. The types of trusts that will preserve the Medi-Cal eligibility of the beneficiary are described in 22 Cal Code Regs §50489.9. Third party SNTs (see §13.23) and LSNTs (see §13.24) are covered under the provisions of this section.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.23 a. Third Party Trusts

§13.23 a. Third Party Trusts

Third party SNTs are included under a catchall definition in 22 Cal Code Regs §50489.9(a)(1). If the trust is irrevocable, the trust assets are not available until distributed. 22 Cal Code Regs §50489.9(b)(2). Prudent practitioners, however, ensure that any third party SNT conforms to the SSI trust rules. See §§13.17-13.20.

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§13.24 b. First Party Trusts

Under rules similar to the SSI trust rules (see §13.18), an irrevocable trust such as an LSNT containing the assets of a disabled individual under age 65 that is established by a parent, grandparent, legal guardian, or court is not considered the individual's resource for Medi-Cal eligibility purposes. 22 Cal Code Regs §50489.9(a)(3). Once the trust assets are distributed, however, they are considered available. 22 Cal Code Regs §50489.9(b)(2).

Title 22 Cal Code Regs §50489.9(a)(3)(A) clarifies that the assets in an LSNT established for a person under age 65 will remain sheltered as long as the beneficiary continues to be disabled after attaining age 65.

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§13.25 F. Statutory "Spendthrift" Protection

If a public benefits recipient is the beneficiary of a trust (even a trust with a "spendthrift" clause) and a California statute makes the beneficiary liable for reimbursement for services, then the appropriate state or county representative may bring a petition under CCP §709.010 for reimbursement from the trust. Prob C §15306(a). See §§9.64-9.68 on spendthrift clauses.

However, there is no liability for reimbursement if the trust is established for the benefit of an individual who has a disability that substantially impairs the individuals' ability to provide for his or her own care or custody and constitutes a substantial handicap. Prob C §15306(b). This limitation is intended to encourage potential settlors to provide in trust for the care or support of a disabled person without the risk that the property of the trust will be taken to reimburse a public agency for the support it provided.

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§13.26 G. Income Taxation of SNTs

A first party SNT is generally taxed as a complex trust under IRC §661 unless the trust falls within the grantor trust definitions of IRC §§671-679. The trust will be treated as a grantor trust if the trust is revocable or if the beneficiary has a reversionary interest or retains certain administrative powers, or has the power to control beneficial enjoyment of trust assets. Generally, these powers are not powers that the beneficiary retains over the SNT because retaining them threatens the beneficiary's eligibility for public benefits.

A third party SNT is usually a complex trust, but a properly designed third party SNT may be treated as a grantor trust. If the trust is a grantor trust, all income will be taxed directly to the settlor. Grantor trust treatment may be advantageous because the settlor's payment of the taxes on trust income prevents depletion of the trust and the payment is not treated as a taxable gift to the beneficiary who would otherwise pay the tax. See Special Needs Trusts: Planning, Drafting, and Administration §§13.2-13.5 (Cal CEB 2008).

If the trust is not treated as a grantor trust, all income will be taxed to the trust subject to a distribution deduction for payments made to or for the benefit of the beneficiary. These distributions will be taxed to the beneficiary. The attorney should consider the likely amount of income that the trust will produce, what distributions are contemplated, and the likely tax situation of the beneficiary before deciding whether to include provisions in the trust that will result in grantor trust treatment. For further discussion of SNT taxation, see generally Special Needs Trusts, chap 13.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.27 H. Chart: Summary of SNTs

§13.27 H. Chart: Summary of SNTs

	First Party SNT	*Third Party SNT*
Legal Authority Federal; California	42 USC §1396p(d)(4)(A), (d)(4)(C); 22 Cal Code Regs §50489.9	Medi-Cal trust rules do not apply; Prob C rules apply.
Who Must Establish	Parent Grandparent Legal Guardian Court	Anyone except beneficiary, spouse (other than by will), agent
Source of Funds	Beneficiary	Anyone except beneficiary, spouse (other than by will), agent
Use of Funds	For special needs only; if used for food or shelter, reduction in public benefits; do not make payments directly to beneficiary.	Same as first party SNT
Countable Resource	No	No
Payback Provision	Yes	No
Remainder Beneficiary	Yes	Yes
Income Taxation	Usually grantor trust	Usually complex trust

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II. ESTABLISHING LSNTs

§13.28 A. Overview of LSNTs

California has a procedure for the management in trust of litigation proceeds for a disabled plaintiff. Probate Code §§3600-3613 authorize a court to order that money from a judgment or settlement for a disabled minor or adult be paid to the trustee of an SNT. Prob C §§3602(d), 3611(c). See §13.32.

To establish an SNT with the proceeds of litigation, the court must determine that the following conditions are met:

- The minor or person with a disability has a disability that substantially impairs the individual's ability to provide for his or her own care (see §13.29);
- The minor or person with a disability is likely to have unmet special needs without the trust (see §13.30); and
- The amount paid to the trust appears reasonably necessary to meet those special needs (see §13.31).

NOTE: Compliance with Probate Code requirements for an LSNT does not ensure compliance with eligibility requirements of the federal benefit programs. The Probate Code provisions establish the criteria that enable the court to direct litigation proceeds to a special needs trust. The relevant federal program requirements, especially the special Medi-Cal trust rules, *must* also be consulted and met. See §13.21.

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§13.29 1. Substantial Impairment

The minor or person with a disability must have a disability that substantially impairs the individual's ability to provide for his or her own care or custody and constitutes a substantial handicap. Prob C §3604(b)(1).

In practice, a person who qualifies for SSI or Medi-Cal on the basis of disability is likely to satisfy the substantial impairment requirement of Prob C §3604(b)(1).

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§13.30 2. Unmet Special Needs

The court must determine that the person is likely to have special needs that will not be met without the trust. Prob C §3604(b)(2). This determination must be based on the projected needs of the beneficiary for the entire term of the trust. Because most SNTs will be established for the life of the beneficiary, the court must decide whether funds to supplement public benefits are likely to be needed at *any* time during the life of the beneficiary.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.31 3. Amount Reasonably Necessary

§13.31 3. Amount Reasonably Necessary

The money to be paid to the trust may not exceed the amount that appears to be reasonably necessary to meet the special needs of the minor or person with a disability. Prob C §3604(b)(3). Under §3604(b)(3), the court must obtain information about the cost of the person's future special needs. The plaintiff's attorney can be helpful in providing this information because the award of damages undoubtedly has been formulated on the basis of similar information.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.32 B. Procedure for Obtaining Court Approval

§13.32 B. Procedure for Obtaining Court Approval

To obtain court approval for establishment of the trust, a petition must be brought by the guardian, conservator, or (if there is no guardian or conservator) any interested person. Prob C §§3602(d), 3610-3611. See Special Needs Trusts: Planning, Drafting, and Administration §§11.22-11.31 (Cal CEB 2008). The Judicial Council Forms for the petition and order are mandatory forms that must be completed prior to a settlement being approved. Notice of the hearing on the petition and a copy of the petition must be mailed to the directors of the Department of Developmental Services, Department of Health Care Services, and Department of Mental Health at least 15 days before the hearing. Prob C §§3602(f), 3611(c). Notice should also be given to a nonpetitioning guardian or conservator.

The order approving the establishment of the trust must state that the trust is subject to the continuing jurisdiction of the court and may provide that the trust is to be subject to court supervision under the Probate Code. Cal Rules of Ct 7.903(b). Unless the court otherwise orders for good cause shown, the trust document also must contain provisions specified in Cal Rules of Ct 7.903(c). For trusts with assets of $20,000 or less, the requirements of Cal Rules of Ct 7.903(c)(5)-(8) do not apply, unless the court orders otherwise for good cause shown. Cal Rules of Ct 7.903(d).

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.33 C. Petition to Terminate Trust

§13.33 C. Petition to Terminate Trust

Once the trust is established, the battle may not necessarily be won. Under Prob C §3604(c), government agencies may petition the court for an order terminating the trust if at any time it appears that

- Any of the requirements of Prob C §3604(b) are not met, or the trustee refuses without good cause to make payments for the special needs of the beneficiary; and
- The Department of Health Care Services (DHCS), the Department of Developmental Services, the Department of Mental Health, or a California city or county has a claim against trust property as discussed in §13.34.

PRACTICE TIP: Although there is no statutory requirement that the agencies receive accountings, the court may require periodic accountings. Comment to Prob C §3604. However, the DHCS will often file a request for special notice after being noticed of the petition authorizing establishment of the special needs trust. Even if there is no request for special notice, the authors recommend that accountings be mailed to the agencies that are entitled to notice on the initial establishment of the trust.

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§13.34 D. Claims by Government Agencies

During the term of an SNT established under Prob C §3604, claims of the Department of Health Care Services, the Department of Mental Health, the Department of Developmental Services, and any county or city and county are deferred until the beneficiary dies or the trust terminates. Prob C §3605(b).

NOTE: Probate Code §3605(b) creates no new reimbursement rights for state agencies. All existing claims statutes (and restrictions) still apply, however. For example, the DHCS may not recover on the death of the beneficiary if the trust assets pass to a disabled person under Welf & I C §14009.5(b). *Shewry v Arnold* (2004) 125 CA4th 186, 22 CR3d 488.

Deferral of state claims does not apply to statutory liens that attached before establishment of the trust. Prob C §3604(d). An example of such a lien is the Medi-Cal third party lien, which is a first lien against any judgment or award for expenditures on behalf of the injured party under the Medi-Cal program that occurred before receipt of the award.

Probate Code §3605(c) establishes procedures for the specified government agencies to assert claims on the death of the special needs beneficiary or termination of the trust. The agencies must be given notice of the beneficiary's death or trust termination under the general notice procedures of Prob C §1215.

After notice is given, the agencies have 4 months to file their claims with the trustee. Prob C §3605(e).

- If a claim is rejected by the trustee, the department making the claim may file a Prob C §17200 petition for an order directing the trustee to pay the claim. Prob C §3605(e).
- If trust property is distributed within 4 months after notice is given without payment of the claim, the agencies have a claim against the distributees. Prob C §3605(f).

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.35 E. Disabled Adults With Capacity

§13.35 E. Disabled Adults With Capacity

Court approval for the disposition of settlements and judgments is typically available only if the plaintiff is a minor or a person with a disability. Prob C §§3600, 3603. However, the procedures set forth in Prob C §§3600-3612 may be used to create an SNT for an adult with capacity if he or she consents. Prob C §3613.

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§13.36 F. Continuing Court Supervision

In its order approving establishment of the trust, the court must require certain protections for the beneficiary. Cal Rules of Ct 7.903. Unless good cause is shown, the trust instrument must, among other protections, require periodic accountings; court approval for certain kinds of investments; court approval for attorney fees, trustee fees, and trust advisory committee member fees; and the giving of a surety bond. Cal Rules of Ct 7.903(c). These requirements apply to all trusts funded under Prob C §§3600-3613. See §13.32.

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§13.37 G. Estate and Gift Tax Consequences of Funding and Termination of LSNTs

The funding and termination of an LSNT may have estate and gift tax consequences. In IRS Letter Ruling 9437034, the Internal Revenue Service indicated what it believed to be the estate and gift tax effects of the funding and termination of an LSNT.

- Because the proceeds were from the settlement of a cause of action personal to the plaintiff, the plaintiff was the transferor of the funds placed in the trust.
- The transfer of funds to the trust constituted an incomplete gift under Treas Reg §25.2511-2(b), because the plaintiff had the power to change the disposition of the trust corpus on his death through the exercise of a special testamentary power of appointment. See §§2.15-2.18.
- Because the plaintiff as transferor retained a power at death to alter, amend, revoke, or terminate his interest in the trust, the trust corpus was includable in his gross estate under IRC §2038(a)(1).

In most instances, it is preferable to avoid gift taxes on funding of the trust. Giving the beneficiary a testamentary special power of appointment, even if the beneficiary is not capable of exercising it, is essential to avoid making a completed gift. The trustee should, however, be prepared to file an estate tax return and pay estate taxes on the beneficiary's death if the value of the trust assets requires it. Note that any Medi-Cal reimbursement claim or other claim against the trust will be deductible from the beneficiary's gross estate as a claim against the estate under IRC §2053.

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III. INTER VIVOS THIRD PARTY SNT CLAUSES

§13.38 A. Introductory Clauses for Third Party SNT

The trust document should be titled as a special needs trust because most SSI and Medi-Cal offices are familiar with the term. Some practitioners prefer to name the trust after the beneficiary's family ("The Doe Family Special Needs Trust") to avoid administrative difficulties with eligibility workers who are unfamiliar with special needs trusts. The authors, however, believe that the term special needs trust is so widely known as a trust that secures eligibility, even in eligibility workers' circles, that it is now an advantage to identify the beneficiary with the term SNT in the title. See form in §13.39.

The introductory clauses in the following sections also may be used in LSNTs. Like an LSNT, a third party SNT must be irrevocable and unamendable. See §§13.17-13.20, 13.23. As in a first party SNT, however, it may be helpful to provide a limited power of amendment to comply with any changes in the public benefit laws affecting trusts. Drafters may prefer to use the power in place of a "backstop" termination clause. See §13.49. The form specifies that in no event shall the beneficiary have any right to alter, amend, revoke, or terminate the trust or to direct the use of the trust corpus for the beneficiary's own support and maintenance. See form in §13.40.

Also like an LSNT, a third party SNT ordinarily should include a statement of purpose that tracks the language of Prob C §15306(b) to establish that the trust should be exempt from reimbursement claims under Prob C §15306(a). See form in §13.41.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.39 1. Form: Title of Third Party SNT

§13.39 1. Form: Title of Third Party SNT

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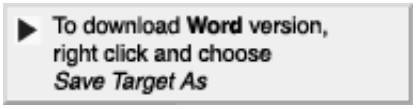
The _ _[*name of beneficiary*]_ _ Special Needs Trust

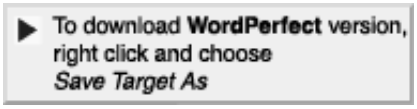
***Trust Agreement*. This trust, dated _ _[*date*]_ _, is made between _ _[*names of settlors*]_ _, as settlors, and _ _[*names of trustees*]_ _, as trustees. By execution of this agreement, the settlors transfer to the trustees the property described in Schedule A, and the trustees accept the property as the initial trust estate. The trustees and successor trustees shall hold and dispose of the trust estate for the sole benefit of _ _[*name of beneficiary*]_ _, as beneficiary, on the terms of trust set forth in this agreement. The singular term "trustee" shall include the plural term "trustees" unless the context indicates otherwise.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.40 2. Form: Irrevocability; Limited Power of Amendment for Third Party SNT

§13.40 2. Form: Irrevocability; Limited Power of Amendment for Third Party SNT



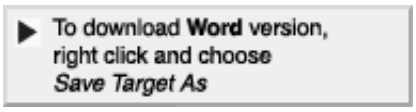


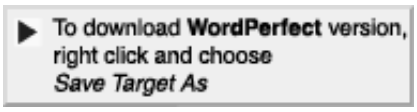
***Irrevocability of Trust*. This trust is irrevocable and unamendable; provided, however, that in the event that any provision of this trust fails to meet the financial eligibility requirements of any program of means-tested public benefits for which the beneficiary is or may be eligible, the then-acting trustee or trustees may, in his, her, or their discretion, amend the trust to ensure eligibility for such benefits. Any such amendment shall be in a writing dated and signed by the trustee or trustees and duly-acknowledged. In no event shall said trustee have any power or authority under this Article that shall constitute a general power of appointment under Internal Revenue Code §2041 and applicable regulations. In addition, nothing herein shall be construed as depriving any person of the right to seek modification or reformation of this trust under California Probate Code §§15400-15414, or other California Probate Code sections then in effect that govern such trusts. In no event shall the beneficiary have any right or power to alter, amend, revoke, or terminate the trust, or any of the terms of the trust instrument, in whole or in part. Furthermore, the beneficiary shall have no right, power, or legal authority to direct the use of the trust corpus for the beneficiary's own support and maintenance.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.41 3. Purpose of Third Party SNT

§13.41 3. Purpose of Third Party SNT





***Purpose of Trust*. The beneficiary of this trust suffers from a disability that substantially impairs** _ _[*his/her*]_ _ **ability to provide for** _ _[*his/her*]_ _ **own care and custody and constitutes a substantial handicap.** _ _[*Add details as appropriate, e.g., the beneficiary has Williams Syndrome and is unable to read or write. He/she is very outgoing and friendly, and as a result is at risk of being unduly influenced by friends, family, or unscrupulous persons.*]_ _ **The purpose of this trust is to supplement, not supplant, the public benefits that would be available to the beneficiary if the trust did not exist.** _ _[*Currently, the beneficiary has/During the term of the trust, the beneficiary will have*]_ _ **basic living needs such as special programs and equipment that public benefits may not provide. It is vitally important that the beneficiary receive these services to maintain a level of human dignity and humane care. If this trust were to be invaded by creditors, subjected to any liens or encumbrances, or cause public benefits to be terminated, the trust corpus would likely be depleted before the beneficiary's death—especially because the cost of care for disabled persons (not including any emergency needs) is high. In this event, there would be no coverage for emergencies or supplementation of basic needs.**

The following trust provisions should be interpreted in light of these concerns and this stated intent. The trustee shall hold, administer, and distribute all property allocated to the trust for the benefit of the beneficiary during the beneficiary's lifetime, unless this trust is terminated earlier.

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§13.42 B. Distribution Provisions for Third Party SNT

The distribution standard of an SNT is often the most important provision in the entire SNT. The distribution standard will affect whether the trust "works" for the disabled beneficiary in two ways:

- Too broad a distribution standard will, in some jurisdictions, cause the trust to be considered an available resource for some needs-based public benefit programs, and disqualify the beneficiary simply by the trust's existence, whether or not distributions are actually made.
- Too narrow a distribution standard restricts the trustee from enhancing the dignity and quality of life of the disabled beneficiary in the most effective manner.

Typically, the main purpose of an SNT is to supplement needs-based government benefits, without supplanting them. See forms in §§13.45-13.46. Trust assets should not be used to provide food or shelter for the beneficiary, unless the practitioner is aware of the consequences of doing so: If the trustee pays for food or shelter, it may cause a reduction or loss of some needs-based public benefits. See §13.11.

EXAMPLE: A trustee may wish to a provide a safe and clean place to live for the disabled beneficiary. SSI provides a modest cash stipend to pay for all of the beneficiary's monthly food and shelter needs. Under the supplemental distribution standard, the SNT can never pay rent from the trust because it would cause a reduction in SSI benefits. This severely limits the availability of housing for the disabled beneficiary. If the discretionary distribution standard is used, the trustee may pay the beneficiary's monthly rent. Social Security would be notified and the payment of rent would cause a limited reduction in the monthly SSI payment. The result is, however, that the beneficiary lives in a decent home. It is important that the practitioner have a clear understanding of the public benefit rules before utilizing these strategies.

However, much greater flexibility (especially in the area of housing) makes a fully discretionary distribution standard desirable in most circumstances. See form in §13.43. The exercise of discretion may be guided by a trust advisory committee. See form in §13.44. There is some concern that a government agency (or new regulations) may, in the future, deem the more flexible discretionary distribution standard exercised and cause a reduction or loss of benefits. However, the SNT could be modified to reduce the discretion available to the trustee at that point to comply with changes in the law, as provided by the form in §13.40.

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§13.43 1. Form: Distribution for Special Needs

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***Distribution for Special Needs*. The trustee may pay to or apply for the benefit of the beneficiary as much of the trust net income and principal as the trustee, in the trustee's discretion, considers necessary or advisable from time to time to meet the beneficiary's special needs. Any income not distributed shall be accumulated and added to principal. As used in this instrument, "special needs" are the requisites for maintaining the beneficiary's good health, safety, and welfare when, in the trustee's discretion, such requisites are not being provided by any public agency, office, or department of any city, county, or state government; the federal government; or any private agency. "Special needs" may include, but are not limited to, the following: _ _**[*e.g., dental care; recreation and entertainment; special equipment; and programs of training, education, and treatment supplemental to those that the beneficiary is entitled to receive under a government assistance program*]**_ _.**

[*If appropriate, add the following option*]

[*Option: Trustee discretion to make distributions that cause reduction of public benefits*]

***Trustee's Absolute Discretion*. Although a primary intent of this trust is to preserve the beneficiary's eligibility for public benefits, the overriding goal of the trust is to ensure that the beneficiary's standard of living will be comfortable and enjoyable. Consequently, the availability of public benefits to pay for a specific need shall not deprive the trustee of the authority, in the trustee's sole and absolute discretion, to make distributions of trust assets for the specific need, even if the distributions cause the reduction of public benefits.**

Comment: The examples of special needs should illustrate specific needs of the beneficiary that are generally unavailable from public resources. These examples should be tailored to the anticipated supplemental needs of the beneficiary. The special needs listed in the bracketed portion of the form are frequently found in third party SNTs for a developmentally disabled beneficiary.

The optional addition is often called a "discretionary" distribution standard, while the primary distribution standard is often called a "supplementary" distribution standard. Under a discretionary distribution standard, the trustee has more flexibility in making distributions.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.44 2. Form: Trust Advisory Committee

§13.44 2. Form: Trust Advisory Committee

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***Trust Advisory Committee*. The Trust Advisory Committee (TAC) is responsible to advise the trustee as to distributions that would be in the best interests of the beneficiary. The TAC serves in an advisory capacity only and its role is to make recommendations to the trustee. The trustee has sole and absolute discretion with regard to trust distributions.**

The TAC members, named below, were chosen because of their knowledge and experience in assisting persons with disabilities and/or their personal interest in the beneficiary. The TAC shall consist of a minimum of three and a maximum of five members. The initial members of the TAC are:

1. _ _[*name*]_ _, _ _[*address*]_ _, _ _[*relationship*]_ _

2. _ _[*name*]_ _, _ _[*address*]_ _, _ _[*relationship*]_ _

3. _ _[*name*]_ _, _ _[*address*]_ _, _ _[*relationship*]_ _

The trustee shall consider the TAC's advice concerning distributions. If it is impossible or impractical for the trustee to obtain the TAC's advice before a distribution, the trustee may make a distribution without such advice.

No trustee or TAC member shall be personally liable to any beneficiary for the trustee's or TAC member's acts or failure to act, except for willful misconduct, gross negligence, or reckless indifference to the interests of any beneficiary.

If a TAC member is unwilling or unable, for any reason, to serve or to continue to serve as a TAC member, the remaining TAC members shall appoint a successor member so that there will be at least three members serving at all times.

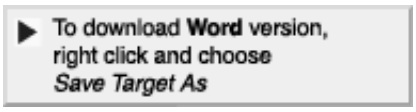
Each TAC member shall be entitled to reasonable compensation for services rendered in this capacity as determined in the trustee's discretion.

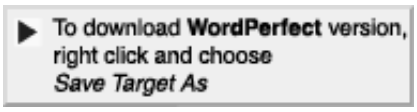
Comment: A trust advisory committee is often used in SNT planning. Because the trustee has such broad discretion on distributions, it is often a good idea to have a check-and-balance system of management for an SNT. Moreover, due to the highly complex area of SNT administration, a trustee of an SNT is often a corporate fiduciary or private, professional fiduciary. A trust advisory committee can be a safeguard against any professional trustee failing to perform its duties with or without a trust protector and allows a family member who is unable to serve as trustee to stay involved and get paid from the trust. See §13.54.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.45 3. Form: Requirement to Seek Public Benefits

§13.45 3. Form: Requirement to Seek Public Benefits





[*Use one of the following alternatives*]

[*Alternative 1: Trustee not required to seek public benefits*]

***Trustee to Consider Public Benefits*. The trustee is not responsible for seeking support and maintenance for the beneficiary from available public resources. In making distributions for the beneficiary's special needs as defined in paragraph _ _[*number*]_ _, the trustee shall, however, consider the applicable resource and income limitations of the public benefit programs for which the beneficiary is eligible, including SSI, Social Security Disability Insurance, Medicare, Medi-Cal, In-Home Supportive Services, Temporary Assistance for Needy Families (TANF), known in California as California Work Opportunities and Responsibility to Kids (CalWORKs), the appropriate Regional Center established under the Lanterman Developmental Disabilities Services Act, the State Department of Mental Health, county mental health services, and any other appropriate federal, state, or local agency serving disabled individuals. All references in this instrument to "Medi-Cal" shall include any other state's equivalent Medicaid program.**

[*Alternative 2: Trustee required to seek public benefits*]

***Trustee to Seek Public Benefits*. Because the beneficiary is disabled and unable to maintain and support _ _[*himself/herself*]_ _ independently, the trustee shall, in the exercise of the trustee's best judgment and fiduciary duty, seek support and maintenance for the beneficiary from all available public resources, including, but not limited to, SSI, Social Security Disability Insurance, Medicare, Medi-Cal, In-Home Supportive Services, Temporary Assistance for Needy Families (TANF), known in California as California Work Opportunities and Responsibility to Kids (CalWORKs), the appropriate Regional Center established under the Lanterman Developmental Disabilities Services Act, the State Department of Mental Health, county mental health services, and any other appropriate federal, state, or local agency serving disabled individuals. In making distributions for the beneficiary's special needs, as defined in paragraph _ _[*number*]_ _, the trustee shall consider the applicable resource and income limitations of the public benefit programs for which the beneficiary is eligible. All references in this instrument to "Medi-Cal" shall include any other state's equivalent Medicaid program.**

Comment: Alternative 1 explicitly relieves the trustee of the duty to seek public benefits for the beneficiary. In directing the trustee to consider the applicable resource and income limitations of the public benefit programs for which the beneficiary is eligible, the trustee is alerted not to make distributions from the trust that may constitute unearned income to the beneficiary and cause a reduction in benefits or a loss of eligibility for SSI and other benefits. For discussion of the SSI unearned income rules, see §§13.10-13.11.

Alternative 2 expands the trustee's fiduciary duty by requiring the trustee to apply for public benefits on behalf of the beneficiary. Traditionally, the trustee's responsibility to conserve the trust corpus and to produce reasonable growth in the value of trust assets has been achieved through investments. This clause indirectly accomplishes the goal of preserving trust assets by attempting to fund the beneficiary's needs with resources obtained outside the trust. If the outside resource is SSI, the savings may be even more significant because SSI benefits are not subject to income tax. Requiring the trustee to seek public benefits on behalf of the beneficiary may place a greater responsibility on trustees than they are willing to bear. The trustee may lack standing to seek public benefits for the beneficiary, the beneficiary may be uncooperative in the application process, or required confidential financial and medical records may be unobtainable by the trustee.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.46 4. Form: Trust Estate to Supplement Public Benefits

§13.46 4. Form: Trust Estate to Supplement Public Benefits

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***Trust Estate to Supplement Public Benefits*. It is the intent of this trust that the trust estate shall be used to supplement public benefits, not supplant them. For purposes of determining the beneficiary's eligibility for SSI, Medi-Cal, TANF, regional center assistance, and residential and program services from the State Department of Developmental Services and any other program of public benefits, no part of the undistributed income or principal of the trust estate shall be considered an available resource to the beneficiary. However, the availability of public benefits to pay for a specific need shall not deprive the trustee of the authority to make a distribution that causes a reduction of public benefits.**

Comment: This clause restates the trustor's intention that trust assets should supplement public benefits, not replace them. See form in §13.43. If trust assets could be used for food or shelter, and medical expenses for which public benefits would otherwise be available, all trust assets might be construed as an available resource to the beneficiary. See §13.17.

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§13.47 C. Termination Provisions for Third Party SNT

This clause marks the principal difference between a third party SNT and an LSNT. When drafting a provision for termination on the death of the beneficiary of a third party SNT, the attorney need not include a special power of appointment for transfer tax purposes as discussed in §13.37. See form in §13.48. Such a power may be included, of course, if the settlors wish the beneficiary to have a power to appoint on death. See form in Special Needs Trusts: Planning, Drafting, and Administration §10.15 (Cal CEB 2008).

In addition, the trustee is not required to reimburse the California Department of Health Care Services (DHCS) on termination of the trust for medical assistance paid on behalf of the beneficiary. See form in §13.50. Generally, the assets in a third party SNT are not liable for the beneficiary's debts after death because they are not part of his or her estate against which a creditor can make claims.

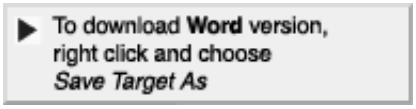
A "backstop" termination clause is designed to protect against possible changes to SSI and Medi-Cal eligibility rules for SNTs. If assets in the trust are determined to be an available resource to the beneficiary and cause the loss of public benefits, the trustee is given the discretion to terminate all or part of the trust. See form in §13.49. The drafter also may include a limited power of amendment as provided in §13.40 for the trustee to try amending the trust to conform to changes before terminating it.

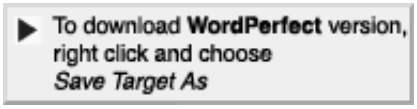
The termination and distribution to remainder beneficiaries may result in a taxable gift by the primary beneficiary. The trustee may therefore need to make provisions for payment of gift taxes. Furthermore, the "transfer" may be considered a transfer by the beneficiary and result in a disqualification period before the beneficiary is eligible for public benefits. However, this is much less likely with a third party SNT than with a first party SNT.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.48 1. Form: Termination of Third Party SNT on Death of Beneficiary

§13.48 1. Form: Termination of Third Party SNT on Death of Beneficiary

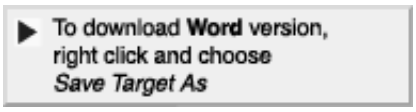


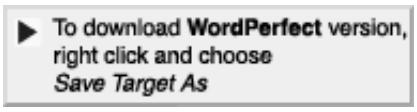


***Termination of Trust*. On the beneficiary's death, the undistributed balance of the trust estate shall be distributed to _ _**[*e.g., the settlors' then-living issue, by right of representation*]**_ _.**

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§13.49 2. Form: Backstop Termination Clause for Third Party SNT





***Backstop Termination Clause*. Despite any contrary provision in this trust, if the existence of this trust renders the beneficiary ineligible for Supplemental Security Income, Medi-Cal, or any other federal, state, or local program of public benefits, the trustee may, but need not, terminate this trust in whole or in part.**

After paying the expenses of trust administration and termination, the trustee shall distribute the portion terminated to the persons and in the relative shares set forth in paragraph _ _[*number*]_ _ as if the beneficiary were deceased.

It is the intent of this trust that if it terminates during the beneficiary's lifetime, the distributee shall conserve, manage, and distribute the proceeds of the former trust estate for the benefit of the former beneficiary to ensure that _ _[*he/she*]_ _ has sufficient funds for _ _[*his/her*]_ _ basic living needs when public benefits are unavailable or insufficient. This request is precatory, not mandatory.

In determining whether the existence of the trust may render the beneficiary ineligible for SSI, Medi-Cal, or any other program of public benefits, the trustee is granted full and complete discretion to initiate either administrative or judicial proceedings, or both, for the purpose of determining eligibility. All costs relating to such proceedings (including reasonable attorney fees) shall be a proper charge to the trust estate.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.50 3. Form: Payment of Expenses of Third Party SNT

§13.50 3. Form: Payment of Expenses of Third Party SNT

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***Payment of Expenses*. On the death of the beneficiary or other termination of this trust, the trustee may, in the trustee's discretion, pay any death taxes attributable to any part of the trust estate or otherwise, last-illness and funeral expenses, and expenses related to administration or distribution of the trust estate if, in the trustee's opinion, other satisfactory provisions have not been made for the payment of these expenses. The trustee shall make no payments for expenses incurred for the beneficiary's health, support, and maintenance if any city, county, state, federal or other government agency was obligated to pay for those expenses while the beneficiary was alive.**

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III. OTHER INTER VIVOS FIRST PARTY SNT CLAUSES

§13.51 A. Introductory Clauses for First Party SNT

The introductory clauses of third party SNTs also may be used for first party SNTs other than LSNTs. See §13.38. In a first party SNT, the settlor is either the beneficiary or a conservator for the beneficiary, although the trust must be established by someone other than the beneficiary. For example, a first party SNT may be established by a conservator for the beneficiary to receive an inheritance. See §13.5.

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§13.52 B. Distribution Provisions for First Party SNT

The distribution provisions used for third party SNTs (see §13.42) also may be used for first party SNTs other than LSNTs.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13 Special Needs Trusts/§13.53 C. Termination of First Party SNT on Death of Beneficiary

§13.53 C. Termination of First Party SNT on Death of Beneficiary

The termination provisions of LSNTs also may be used for first party SNTs other than LSNTs. The trust termination clauses mark the principal difference between a third party SNT on the one hand and a first party SNT on the other hand. See §13.47.

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§13.54 D. Trust Protector Clause

A trust protector clause is a useful tool in both first-party and third-party SNT planning. Because the trustee has so much control over the performance of an SNT, a trustee who is negligent, does not work well with the beneficiary, or is merely slow to respond may cause a disabled beneficiary considerable harm. As protection against such a trustee, a trust protector may be given the authority to remove and replace the trustee with or without cause, to review investments and disbursements, and to modify the trust document to keep it current with public benefits law. For further discussion and forms, see Special Needs Trusts: Planning, Drafting, and Administration §§6.36-6.42 (Cal CEB 2008).

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13A

Dynasty Trusts

Richard S. Kinyon

I. INTRODUCTION TO DYNASTY TRUSTS §13A.1

II. BASIC FEATURES OF A GST-EXEMPT DYNASTY TRUST
- A. GST Exemption Allocated to Trust §13A.2
- B. Discretionary Accumulation Trust §13A.3
- C. Trust Divided Into Separate Trusts in Each Generation §13A.4
- D. Duration of Trust Limited by Rule Against Perpetuities §13A.5

III. ADDITIONAL FEATURES OF A GST-EXEMPT DYNASTY TRUST
- A. Intentionally Defective Grantor Trust §13A.6
- B. Using Valuation Discounts to Enhance Trust §13A.7
- C. Leveraging the Trust §13A.8
- D. Example of Leveraged Intentionally Defective Grantor, GST-Exempt Dynasty Trust §13A.9
  - 1. Income Tax Treatment of Sale to Trust §13A.10
  - 2. Annual Exclusion Gifts of Remaining LLC Units to Issue §13A.11
  - 3. Grantor Trust Status Ends on Settlor's Death §13A.12
- E. Alternative Example—Bargain Installment Sale to Dynasty Trust §13A.13
- F. Private Annuity Alternative to Promissory Note §13A.14

IV. FORM OF DYNASTY TRUST AND RELATED INSTRUMENTS
- A. Form: Generation-Skipping Dynasty Trust §13A.15
- B. Form: Installment Promissory Note §13A.16
- C. Form: Secured Installment Promissory Note §13A.17
- D. Form: Secured Annually Renewable Demand Promissory Note §13A.18
- E. Form: Security Agreement for Limited Liability Company Units §13A.19
- F. Form: Deed of Trust with Assignment of Rents §13A.20

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§13A.1 I. INTRODUCTION TO DYNASTY TRUSTS

A dynasty-type generation-skipping trust (referred to in this chapter as a "dynasty trust") is an irrevocable trust that is exempt from any estate or gift taxes, other than the estate or gift taxes incurred at the time property was originally transferred or added to it. The trust also will be exempt from the generation-skipping transfer (GST) tax to the extent that the settlor's GST exemption is allocated to it. See §13A.2.

NOTE: A generation-skipping trust established by a settlor who is neither a citizen nor a domiciliary of the United States transferring non-U.S. situs assets that are not subject to U.S. estate or gift taxes is also exempt from GST tax.

GST-exempt dynasty trusts are extremely valuable to wealthy families and are usually drafted as discretionary accumulation trusts. See §13A.3. A GST-exempt dynasty trust is usually divided into separate trusts following the settlor's death, on a per stirpetal basis. See §13A.4.

A GST-exempt dynasty trust can benefit the settlor's issue (*i.e.,* lineal descendants of all degrees), or other so-called "skip persons," free of any further gratuitous transfer taxes, for as long as allowed by the rule against perpetuities, if any, applicable to the trust. As used in this chapter, the term "dynasty trust" does not refer specifically to perpetual trusts. See §13A.5.

GST-exempt dynasty trusts are often drafted as intentionally defective grantor trusts (IDGTs) so that the existence of the trust is disregarded for income tax purposes during the settlor's lifetime. See §13A.6. The income tax-exempt value of these trusts can be further enhanced by the use of valuation discounts and leverage used in funding them. See §§13A.7-13A.8. A basic strategy is for the settlor to transfer assets to the trust in exchange for a promissory note (or private annuity agreement) with a face value (or present value) equal to the fair market value of the assets at the time of the transfer so that there is no taxable gift on the sale to the trust, as discussed in §3.44B. For an example of estate planning with a GST-exempt dynasty trust, see §§13A.9-13A.12. For an alternative bargain-sale example, see §13A.13. For discussion of the private annuity alternative, see §13A.14. For a form of dynasty trust and related instruments, see §§13A.15-13A.20.

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II. BASIC FEATURES OF A GST-EXEMPT DYNASTY TRUST

§13A.2 A. GST Exemption Allocated to Trust

A trust established after September 25, 1985, or property transferred to a preexisting trust after that date, by a U.S. person (or by a non-U.S. person with U.S. situs property) will be exempt from the generation-skipping transfer (GST) tax if the settlor's GST exemption is allocated to the property, based on its fair market value at the time of transfer, on the settlor's timely filed estate or gift tax return. IRC §2632. The maximum GST exemption is equal to the IRC §2010 estate tax applicable exclusion amount. IRC §2631(c). See chap 4.

NOTE: A primary reason for using a dynasty trust rather than a grantor retained annuity trust (GRAT; see chap 15) or a qualified personal residence trust (QPRT; see chap 17) is that GST exemption cannot be allocated to a GRAT or a QPRT until the end of the trust term under the estate tax inclusion period (ETIP) rules in IRC §2642(f), unless a nonskip person beneficiary has a withdrawal power over the trust assets. The resulting waste of GST exemption on the appreciation of trust assets would defeat the purpose of the trust.

As used in this chapter, a "GST-exempt dynasty trust" is an irrevocable trust that has a generation-skipping transfer (GST) tax inclusion ratio of zero under IRC §2642(a) and therefore is exempt from any estate, gift, or GST taxes (gratuitous transfer taxes) other than the gift or estate taxes incurred at the time the property is transferred to the trust. Under current law, the trust will remain exempt for as long as the trust exists, no matter how many generations benefit from it, unless a beneficiary becomes the GST transferor of a portion of the trust because he or she has a power over the trust that is treated as a general power of appointment under IRC §2041.

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§13A.3 B. Discretionary Accumulation Trust

As a general rule, a GST-exempt dynasty trust is drafted as a discretionary accumulation trust, so that income or principal may only be distributed to needy beneficiaries or in the trustee's discretion. This minimizes the possibility of an unnecessary or inappropriate drain on the value of the trust property and enables the trust to continue growing generation after generation, subject to diminution only by income and property taxes, expenses of administration, and market fluctuations.

The primary beneficiary might be given an annual power to withdraw the greater of $5000 or 5 percent of the net fair market value of the trust determined as of the end of the year (a "5000 or 5 percent annual power of withdrawal") to provide some flexibility, without risking inclusion of any of the trust principal in the power holder's estate under IRC §2041(b)(2) if the power is not exercised. Even if the trust is not (or is no longer) an intentionally defective grantor trust (IDGT), it apparently will then become a gradually increasing "grantor trust" for income tax purposes with respect to the primary beneficiary for every year in which this power is not fully exercised, which will shift the liability for an ever increasing portion of the tax on the trust's accumulated income to the primary beneficiary under IRC §678(a)(2). See §13A.6.

An exception to this general rule arises when the settlor transfers an interest in California real property to the trust and the settlor wishes to avoid a reassessment of the interest for property tax purposes. The parent-child exclusion from a change of ownership under Rev & T C §63.1 may be available for a transfer to a trust only if one or more children of the settlor (and possibly children of a deceased child) are the sole beneficiaries of the trust and are entitled to all of the trust income. See 18 Cal Code Regs §462.160(b)(1)(A), Examples 2-3.

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§13A.4 C. Trust Divided Into Separate Trusts in Each Generation

A GST-exempt dynasty trust typically is divided into separate trusts following the settlor's death, and the beneficiaries of each such subtrust usually are one of the settlor's descendants and his or her issue, determined on a per stirpetal basis.

EXAMPLE: Wealthy Settlor, who has not previously made any taxable gifts or allocated any of his GST exemption, transfers $2 million worth of money or other property to a GST-exempt dynasty trust for the benefit of his or her issue in 2009. The trust property generally would be invested to maximize long-term growth and few, if any, distributions would be made to the beneficiaries during the settlor's lifetime, especially if the trust is a "grantor trust" for income tax purposes. See §13A.6.

The transfer in the above Example would be a taxable gift totaling $2 million, resulting in a net gift tax liability of $435,000 ($780,800 minus $345,800) because the IRC §2505 gift tax applicable exclusion amount is limited to $1 million. IRC §§2001(c), 2501-2502. See chap 2. However, the trust would be fully exempt from any further gratuitous transfer taxes if $2 million worth of the settlor's GST exemption were allocated to the trust.

On the settlor's death, the trust would be divided into equal separate trusts for the benefit of each of his children and such child's issue. On each child's later death, his or her trust would be further subdivided into equal similar separate trusts for the benefit of each of that child's children (the settlor's grandchildren) and their issue, subject to such child's special testamentary power of appointment, ad infinitum, without incurring any gratuitous transfer tax.

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§13A.5 D. Duration of Trust Limited by Rule Against Perpetuities

The rule against perpetuities is a common law concept that has been enacted in substantially all of the states. It generally provides that a trust may not last longer than 21 years after the death of the last potential beneficiary to die who was living at the time the trust was established. This can be a long time. For example, a trust established in 1951 by the will of newspaper publisher William Randolph Hearst is expected to last until at least 2040. See *Hearst v Ganzi* (2006) 145 CA4th 1195, 52 CR3d 473. California and several other states have enacted the Uniform Statutory Rule Against Perpetuities (Prob C §§21200-21231), which provides that a trust may last at least 90 years before the common law rule is applied. Prob C §21205. Thus, a California (or Nevada) trust created today could last beyond the end of the 21st century. A number of states (*e.g.,* Alaska, Delaware, Idaho, New Jersey, North Carolina, and South Dakota) have repealed their rules against perpetuities, at least for personal property, so that a trust governed by the laws of one of those states may last as long as it has any beneficiaries. Other states may well follow suit, in which case the rule against perpetuities may eventually become a thing of the past. However, this chapter does not discuss additional requirements for perpetual trusts created by California settlors in other jurisdictions that have no rule against perpetuities.

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III. ADDITIONAL FEATURES OF A GST-EXEMPT DYNASTY TRUST

§13A.6 A. Intentionally Defective Grantor Trust

It is possible for an irrevocable trust to be a grantor trust for income tax purposes but not to be treated as owned by the settlor for gratuitous transfer tax purposes, because the income and gratuitous transfer tax laws are not completely consistent with each other. Thus, a dynasty trust can be drafted as a grantor trust, *i.e.,* it is intentionally drafted so as to cause the settlor to be treated as the owner of the trust property for income tax purposes under IRC §§671-679, but the trust will not be included in the settlor's gross estate for estate tax purposes. Such a trust is sometimes referred to as an "intentionally defective grantor trust" (IDGT) because grantor trust status is achieved by failing one of several tests for maintaining a separate taxpayer identity for the trust. See chap 3.

This grantor trust feature can make a dynasty trust even more valuable for estate planning purposes, because the trust is not reduced by the income taxes attributable to its taxable income. Instead, the trust itself is exempt from income tax, and the settlor must include all items of income, deduction, gain, loss, and credit against tax of the trust on his or her individual income tax return, which results in what amounts to a tax-free gift by the transferor to the trust each year in an amount equal to the income tax liability attributable to the trust's taxable income. This usually results in little or no additional tax liability, because of the compressed income tax brackets applicable to trusts, and it enables the trust to grow, in effect, income-tax free. Any net income taxes attributable to the trust property are payable by the settlor and result in a gift-tax free addition to the trust, provided that the settlor is not entitled to reimbursement from the trust. Rev Rul 2004-64, 2004-2 Cum Bull 7.

This grantor trust feature also enables the settlor to deal with the trust on an arm's-length basis without adverse income tax consequences, which allows the settlor to enhance the value of the trust by using leverage. Thus, sales or exchanges of property or loans to and from the trust are disregarded for income tax purposes. Rev Rul 85-13, 1985-1 Cum Bull 184. Usually, the trust is established with a taxable gift of seed money or property, but there is no further taxable gift on the sale to the trust because the note has the same value as the property. The benefits of the trust can be enhanced by obtaining valuation discounts for gifts or sales of minority or fractional property interests. See §13A.7.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13A Dynasty Trusts/§13A.7 B. Using Valuation Discounts to Enhance Trust

§13A.7 B. Using Valuation Discounts to Enhance Trust

Minority or fractional interest and lack-of-marketability discounts in valuing interests in property transferred to a trust by gift or sale substantially enhance the value of the trust. Thus, if a minority interest in a closely held business or investment company or a fractional interest in real or tangible personal property is gifted or sold to the trust, a substantial discount, typically ranging from 15 to 45 percent relative to the net value of a proportionate interest in the entity or property as a whole, may be obtained in determining the fair market value of the interest in the property transferred for gratuitous transfer tax purposes. If there is no closely held business in the family, the senior family member(s) may be able to obtain the substantial tax-saving advantages available with respect to GST-exempt dynasty trusts by forming a family investment company. Despite the hostility of the Internal Revenue Service to such companies, substantial valuation discounts are frequently sustained by the courts if the company has a legitimate and significant nontax savings purpose, and the parties respect the formal requirements of the arrangement. See chap 2.

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§13A.8 C. Leveraging the Trust

Leverage can be applied to the trust by loaning money or selling property to it in exchange for a promissory note of equivalent value. Thus, if the net income from and appreciation in value of the money or other property loaned or sold to the trust is greater than the interest payable with respect to the note under IRC §1274(d), the value of the trust can be further enhanced. Of course, leverage is a double-edged sword; loss in value of the trust property could result in an enhanced loss to the trust. In any event, the current relatively low applicable federal rates make reasonable leveraging strategies potentially very beneficial.

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§13A.9 D. Example of Leveraged Intentionally Defective Grantor, GST-Exempt Dynasty Trust

A married couple domiciled in California who have made no prior taxable gifts or used any of their GST exemptions own 100 percent of the units of a business or investment limited liability company (LLC) that is their community property and is worth $30 million. They transmute 10 percent of the units into equal shares of their respective separate property under Fam C §850 and each of them gives his or her 5-percent interest in the LLC to an intentionally defective grantor GST-exempt dynasty trust for the benefit of their issue early in 2009. A reputable appraiser values the gift of each 5-percent interest at $1 million, reflecting a combined minority-interest and lack-of-marketability discount of 33-1/3 percent ($30,000,000 × 0.05 × 2/3 = $1,000,000). The couple can report the gifts on gift tax returns for 2009 with no net gift tax liability, using all of their combined $2 million IRC §2505 gift tax applicable exclusion amounts, and they can assign $2 million of their combined $7 million IRC §2631 GST exemptions to the two trusts, giving each trust a GST tax inclusion ratio of zero.

The couple then transmutes another 40 percent of the units into equal shares of their respective separate property and each of them sells his or her 20-percent separate property interest to the trust established by him or her in exchange for a promissory note with a face value of $4 million, bearing interest at the appropriate applicable federal rate so that there is no taxable gift on the sale to the trust. In the case of a promissory note with a term over 3 years and not over 9 years, the IRC §1274(d) interest rate used to determine the gift tax value of the note under IRC §7872 is the federal mid-term rate. See §3.44B. The mid-term applicable federal rate, compounded annually, for a note issued in January 2009 is 2.06 percent. The face value of the note is based on the appraiser's valuation of the 20-percent interest in the LLC at $4 million, reflecting the 33-1/3 cent combined minority-interest and lack of marketability discount referred to above ($30,000,000 × 0.20 × 2/3 = $4,000,000).

If the discount is accepted by the IRS or sustained by the courts, the couple will have transferred $15 million worth of property (undiscounted) to the two trusts ((0.05 + 0.05) + (0.20 + 0.20) = 0.50; $30,000,000 × 0.50 = $15,000,000), subject to $8 million worth of indebtedness (which they still own) and used up $2 million of their IRC §2010 estate tax applicable exclusion amounts. They continue to hold 50 percent of the LLC units as community property, half of which has a current fair market value with respect to each of them of $5 million ($30,000,000 × 0.25 × 2/3). Thus, the fair market value of the LLC for gratuitous transfer tax purposes, in effect, is only $20 million ($8 million + $2 million + $10 million), half of which has been "frozen" at $10 million.

NOTE: In this example, the original gifts to the trusts of $3 million worth of assets (with a discounted gift tax value of $2 million) represents 20 percent of the $15 million asset value of the LLC after the sale to the trust of $12 million worth of units (with a fair market value of $8 million). Practitioners usually recommend that settlors make a gift of seed money or property equal to at least 10 percent of the asset value of the trust to ensure that the entire transaction will not be treated as lacking economic substance. See §3.44B.

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§13A.10 1. Income Tax Treatment of Sale to Trust

Since each trust in §13A.9 is a grantor trust for income tax purposes, no gain or loss will be recognized on the sales of the LLC units to the trust in exchange for the notes, no interest will be treated as being paid on the notes during the spouses' lifetimes, and all items of income, deduction, gain, loss, and credit against tax flowing through to the trusts from the LLC will be includable on the couple's income tax returns rather than the trusts' returns. If the value of the trusts' property grows at a substantially greater rate than the rate of interest payable on the notes during the settlors' remaining lifetimes, a substantial estate tax savings is likely on the settlors' deaths.

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§13A.11 2. Annual Exclusion Gifts of Remaining LLC Units to Issue

The settlors in §13A.9 could make annual exclusion gifts of their remaining units of the LLC to their issue in 2009 and subsequent years, either outright, to CUTMA custodianships, or to an IRC §2503(c) or *Crummey* trust. See chap 13. Thus, in 2009, assuming the same 33-1/3 cent valuation discount, an additional 0.13-percent LLC interest could be given to each individual donee shielded by the couple's combined $26,000 gift tax annual exclusion ($30,000,000 × 0.13 × 2/3 26,000). However, the settlors cannot make additional annual exclusion gifts to the trust, because the annual exclusion does not apply to gifts in trust for GST tax purposes under IRC §2642(c) unless the trust has only one current beneficiary with a vested interest. See chap 4.

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§13A.12 3. Grantor Trust Status Ends on Death of Settlor

On each settlor's death in the example in §13A.9, his or her community property one-half interest in the remaining 50 percent (or less) of the LLC units will be included in his or her gross estate for estate tax purposes, and a substantial valuation discount should be available with respect to the 25-percent (or lesser) interest in the LLC included in his or her estate.

Following the death of each settlor, the trust established by him or her will no longer be a grantor trust for income tax purposes. Instead, it will be a regular, nongrantor trust and probably should be divided into separate trusts for the benefit of each of the couple's children and his or her issue, although the couple may prefer that this division not occur until after the deaths of both settlors. These trusts could be supplemented by the couple's remaining GST-exempt property distributable on their deaths, net of any estate taxes (each settlor will have at least $2.5 million of GST exemption at death under the law in effect in 2009 unless the settlor makes additional lifetime taxable gifts), and continue for the benefit of succeeding generations of the couple's issue.

PRACTICE TIP: Care should be taken to avoid inclusion of the trusts in the spouses' gross estates for estate tax purposes by reason of the reciprocal trust doctrine. Thus, no beneficial interest or other right or power, as a fiduciary or otherwise, should be given in either trust to the other settlor that would cause the trust property to be included in the other settlor's gross estate if he or she were treated as having been the settlor of that trust. See §2.37A.

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§13A.13 E. Alternative Example—Bargain Installment Sale to Dynasty Trust

In the example in §13A.9, assume instead that the spouses transmute 50 percent of the LLC units into equal 25-percent shares of their respective separate property. A reputable appraiser values each 25-percent interest at $5 million, reflecting a combined minority-interest and lack-of-marketability discount of 33-1/3 cent ($30,000,000 × 0.25 × 2/3 5,000,000). Each spouse then establishes an intentionally defective grantor GST-exempt dynasty trust for the benefit of his or her issue and makes a bargain sale of his or her 25-percent interest to the trust in exchange for a 20-year fully amortizing installment promissory note with a face value of $4 million, bearing interest at the long-term applicable federal rate of 3.57 percent for a note issued in January 2009, and requiring 20 annual payments of $283,230. This results in a net gift by each spouse of $1 million ($5,000,000 − $4,000,000). Each spouse can report the gift on his or her gift tax return for 2009 with no net gift tax liability, and each can assign $1 million of his or her $3.5 million GST exemption to his or her trust, giving it a GST inclusion ratio of zero.

Since each dynasty trust is a grantor trust for income tax purposes, no gain or loss will be recognized on the bargain sale of the LLC units to the trust in exchange for the note, no interest will be treated as being paid on the note during the spouse's lifetime, and all items of income, deduction, gain, loss, and credit against tax flowing through to the trust from the LLC will be includable on the spouse's income tax returns rather than the trust's returns. If the LLC distributes each year for the next 20 years an amount equal to at least 4 percent of the initial $30 million worth of investment assets transferred to it, each dynasty trust would receive $300,000 ($30,000,000 × 0.25 × 0.04 = $300,000) per year, which is more than enough to make the $283,230 annual installment payments on its $4 million installment note to the settlor.

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§13A.14 F. Private Annuity Alternative to Promissory Note

In the example in §13A.9, the married couple might leverage the trust with a private annuity agreement rather than a promissory note. Thus, after funding each of the two trusts with 5 percent of the LLC units, they could divide another 40 percent of the LLC units into equal 20-percent interests as their respective separate property, and each of them could then sell his or her 20-percent interest to the trust established by him or her in exchange for a private annuity for his or her lifetime having an actuarial value equal to the appraised fair market value of the 20-percent interest. As with the sales for promissory notes in §13A.9, no gain or loss would be recognized to the spouses and no interest element would be treated as paid with respect to the annuities received by them during their remaining lifetimes. Instead, all items of income, deduction, gain, loss, and credit against tax would simply flow through from the LLC and be includable on the couple's income tax returns rather than the trust's returns.

NOTE: The IRS has issued proposed regulations providing that the exchange of appreciated property for an annuity contract will be treated as a realization of gain. Prop Treas Reg §§1.72-6(e), 1.1001-1(j). See discussion in California Estate Planning §20.30 (Cal CEB 2002). However, the proposed regulations only affect a private annuity transaction that is a taxable event, and the transfer of property to a grantor trust is not a taxable event. Therefore, the receipt of a private annuity is still an attractive alternative to the receipt of an installment note in a transaction with a grantor trust. Theoretically, at least, a private annuity transaction with a grantor trust could save substantial estate taxes if the settlor dies prematurely and could also provide the settlor with needed payments if he or she outlives his or her life expectancy, and there are no adverse income tax consequences.

Upon each spouse's death, nothing would be includable in his or her gross estate with respect to his or her annuity, except for the pro rata amount (if any) payable through the date of his or her death. His or her community one-half interest in the remaining 50 percent of the LLC units would be included in his or her gross estate, but as in the example in §13A.9, a substantial valuation discount should be available with respect to a 25-percent interest.

For the annuity to be upheld as a true arm's-length annuity for estate tax purposes and not a transfer with a retained life estate under IRC §2036, there must be no tie-in between the income of the trust and the amount of the annuity payments. The trust as an entity should be liable for the annuity payments and should have sufficient other assets out of which to make the annuity payments, if necessary, in addition to the income and principal from the property transferred to the trust in exchange for the annuity. In addition, the trustee should be allowed to retain any excess income and principal over the amount needed to make the annuity payments and use it for the benefit of the trust beneficiaries. See *La Fargue v Commissioner* (9th Cir 1982) 689 F2d 845. See also *Stern v Commissioner* (9th Cir 1984) 747 F2d 555, which held in favor of the taxpayer-annuitants who were not the original settlors of the trust but held limited powers of appointment over the trust assets and had the power to remove the trustee and appoint a qualified successor. For further discussion, see Wojnaroski, *Private Annuities and Self-Canceling Installment Notes*, Tax Management Portfolios 805-2d (2002). See also Business Succession Planning: Strategies for California Estate Planners and Business Attorneys, chaps 9-11 (Cal CEB 2010).

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Source: Estate Planning/Drafting California Irrevocable Trusts/13A Dynasty Trusts/ IV. FORM OF DYNASTY TRUST AND RELATED INSTRUMENTS/§13A.15 A. Form: Generation-Skipping Dynasty Trust

IV. FORM OF DYNASTY TRUST AND RELATED INSTRUMENTS

§13A.15 A. Form: Generation-Skipping Dynasty Trust

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_ _[*NAME OF SETTLOR*]_ _ 2009 DYNASTY TRUST

ARTICLE ONE
Establishment of Trust and Naming of Trustees

I, _ _[*name of settlor*]_ _, a resident of _ _[*name of county*]_ _ County, California (sometimes referred to as the "Settlor"), hereby transfer and deliver to _ _[*the Settlor/_ _[name of trustee*]_ _]_ _, as trustee, the property described in the attached Schedule A. If _ _[*the Settlor/_ _[name of trustee*]_ _]_ _ fail(s) to qualify or cease(s) to act as the trustee of any trust established under this instrument, I hereby name _ _[*name of spouse*]_ _ as the trustee if _ _[*he/she*]_ _ is then living _ _[*and was married to me at that time*]_ _; and if _ _[*name of spouse*]_ _ fails to qualify or ceases to act as the trustee of any trust established hereunder, I hereby name _ _[*name of successor trustee*]_ _ as the trustee. I reserve the right, by an instrument in writing, to appoint a trustee or cotrustee, remove any trustee or cotrustee (without cause), appoint one or more alternative successor trustees or cotrustees, remove a successor trustee or cotrustee (without cause) and appoint a new successor trustee or cotrustee, and alter the order in which two or more successor trustees or cotrustees shall serve as the trustee or cotrustee _ _[*; and following my death or Incompetency (as defined in Section 8.6, below) _ _[name of spouse*]_ _ *shall have the same right if _ _[he/she*]_ _ *is then living and married to me or was married to me at the time of my death or Incompetency*]_ _.

Notwithstanding the foregoing, after attaining age 35, each Primary Beneficiary of a separate trust established under Section 4.3, below, shall have the right to act as the sole trustee of that trust, by delivering an instrument in writing exercising this right to the existing trustee and copies of such instrument to the other Beneficiaries of the trust; and if he or she later ceases to act as the trustee, the persons named or appointed as provided above or appointed pursuant to Section 7.1, below, shall act as successor trustees in the order named; provided, however, that this right to act as the sole trustee may not be exercised if the Trustee determines that the Primary Beneficiary is substantially unable to manage his or her financial resources or resist fraud or undue influence.

This trust may be referred to as the "_ _[*Name of Settlor*]_ _ 2009 Dynasty Trust." The term "Trustee" refers to any person or persons acting as trustee. All property subject to this trust (the "Trust Estate") shall be administered as provided below. The capitalized terms used in this instrument shall have the meanings specified in Article Eight, below, or as defined elsewhere herein.

ARTICLE TWO
Irrevocability and Unamendability of Trust

Except as specifically provided in this instrument, this trust is irrevocable and unamendable.

ARTICLE THREE
Declarations Regarding Beneficiaries

This trust is for the benefit of My Issue. I have _ _[*number*]_ _ children now living, whose names and birthdates are as follows: _ _[*insert names and birthdates*]_ _.

_ _[*All references to "My Child" and "My Children" are to them/The terms "My Child" and "My Children" include any other children hereafter born to or adopted by me*]_ _ and the term "My Issue" refers to My Children and their Issue.

ARTICLE FOUR
Disposition of Trust Estate

The Trustee shall administer the Trust Estate as follows:

4.1. *During Settlor's Lifetime*. During my lifetime the Trustee shall pay to My Issue as much of the net income and principal of the trust (or two separate trusts designated as the "Exempt Trust" and the "Nonexempt Trust," established pursuant to Section 4.5(d), below) as (a) is necessary for their proper Health, Education, Support, and Maintenance and (b) the Trustee in its discretion deems appropriate for their General Welfare, subject to Subsections (a) and (b) of Section 4.5, below. The Primary Beneficiaries of the trust(s) are My Children.

4.2. *Following Settlor's Death*. Following my death, the trust(s) shall be distributed to those of My Issue who survive me, per stirpes (by right of representation), subject to Section 4.3, below _ _[*; provided, however, that if* _ _[*name of spouse*]_ _ *survives me*_ _[*and was married to me at the time of my death*]_ _**,** *the trust(s) shall continue for* _ _[*his/her*]_ _ *lifetime in the same manner as provided during my lifetime in Section 4.1, above, and following* _ _[*his/her*]_ _ *death the trust(s) shall be distributed to those of My Issue who survive* _ _[*him/her*]_ _*, per stirpes (by right of representation), subject to Section 4.3, below*]_ _**.**

4.3. *Separate Trusts for Issue*. Any share of the Trust Estate otherwise required to be distributed to one of My Issue (hereinafter referred to as "My Descendant"), other than by the exercise of a power of withdrawal or appointment, shall instead be retained and administered by the Trustee in a separate trust as provided below bearing My Descendant's name (or two separate trusts designated as My Descendant "Exempt Trust" and My Descendant's "Nonexempt Trust," established as a result of Section 4.5(d), below):

(a) *During My Descendant's Lifetime*. During My Descendant's lifetime, the Trustee shall pay to My Descendant and his or her Issue as much of the net income and principal of the trust(s) as (1) is necessary for their proper Health, Education, Support, and Maintenance, and (2) the Trustee in its discretion deems appropriate for their General Welfare, subject to Section 4.5(b), below. After attaining age 25, My Descendant shall have a $5000 or 5 Percent Annual Power of Withdrawal with respect to the trust(s); provided, however, that this power of withdrawal may not be exercised if the Trustee determines that My Descendant is substantially unable to manage his or her financial resources or resist fraud or undue influence. Notwithstanding the foregoing, as long as either trust holds an interest in (A) a parcel of real property situated in California that has an assessed value less than its full cash value or fair market value as determined for property tax purposes as of the time of acquisition, (B) a tangible article of a personal nature, or (C) a personal residence, the Trustee shall pay to My Descendant the entire net income with respect to that interest and as much of the principal with respect to it as (1) is necessary for his or her proper health, education, support, and maintenance and (2) the Trustee in its discretion deems appropriate for My Descendant's general welfare, subject to Section 4.5(b); and that interest shall be excluded in determining, but may be utilized in satisfying, the amount subject to My Descendant's $5000 or 5 Percent Annual Power of Withdrawal with respect to the trust; _ _[*provided, however, that if My Descendant is a child of one of My Children who is deceased but my said grandchild's other parent is living and is treated as a child of mine for purposes of Article XIIIA, §2(h)(2)(A), of the California Constitution, and if an interest in property described in clause (A) of this sentence, above, would otherwise benefit from the grandparent-grandchild exclusion from a "change in ownership" for California property tax purposes, the Trustee shall instead pay to such other parent during his or her lifetime (but not after the death of My Descendant) the entire net income with respect to that interest and as much of the principal with respect to it as the Trustee in its discretion deems appropriate for any purpose*]_ _**. The Primary Beneficiary of the trust(s) is My Descendant.**

(b) *Following My Descendant's Death*. Following My Descendant's death, the trust(s) shall be distributed to those of his or her Heirs who are My Issue, per stirpes (by right of representation), subject to this Section 4.3 and Section 4.5(e), below; provided, however, that My Descendant shall have (1) a General Testamentary Power of Appointment over that portion of the trust(s) that otherwise would be subject to the federal estate or generation-skipping transfer tax at that time as a result of his or her death, and (2) a Special Testamentary Power of Appointment over the balance of the trust(s), exercisable in favor of _ _[*his or her Qualified Relatives and Qualified Charities/anyone other than his or her estate, his or her creditors, and the creditors of his or her estate*]_ _**.**

4.4. *Ultimate Disposition if No Issue*. If, at any time before full distribution of the Trust Estate, I have died or attained age _ _[*e.g., 60*]_ _**, I have no living Issue, and no other disposition of the Trust Estate or any portion thereof is directed by this instrument, the Trust Estate or such portion shall be distributed to me if I am then living, or if I am not,** _ _[*to* _ _[*name of spouse*]_ _ *if* _ _[*he/she*]_ _ *is then living* _ _[*and was married to me at the*

time of my death]_ _, *or if* _ _[*he/she*]_ _ *is* _ _[*or was*]_ _ *not,*]_ _ **in equal shares to those of** _ _[*name of spouse's and*]_ _ **my nieces and nephews who are then living and to the living Issue of** _ _[*my/our*]_ _ **deceased nieces and nephews, per stirpes (by right of representation), subject to Section 4.3, above, as though** _ _[*my/our*]_ _ **nieces and nephews were My Children, or if none of** _ _[*my/our*]_ _ **nieces and nephews and none of their Issue is then living,** _ _[*to my Heirs* _ _[*who are my Qualified Relatives*]_ _, *or if there is none,*]_ _ **to** _ _[*name(s) of charity(ies)*]_ _**.**

4.5. ***Overriding Provisions*****. Anything in this instrument to the contrary notwithstanding, the following provisions shall apply to each trust:**

(a) ***Restrictions on Settlor's*** _ _[*and* _ _[*Name of Spouse's*]_ _]_ _ ***Powers, and on Powers of a Related or Subordinate Party Appointed by*** _ _[*Me/Either of Us*]_ _***, as Trustee*****. While I am or** _ _[*name of spouse*]_ _ **is living, neither I,** _ _[*name of spouse*]_ _**, nor any successor trustee appointed by** _ _[*me/either of us*]_ _ **pursuant to the last sentence of the first paragraph of Article 1, above, who is a "related or subordinate party" to** _ _[*me/either of us*]_ _ **as defined in Internal Revenue Code §672(c) shall have the power as trustee to (1) vote (directly or indirectly) any shares of stock of a Controlled Corporation (as defined in Internal Revenue Code §2036(b)) owned by the trust, (2) exercise any "Incident of Ownership" (within the meaning of Internal Revenue Code §2042) with respect to any insurance policy on my life** _ _[*or the life of* _ _[*name of spouse*]_ _]_ _ **held in the trust, (3) sell (directly or indirectly) any shares of stock or life insurance policy referred to in clauses (1) or (2) of this Subsection (a), above, to me** _ _[*or* _ _[*name of spouse*]_ _]_ _**, (4) make discretionary payments of income or principal to any Beneficiary for his or her General Welfare or to any Qualified Charity, or (5) do anything else that would cause any portion of the Trust Estate to be included in my gross estate** _ _[*or the gross estate of* _ _[*name of spouse*]_ _]_ _ **for federal estate tax purposes, and those powers may be exercised only by a trustee other than me** _ _[*or* _ _[*name of spouse*]_ _]_ _**, as provided in the second sentence of Section 7.2, below.**

(b) ***Trustee-Beneficiary Self-Dealing*****. A power to make discretionary payments of income or principal to a particular Beneficiary for his or her General Welfare, to enter into a transaction with a particular Beneficiary for less than an adequate and full consideration in money or money's worth, to disclaim property in favor of a particular Beneficiary or other person, or to do anything else, directly or indirectly, that would cause any portion of the trust to be included in the Trustee's gross estate for federal estate tax purposes, may be exercised only by a trustee other than that Beneficiary or other person (or a "related or subordinate party" within the meaning of Internal Revenue Code §672(c), appointed by him or her pursuant to Section 7.1, below), as provided in the second sentence of Section 7.2, below.**

(c) ***Insurance on Life of Trustee-Beneficiary*****. A Beneficiary who is acting as a trustee shall not have the power to exercise any "Incident of Ownership" (within the meaning of Internal Revenue Code §2042) with respect to any insurance policy on the life of such Beneficiary held in the trust, if it would cause the proceeds of such policy to be included in his or her gross estate for federal tax purposes and such proceeds otherwise would not be so included. Any such Incident of Ownership may be exercised only by a trustee other than that Beneficiary, as provided in the second sentence of Section 7.2, below.**

(d) ***Division of Trust into Exempt and Nonexempt Generation-Skipping Subtrusts*****. If the trust's GST Tax Inclusion Ratio otherwise would be greater than zero and less than one, the Trustee shall establish another trust as follows so that the GST Tax Inclusion Ratio for the original trust is zero (in which case it will be wholly exempt from the federal generation-skipping transfer tax) and for the other trust is one (in which case it will be wholly subject to such tax): The Trustee shall distribute to the other, nonexempt trust the amount necessary to reduce the Net Fair Market Value of the original, exempt trust to an amount such that its GST Tax Inclusion Ratio is zero. The amount distributable to the nonexempt trust may be satisfied in cash or in kind, or partly in each; and assets distributed in kind shall be deemed to satisfy this amount on the basis of their values at the date or dates of distribution. If the Net Fair Market Value of the exempt trust is incorrectly determined, then within a reasonable period after the value is finally determined for Federal estate or gift tax purposes, the Trustee shall distribute from the exempt trust to the nonexempt trust (in the case of an undervaluation) or shall return from the nonexempt trust to the exempt trust (in the case of an overvaluation) an amount equal to the difference between the amount properly distributable to the nonexempt trust and the amount actually distributed to that trust. Both of these trusts shall be administered as otherwise provided in this instrument, except that any distribution that would constitute a "Generation-skipping Transfer" (as defined in Internal Revenue Code §2611) shall be made from the exempt trust to the extent possible, and all other distributions generally should be made from the nonexempt trust.**

(e) *Combination of Substantially Identical Trusts Under this Instrument*. All property that otherwise would be administered in two or more trusts established under this instrument that have substantially identical terms and GST Tax Inclusion Ratios shall be combined and administered as a single trust.

[*If appropriate, add*]

[(f)] *Addition of Trust to Substantially Identical Trust Under Another Instrument*. Any trust being administered under this instrument that is substantially identical to, and has the same GST Tax Inclusion ratio as, a trust established by me _ _[*or* _ _[*name of spouse*]_ _]_ _ under another instrument may in the Trustee's discretion be added to that trust and administered according to its terms.

[*Continue*]

[(g)] *Equitable Adjustments*. Subject to subsections (a) and (b) of this Section 4.5, above, the Trustee shall make additional payments to Beneficiaries, or make adjustments in the rights of any Beneficiary or between the income and principal accounts, to compensate for the consequences of any tax decision or election, investment or other administrative decision, or other circumstance that has had the effect, directly or indirectly, of unfairly preferring one Beneficiary or group of Beneficiaries over others, as determined by the Trustee in its discretion.

[(h)] *S Corporation Stock and Electing Small Business Trust*. If the trust owns stock of an S corporation and would otherwise be an Electing Small Business Trust, the Trustee shall exercise all powers only in a manner consistent with, and shall amend the trust if necessary to conform to the requirements of, Subchapter S of Chapter 1 of Subtitle A (§§1361-1379) of the Internal Revenue Code.

[(i)] *Anti-Retaliation Provision*. A Beneficiary who is acting as a trustee of the trust and who either (1) is removed as trustee for fraud, willful misconduct, or gross negligence in the performance of his or her duties as trustee, or (2) resigns as trustee under threat of being so removed and is later found by the court to have performed his or her duties in such a manner, shall not be entitled to exercise a Special Testamentary Power of Appointment over the trust except as authorized by the court.

[(j)] *Trustee's Authority to Retain Shares of* _ _[*name of company*]_ _. The Trustee is authorized to retain the shares of _ _[*name of company*]_ _ or any successor thereto or affiliate thereof, and acquire additional shares thereof, for as long as the Trustee in its discretion deems appropriate, without regard to its general duty of diversification; and I desire, but do not direct, that it do so.

[(k)] *Grantor Trust Provisions*.

(1) *Settlor's Power to Reacquire Principal of the Trust and Substitute Other Property of Equivalent Value*. During my lifetime I shall have the power as Settlor (in a nonfiduciary capacity, without the approval or consent of the Trustee or any other person acting in a fiduciary capacity, and without regard to the effect it may have on any Beneficiary of the trust) to reacquire all or any portion of the principal of the trust (other than shares of stock of a Controlled Corporation (as defined in Internal Revenue Code §2036(b)) or insurance policies on my life _ _[*or the life of* _ _[*name of spouse*]_ _]_ _ by substituting other property having an equivalent fair market value; provided, however, that the federal income tax basis of such other property must be no less than the federal income tax basis of such principal. I shall assist and cooperate with the Trustee to determine the value of the property to be acquired and substituted by me prior to effecting any such substitution. _ _[*If at the time this power is exercised, I am also serving as Trustee, then the first successor to the trustee who is not related or subordinate to me (within the meaning of Internal Revenue Code §672(c)), shall ensure that the property acquired and substituted by me is in fact equivalent in value.*]_ _ Any such reacquisition of principal and substitution of other property shall be binding on the Trustee and all Beneficiaries of the trust, and neither the Trustee nor any Beneficiary shall have any recourse against me for any such action. If I become Incompetent, this power may be exercised by the person acting as my attorney-in-fact under a durable general power of attorney for financial management, or, if there is none, by the conservator of my estate.

(2) *Special Trustee's Power to Add Charitable Beneficiaries*. During my lifetime the first successor to the trustee who has the power to make discretionary payments of income or principal to any Beneficiary for his or her General Welfare under Section 4.1, above, which successor is not related or subordinate to me or any of My Issue (within the meaning of Internal Revenue Code §672(c)), shall have the power from time to time to add one or more Qualified Charities to the class of Beneficiaries designated to receive the income or principal of the trust, or to delete any such Qualified Charity from such class, by an instrument in writing delivered to the

Trustee specifying such Qualified Charities, and such successor shall act as a special trustee with respect to such power. The Trustee (who must be someone other than such special trustee) shall pay to such Qualified Charities as much of the net income and principal of the trust as the Trustee in its discretion deems appropriate, and the standards and purposes applicable to payments to individual Beneficiaries shall not apply. The special trustee shall irrevocably release and relinquish this power at any time if he, she, or it deems it appropriate to do so, and any such release and relinquishment of this power shall be binding on that special trustee and on all successor special trustees specified or appointed pursuant to the terms of this trust instrument. Following my death this power shall lapse, and any such Qualified Charities shall no longer be Beneficiaries of the trust.

ARTICLE FIVE
General Trust Provisions

Except as otherwise specifically provided, the following general provisions shall apply to every trust established under this instrument:

5.1. *Mandatory and Discretionary Payments of Income and Principal*. Mandatory payments of income shall be made quarter-annually, unless otherwise requested by the Beneficiary, but no less often than annually. In determining whether payments are necessary for an individual Beneficiary's proper Health, Education, Support, and Maintenance, or whether discretionary payments for an individual Beneficiary's General Welfare or otherwise are appropriate, the Trustee shall take into consideration any other income or resources of the Beneficiary (including his or her ability to be gainfully employed), known to the Trustee and reasonably available for these purposes (as well as the size of the trust and the current circumstances and probable future needs of all the Beneficiaries). However, the Beneficiary need not exhaust his or her other income or resources in order to be entitled to such payments. In making payments to a minor individual Beneficiary, the Trustee shall construe its authority liberally to permit payments reasonably necessary to ease the financial burden on the guardian of the person of the minor, or other suitable individual with whom the minor resides, and on such individual's family, resulting from the minor's presence in his or her household; provided, however, that these payments may only be made by a trustee other than such guardian or other individual, as provided in the second sentence of Section 7.2, below. Discretionary payments of income or principal for an individual Beneficiary's General Welfare or otherwise, as well as payments for his or her proper Health, Education, Support, and Maintenance, may be made to or for the benefit of the Beneficiary, and on such terms and conditions as the Trustee may specify, either outright or to the Trustee or any other qualified person, in trust (including the establishment of higher education savings entities under §§529 and 530 of the Internal Revenue Code) and may include the creation of powers of appointment. Any net income not distributed (or required to be distributed) shall be added to principal.

5.2. *Discretionary Payments to More than One Beneficiary*. If discretionary payments may be made to more than one Beneficiary, the Trustee may pay more to or for the benefit of some Beneficiaries than others and make payments to or for the benefit of one or more Beneficiaries to the exclusion of others if the Trustee deems this necessary or appropriate. Any such payments shall be charged against the trust as a whole rather than against the ultimate distributive share of a Beneficiary to whom or for whose benefit the payment is made. Discretionary payments to an individual's Issue may be made to Issue of any degree, including those whose ancestor or ancestors are still living.

5.3. *Use of Trust Property by Beneficiaries*. A Beneficiary who is entitled to the net income of all or a portion of the trust property shall be entitled to use or occupy any such real or tangible personal property rent-free, but subject to payment of property taxes, insurance premiums, expenses for maintenance and ordinary repairs, reasonable amounts for depreciation or amortization, and similar items generally allocated to trust income. The Trustee is authorized to permit any other Beneficiary having a present interest in the trust to use or occupy any trust property on such terms and conditions as the Trustee deems proper, whether rent-free, in consideration of payment of property taxes, insurance premiums, expenses for maintenance and ordinary repairs, reasonable amounts for depreciation or amortization, and similar items generally allocated to trust income, or otherwise.

5.4. *Purchase of Property from and Loans to Beneficiaries*. The Trustee is authorized (a) to purchase property belonging to a Beneficiary of the trust, and (b) to make loans (or guarantee, or encumber or hypothecate trust property for, loans made) to a Beneficiary of the trust, on such terms and conditions as the Trustee deems proper.

5.5. *Spendthrift Provision*. No interest in the income or principal shall be anticipated, assigned, or

encumbered, or subject to any creditor's claim or to legal process, prior to its actual receipt by the Beneficiary; provided, however, that any individual Beneficiary may assign all or part of his or her interest in the trust to any one or more of his or her Qualified Relatives and Qualified Charities, or to a trust that is primarily for the benefit of the Beneficiary and/or such persons.

5.6. *Perpetuities Savings Provision*. Unless sooner terminated in accordance with other provisions of this instrument, the trust shall terminate 21 years after the death of the last survivor of those of My Qualified Relatives and all other Beneficiaries who are living at the time the trust becomes irrevocable, but only if California has not repealed its rule against perpetuities (presently in Probate Code §§21200-21231). All principal and undistributed income shall be distributed to the then income Beneficiaries of the trust in the proportions in which they are, at the time of termination, unconditionally entitled to receive the income; provided, however, that if the rights to income are not then fixed by the terms of the trust, distribution under this section shall be made to those of My Issue, per stirpes (by right of representation), or if there is none, in equal shares to those Beneficiaries who are then entitled or authorized in the Trustee's discretion to receive income payments.

5.7. *Multiple Trusts-No Physical Division Required*. There need be no physical segregation or division of the various trusts except as segregation or division may be required by the termination of any of the trusts, but the Trustee shall keep separate accounts for the different undivided interests.

5.8. *Additions to Trust*. Property may be added to the trust by any person by designating it as the beneficiary of a life insurance policy or Employee Benefit Plan, by exercising a power of appointment in favor of the trust, or in any other manner; but any such property not acceptable to the Trustee may be disclaimed.

ARTICLE SIX
Trustee's Administrative Powers

Except as otherwise specifically provided, the Trustee shall have the following powers with respect to every trust established under this instrument, in addition to the powers specified in California Probate Code §§16200-16249. All powers shall be exercised with due regard to the Trustee's fiduciary obligations, and the Trustee shall be mindful of the fact that it is subject to the standard of care prescribed by §16040, and the other duties specified in California Probate Code §§16000-16105:

6.1. *Trustee Self-Dealing*. The Trustee shall have the power to lend or advance its own funds to the trust for any purpose, with interest not in excess of current rates, to receive no more than adequate security for such loans in the form of a mortgage, pledge, deed of trust, or other encumbrance of any assets of the trust, to purchase trust property for no less than its fair market value as determined by an independent appraisal, and to sell property to the trust at a price not in excess of its fair market value as determined by an independent appraisal.

6.2. *Retention, Disposition, or Liquidation of Interest in a Closely Held Entity; Power to Guarantee Loans to the Entity*. The Trustee is authorized to continue to hold and operate, to sell, or to liquidate, at the risk of the Trust Estate, any interest in a closely held entity (*i.e.,* a proprietorship, partnership, limited liability company or partnership ("LLC" or "LLP"), or corporation) that the Trustee receives or acquires under the trust, as the Trustee deems advisable. This authorization to sell shall include sales to the partnership, LLC, LLP, or corporation itself and to another partner, member, or shareholder, regardless of whether such partner, member, or shareholder also is the Trustee. The Trustee also is authorized to guarantee any loans, at the risk of the Trust Estate, made to any such closely held entity, as the Trustee deems advisable.

6.3. *Closely Held Entity Regarded as Separate from the Trust*. The Trustee shall incur no liability for misconduct, mismanagement, or negligence on the part of any employee, partner, member, officer, or director of a closely held entity in which the trust has an interest, who is not an officer or employee of the Trustee. In the absence of any notice to the contrary, the Trustee may accept as correct financial or other statements rendered by an accountant for any such entity. Any such entity shall be regarded as an entity separate from the trust, and no accounting as to its or operations shall be required to be made by the Trustee.

6.4. *Management of Closely Held Entity*. The Trustee is encouraged, but not required, to vote any shares of a closely held entity to elect as directors, managers, and officers of the entity those persons actively participating in its management at the time of the addition of the shares to the trust. The management of the entity and the conduct of its operations may be delegated to such persons as the board of directors or managers of the entity shall direct.

6.5. ***Specific Authority Regarding Certain Transactions*****. The Trustee shall have the power to buy commodities, to trade securities on margin, to sell securities short, to borrow securities, to cause credit to be extended through securities' accounts and to secure the performance of obligations in securities' accounts with assets in such accounts, and to trade in options (including the purchase and sale of puts and calls and the writing of index participation contracts and covered and uncovered option contracts).**

6.6. ***Beneficiary with Power of Revocation or Withdrawal*****. If any Beneficiary has a currently exercisable power of revocation or withdrawal over any portion of the trust and is acting as the sole trustee of the trust, he or she shall have the power to deal with the property subject to such power in the same manner as if the property were owned by him or her outright, free of trust. If any Beneficiary has such a power but is not acting as the sole trustee, the Trustee shall follow all directions of that Beneficiary with respect to the property subject to such power; and the Trustee shall not be liable to that Beneficiary or to any other person for any loss resulting from following such directions.**

ARTICLE SEVEN
Provisions Relating to the Trustee

Except as otherwise specifically provided, the following provisions shall apply to every trust established under this instrument:

7.1. ***Resignation, Declination, and Removal of Trustee and Appointment of Successor Trustee*****. A person may resign or decline to serve as trustee of the trust by delivering an instrument in writing to the cotrustee, if any, to each Beneficiary of the trust, and to the successor trustee, if any, named or appointed as provided in this instrument. An individual trustee shall be deemed to have resigned or declined to serve if he or she dies or becomes Incompetent. A majority of the individual trustees, or if there is no individual trustee, a majority of the Beneficiaries of the trust (which majority must include all of the Primary Beneficiaries of the trust), may, by an instrument in writing, appoint a corporate trustee or cotrustee or remove a corporate trustee or cotrustee, without cause, and appoint a substitute corporate trustee or cotrustee. All of the Primary Beneficiaries of the trust who have attained age 35 acting together, or if there is no Primary Beneficiary then a majority of the Beneficiaries of the trust who have attained that age, may, by an instrument in writing, appoint a trustee or cotrustee, remove any trustee or cotrustee, without cause, appoint one or more alternative successor trustees or cotrustees, remove a successor trustee or cotrustee, without cause, and appoint a new successor trustee or cotrustee, and alter the order in which two or more successor trustees or cotrustees shall serve as the trustee or cotrustee. Notwithstanding the preceding two sentences, if the event causing the trust to terminate has occurred or the trust is fully withdrawable by the Beneficiaries, a majority in interest of the Beneficiaries acting together may, by an instrument in writing, appoint any trustee or cotrustee or remove any trustee or cotrustee, without cause, and, if necessary or desirable, appoint a substitute trustee or cotrustee. Any corporate trustee or cotrustee appointed pursuant to one of the preceding three sentences must be authorized to engage in a trust business in one or more states of the United States, unless otherwise authorized by all of the Beneficiaries of the trust or by the court. Any such resignation or removal shall be effective upon acceptance in writing by the person then entitled to act as the Trustee or as otherwise ordered by the court. References in this section to a trustee or cotrustee include a successor trustee or cotrustee, who shall be authorized to act as a special trustee as provided in the second sentence of Section 7.2, below.**

7.2. ***Disclaimed and Precluded Trustee Powers; Special Trustee*****. The Trustee may disclaim, release, or restrict any of its powers by delivering a written instrument to the cotrustee, if any, to the first person specified as the successor trustee in Article 1, above, if any, and to each Beneficiary, specifying the powers disclaimed, released, or restricted and the nature of any such restriction. Any such disclaimed, released, or restricted power, as well as any other power that the Trustee is precluded from exercising, shall be exercised only by the cotrustee, or if there is none, by the person specified as the successor trustee in Article 1 or appointed pursuant to Section 7.1, above, who shall act as special trustee with respect to such powers. The Trustee shall provide sufficient liquidity in the trust or otherwise act in a manner that will enable the special trustee to carry out its duties.**

7.3. ***Actions by Multiple Trustees*****. If two or more persons are acting as cotrustees, all must unite in any act to bind the trust property, unless otherwise agreed by all of them in writing.**

7.4. ***Trustee's Duty to Report Information and Account to Beneficiaries*****. The Trustee shall report information and account to the Beneficiaries as provided in California Probate Code §§16060-16064. Notwithstanding the foregoing, if (a) the Trustee delivers to a Beneficiary an account or report and a notice in the form provided in**

California Probate Code §16461(c)(3) with respect to said account or report, which notice advises the Beneficiary that he or she has a specified period of time, which period shall not be less than 180 days from the Beneficiary's receipt of the account or report, to deliver to the Trustee the Beneficiary's written objection (if any) to the account or report, and (b) the Beneficiary does not deliver to the Trustee, within the period specified in the notice, the Beneficiary's written objection to the account or report, then the Trustee shall not be liable to the Beneficiary for any claim against the Trustee (excluding any claim for fraud, willful misconduct, or gross negligence in the Trustee's performance of his, her, or its duties) with respect to any item that is adequately disclosed (as provided in California Probate Code §16460(a)(1)) in the account or report.

7.5. *Limits on Liability of Trustee*. An individual named or appointed as a trustee in or according to this instrument who is serving without compensation (other than reimbursement for his or her reasonable expenses) shall not be liable to any Beneficiary for the individual trustee's act or failure to act, except for fraud, willful misconduct, or gross negligence in the performance of his or her duties as trustee. In addition, (a) a majority of the Beneficiaries of the trust (which majority must include all of the Primary Beneficiaries of the trust), or (b) a majority in interest of the Beneficiaries if the event causing the trust to terminate has occurred or the trust is fully withdrawable by the Beneficiaries, may, by an instrument in writing, amend the trust to provide that any other Trustee shall not be liable to any Beneficiary for the Trustee's act or failure to act, except for fraud, willful misconduct, or gross negligence in the performance of its duties as trustee; and a majority (or majority in interest) of the Beneficiaries may later terminate this limitation of the Trustee's liability by an instrument in writing delivered to the Trustee and all of the other Beneficiaries of the trust. Any such termination shall be effective with respect to all acts or failures to act occurring more than 30 days after delivery of such instrument to the Trustee.

7.6. *Indemnification of Trustee for Environmental Problems*. The Trustee shall be reimbursed and indemnified from the trust for any and all liabilities, penalties, claims, and expenses of any kind or nature (including, without limitation, reasonable fees and disbursements of counsel or consultants) in any manner arising out of or related to any environmental problem, whether currently existing or subsequently arising (including but not limited to, any release or threatened release of any contaminant into the indoor or outdoor environment), on, at, under, or in connection with any property held in the trust, including, but not limited to, real property owned or operated directly by the trust and real property owned or operated by a closely held corporation or by a general or limited partnership or limited liability company in which the trust has an ownership or management interest (collectively, "Liabilities and Costs"), even if the Liabilities and Costs equal the entire value of the trust; provided, however, that the Trustee shall have no right to indemnification or reimbursement hereunder for any Liabilities and Costs attributable to the Trustee's gross negligence, willful misconduct, or fraud.

7.7. *Bonding of Individual Trustee; Custody of Assets*. No bond shall be required of any individual named or appointed as a trustee in or according to this instrument, whether acting jointly or severally in the administration of the Trust Estate, unless requested in writing by any of the Primary Beneficiaries or by a majority of the other Beneficiaries of the trust. Substantially all intangible personal property of the trust shall be held in the custody of the corporate trustee, or if there is no corporate trustee, in the custody of a corporation authorized to engage in a trust business in one or more states of the United States if requested in writing by any of the Primary Beneficiaries or by a majority of the other Beneficiaries of the trust.

ARTICLE EIGHT
Definitions and Miscellaneous Provisions

Except as otherwise specifically provided, the following provisions apply to this instrument:

8.1. *Definition of Beneficiary and Primary Beneficiary*. The terms "Beneficiary" and "Beneficiaries" refer only to those beneficiaries generally entitled to notice of hearing on a petition described in California Probate Code §17200. The terms "Primary Beneficiary" and "Primary Beneficiaries" refer to the beneficiary or beneficiaries, if any, who are specified as such in this instrument; and if no one is so specified, the trust shall be treated as having no Primary Beneficiary. The interests in the trust of other beneficiaries (as defined in California Probate Code §24) are subordinate to the interests of the Primary Beneficiary or Beneficiaries.

8.2. *Definition of Education*. The term "Education" shall be construed to include (but is not limited to) undergraduate, graduate, and non-degree programs of study, at an accredited institution of the individual's choice, as long as such studies are pursued to his or her advantage. In making payments for education, the Trustee shall take into consideration the individual's related living and traveling expenses to the extent that

they are reasonable.

8.3. *Definition of General Welfare*. The term "General Welfare" shall be construed as broadly or as narrowly as the Trustee deems appropriate. It may, for example, include (a) payments for the individual's entertainment, travel, vacations, and promising business opportunities, (b) payments to or for the benefit of the individual that would likely result in a significant reduction in taxes otherwise payable with respect to trust income and/or principal, and (c) distributions resulting in the termination of the trust in favor of the individual if he or she is of sufficient age, maturity, and competence to manage the assets properly and there is no compelling tax or other advantage to continuing the trust.

8.4. *Definition of GST Tax Inclusion Ratio*. The term "GST Tax Inclusion Ratio" refers to the federal generation-skipping transfer tax inclusion ratio described in Internal Revenue Code §2642.

8.5. *Definition of Health*. The term "Health" includes both mental and physical well-being, and includes payments for psychiatric and psychological counseling and fitness programs designed to maintain and improve the individual's condition as well as to treat an illness, injury, or disorder. I desire, but do not direct, that no payments be made for the prolongation of the individual's life or the provision or continuance of life-sustaining treatment if the burdens of the treatment outweigh the expected benefits, and that the Trustee consider the relief of suffering and the quality as well as the extent of the possible extension of the individual's life in deciding whether to make payments for life-sustaining treatment.

8.6. *Determination of Heirs*. An individual's Heirs shall be determined as provided under California law relating to the succession of separate property not acquired from a predeceased spouse.

8.7. *Definition of Incompetent*. An individual shall be deemed to be "Incompetent" if (a) he or she is an unemancipated minor, (b) a conservator of the person or estate is acting on behalf of the individual, (c) the court has determined that the individual is incompetent or lacks capacity, or (d) the agent designated in the individual's power of attorney for health care (including the person appointed by the individual as his or her health care agent in an advance health care directive), or one licensed physician who is the individual's attending physician or primary care physician, has declared in writing under penalty of perjury that in his or her opinion the individual is substantially unable to manage his or her financial resources or resist fraud or undue influence.

8.8. *Definition of Issue*. The term "Issue" refers to lineal descendants of all generations_ _[*; provided, however, that for purposes of determining whether a person is the issue, child, or grandchild of a certain person, the relationship of parent and child shall exist between an adopted person and that person's adopting parent or parents only if the child was legally adopted before attaining the age of eighteen (18). In addition, the relationship of parent and child shall be deemed not to exist for purposes of this instrument between a child and that child's natural parent if such child was born while such parent was not legally married to such child's other natural parent and such parents do not become legally married to each other before such child attains the age of eighteen (18)***]_ _.**

8.9. *Definition of Net Fair Market Value of a Trust*. In determining the "Net Fair Market Value" of a trust as of a particular time, the Trustee shall take into account accrued tax (and other) liabilities but shall disregard potential future tax liabilities with respect to unrealized gains or losses.

8.10. *Definition of Qualified Relatives and Qualified Charities*. The term "Qualified Relatives" refers to an individual's _ _[*grand*]_ _ parents, their Issue, the Spouses of their Issue, and the Issue of such Spouses. The terms "Spouse" and "Spouses" include widows and widowers, regardless of whether they have remarried. The term "Qualified Charities" refers to those organizations that are described in Internal Revenue Code §§170(c), 2055(a), and 2522(a).

8.11. *Definition of Support and Maintenance*. The terms "Support" and "Maintenance" shall be construed liberally to include payments that are necessary to maintain the individual in his or her accustomed manner of living.

8.12. *Distributions to or for Benefit of Individual Beneficiary*. Any income or principal required or authorized to be distributed to an individual Beneficiary may be either applied for the Beneficiary's benefit or distributed (a) directly to the Beneficiary if he or she is of sufficient age, maturity, and competence to manage it properly, (b) to the legal guardian or conservator of the Beneficiary's estate, or (c) to the Trustee or any other qualified person as custodian for the Beneficiary, up to the maximum age permitted, under the Uniform Transfers/Gifts

to Minors Act of any state selected by the Trustee. Distributions for the benefit of an individual Beneficiary include distributions for the Support or Maintenance of an individual whom the Beneficiary is legally obligated to support or maintain.

8.13. *Governing Law*. This instrument shall be construed and administered in accordance with the laws of the State of California and the United States of America; and unless otherwise indicated, all words and phrases used herein shall have the same meanings as they have in the California Probate, Family, and Civil Codes and the Internal Revenue Code. Reference to, or incorporation by reference of, any law shall mean such law as amended from time to time.

8.14. *Ninety-Day Survival Requirement*. An individual shall not be deemed to have survived another (or an event resulting from the death of another) unless the former survives the latter for 90 days.

8.15. *$5000 or 5 Percent Annual Power of Withdrawal*. A present power to withdraw all or a portion of the trust may be exercised in whole or in part at any time during the powerholder's lifetime and lapses on his or her death. If a Beneficiary has a "$5,000 or 5 Percent Annual Power of Withdrawal" with respect to the trust, the Trustee shall pay to the Beneficiary such sums as the Beneficiary may request in writing, not exceeding with respect to any calendar year the greater of the following amounts: five thousand dollars ($5,000) or five percent (5%) of the Net Fair Market Value of the trust determined as of the end of the calendar year (or such greater amount as may be specified in Internal Revenue Code §§2041(b)(2) and 2514(e)). A $5,000 or 5 Percent Annual Power of Withdrawal (a) may be exercised by a written instrument delivered to the Trustee at any time during the calendar year, but will be effective only if the Beneficiary is living at the end of the calendar year, (b) is noncumulative, and (c) lapses at the end of the calendar year to the extent not exercised.

8.16. *Representation of Incompetent Beneficiary*. Unless otherwise ordered by the court, an individual Beneficiary who is Incompetent may be represented by the legal guardian or conservator of the estate of the Beneficiary, or if there is none, by the legal guardian or conservator of the person of the Beneficiary, or if there still is none, by (a) the person legally entitled to custody of the Beneficiary (if the Beneficiary is an unemancipated minor), or (b) the person acting as attorney-in-fact for the Beneficiary under a durable general power of attorney for property matters (if the Beneficiary is an emancipated minor or an adult).

8.17. *Testamentary Powers of Appointment*. If an individual has a "General Testamentary Power of Appointment" over the trust, the power holder has the power to direct the Trustee to distribute the trust property to such one or more persons, including the power holder's own estate, as the power holder may appoint. If an individual has a "Special Testamentary Power of Appointment" over the trust, the power holder has the power to direct the Trustee to distribute the trust property to such one or more specified persons as the power holder may appoint, other than the power holder's creditors, his or her estate, or creditors of his or her estate. Any testamentary power of appointment may be exercised by a will or notarized instrument (including a revocable trust) whether executed before or after the power becomes exercisable, but only if the document specifically refers to and exercises such power. An appointment may be either outright or in trust (including the creation of further powers of appointment) and on such terms and conditions as the power holder may specify; provided, however, that the exercise of a Special Testamentary Power of Appointment may not create another power of appointment that can be validly exercised so as to postpone the vesting of any estate or interest in the trust property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

IN WITNESS WHEREOF, I have executed this trust instrument at _ _[*name of city*]_ _**, California, on** _ _[*date*]_ _.

__[*Signature*]__
_ _[*Typed name*]_ _
Settlor _ _[*and Trustee*]_ _

State of California)
)
County of _ _[*name of county*]_ _)
)
)

_____

On _ _[*date*]_ _, before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

[*Add if settlor is not sole trustee*]

ACCEPTANCE BY TRUSTEE

I certify that I have read the foregoing trust instrument, and I accept the Trust Estate upon the terms and conditions under which it is to be administered by the Trustee.

[*Add one of the following alternatives*]

[*Alternative: Individual trustee*]

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _, **Trustee**

[*Alternative: Corporate trustee*]

Date: _ _ _ _ _ _ _ _[*NAME OF TRUST COMPANY*]_ _, **Trustee**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title of officer*]_ _

[*Acknowledgment*]

[*Continue*]

SCHEDULE A

TO THE _ _[*NAME OF SETTLOR*]_ _ 2009 DYNASTY TRUST

_ _[*Number*]_ _ shares (the "Shares") of _ _[*name of company*]_ _, LLC (the "Company"), which is the Settlor's separate property. The Shares are being transferred by the Settlor to _ _[*himself/_ _[name of trustee*]_ _]_ _, as Trustee of the _ _[*Name of Settlor*]_ _ 2009 Dynasty Trust (also, "this Trust"), in exchange for this Trust's promissory note, payable to the Settlor (or _ _[*his/her*]_ _ designee), having a principal amount equal to eighty percent (80%) of the fair market value of the Shares, bearing interest at the _ _[*mid-term*]_ _ applicable federal rate as of the date hereof, compounded annually, payable on each anniversary date of this Trust instrument, and payable in full on the _ _[*ninth*]_ _ anniversary date of this Trust instrument, in the form attached to this Schedule A as Exhibit 1 (the "Note").

It is estimated that the fair market value of the Shares on the date hereof is $_ _[*amount*]_ _ and that the principal amount of the Note is $_ _[*80 percent of preceding amount*]_ _ ($_ _[*amount*]_ _ x 0.80). If a qualified independent appraiser determines that for gift tax purposes the fair market value of the Shares is more or less than $_ _[*amount*]_ _, the principal amount of the Note shall be increased or reduced to an amount that equals eighty percent (80%) of the fair market value of the Shares as determined by said appraiser (also, the "appraiser adjusted fair market value"). If the fair market value of the Shares is finally determined for federal gift tax purposes to be more or less than $_ _[*amount*]_ _ or the appraiser adjusted fair market value (also, the "final adjusted fair market value"), the principal amount of the Note shall be further increased or reduced to an amount that equals eighty percent (80%) of the final adjusted fair market value of the Shares. Both of these adjustments shall be retroactive to the date of this instrument.

EXHIBIT 1

[*Attach installment promissory note; see §§13A.16-13A.18*]

Comment: This form is designed to be used in connection with a bargain sale of interests in a family investment company by the settlor to a dynasty trust in exchange for a secured or unsecured promissory note with a face value equal (or nearly equal) to 80 percent of the appraised fair market value of the interests, so that there is a taxable gift of 20 percent of the appraised fair market value of the interests on the sale. See discussion in §13A.1. For a complete text of the form with a detailed table of contents, see Appendix N.

As discussed in §13A.2, it is expected that the settlor's GST exemption will be allocated to the trust so that the trust is fully exempt from GST tax, but the trustee is required to divide the trusts into exempt and nonexempt trusts under Section 4.5(d) if the trust is not fully exempt.

As discussed in §13A.3, the trust is a discretionary accumulation trust under Section 4.1 that benefits the settlor's children and their issue, and the trust divides into separate trusts on the settlor's death under Section 4.3 and again on the death of the settlor's children and their issue, unless the settlor has no surviving issue under Section 4.4. See §13A.4. The trusts continue for as long as permitted by the rule against perpetuities under Section 5.6. See §13A.5.

Section 4.3(a) contains an overriding provision designed to enable any California real property that might otherwise be subject to reassessment, with an assessed value less than its full cash or fair market value as determined for property tax purposes as of the time of acquisition by the trust, to qualify for the parent-child or grandparent-grandchild exclusion from a "change in ownership." (The grandparent-grandchild exclusion requires that the child's other parent also be deceased. This provision continues the deceased child's income interest during the parent's lifetime.) As long as the trust holds any such property, along with any tangible articles of a personal nature or a personal residence generally, all such property would be administered as a separate share within the trust as a whole for the benefit of the Settlor's child or grandchild (or possibly the grandchild's other surviving parent).

As discussed in §13A.6, the trust is an intentionally defective grantor trust under Section 4.5(j). As a result, the sale of interests to the trust is disregarded for income tax purposes, and the trust can continue to accumulate income-tax free to the trust until the settlor's death. See §13A.7.

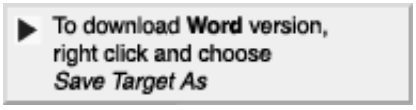
As discussed in §13A.8, it is expected that the settlor will obtain substantial valuation discounts for the bargain sale of interests to the trust that results in a taxable gift of 20 percent of the fair market value of the interests transferred to the trust. See §13A.13. The settlor also may sell the assets for a private annuity rather than a promissory note. See §13A.14. The settlor will need to pay gift tax if the net gift is greater than $1 million per settlor ($2 million for a married couple), but the trust can be made fully exempt from GST tax as long as the net gift is not greater than $3.5 million per settlor ($7 million for a married couple).

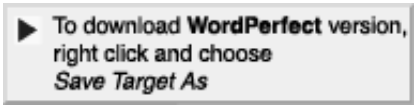
It is expected that the formation of the family investment company and the sale of interests may be contemporaneous with the creation of the trust. Section 6.3 is intended to make clear that the trust is a separate entity from the company, and Schedule A indicates that the promissory note received in exchange for the interests is attached to the trust document. For a form of unsecured installment promissory note, see §13A.16. For a form of secured installment promissory note, see §13A.17. For a form of secured annually renewable demand promissory note, see §13A.18. For a form of security agreement to be used in connection with a sale of interests in exchange for a secured promissory note, see §13A.19. For a form of deed of trust with assignment of rents to be used in connection with a sale of real property to the trust, see §13A.20.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13A Dynasty Trusts/§13A.16 B. Form: Unsecured Installment Promissory Note

§13A.16 B. Form: Unsecured Installment Promissory Note





UNSECURED INSTALLMENT PROMISSORY NOTE

_ _[*Date of execution*]_ _

$_ _[*Amount of promissory note*]_ _

FOR VALUE RECEIVED, the undersigned, _ _[*name of settlor or trustee*]_ _**, as Trustee of the** _ _[*Name of Settlor*]_ _ **2009 Dynasty Trust, dated** _ _[*date of execution of dynasty trust*]_ _ **(hereinafter referred to as "Maker"), hereby promises to pay to the order of** _ _[*name of settlor or trustee*]_ _**, as Trustee of the** _ _[*name of settlor's separate property subtrust*]_ _ **Trust under the** _ _[*name of settlor's revocable trust*]_ _ **Revocable Trust instrument, dated** _ _[*date of execution of settlor's revocable trust*]_ _ **(Separate Property of** _ _[*name of settlor*]_ _**) (hereinafter referred to as "Payee"; Payee and any subsequent holder hereof being hereinafter referred to as "Holder") at** _ _[*name of city*]_ _**, California (or such other place as Holder may direct from time to time), in lawful money of the United States of America and in immediately available funds, the principal sum of** _ _[*dollar amount*]_ _ **dollars ($**_ _[*amount*]_ _**), together with interest from the date hereof on the unpaid principal balance at the rate of** _ _[*number*]_ _ **percent (**_ _[*number*]_ _**%) per annum payable as follows: Interest only shall be due and payable in** _ _[*number more than three and not more than nine*]_ _ **annual installments commencing on the first anniversary date of this Note and continuing on each subsequent anniversary date. All outstanding principal and accrued but unpaid interest shall be payable in full on the** _ _[*ordinal number more than third and not more than ninth*]_ _ **anniversary date of this Note.**

Payments. **Interest shall be computed on the basis of a year of 365 days for the actual number of days elapsed. Should any interest not be paid when due hereunder, it shall be added to the principal and thereafter bear like interest as the principal, but such unpaid interest so compounded shall not exceed an amount equal to simple interest on the unpaid principal at the maximum rate permitted by law. All amounts due under this Note are payable in lawful money of the United States, without notice, demand, offset or deduction. For purposes of interest accrual, checks will constitute payment on receipt, if paid in due course.**

Prepayments**. Maker reserves the right to prepay the outstanding principal amount of this Note in full or in part at any time during the term of this Note, without notice and without premium or penalty; provided, however, that any such prepayment of principal shall include all interest due on the principal so prepaid plus any unpaid late charges.**

Default**. It is hereby expressly agreed that should an event of default occur, then the indebtedness evidenced hereby, including all sums advanced or accrued hereunder, and all unpaid interest accrued thereon, shall, at the option of Holder and without notice to Maker, at once become due and payable and may be collected forthwith, whether or not there has been a prior demand for payment and regardless of the stipulated date of maturity. The remedies of Holder in this Note, or at law or in equity, shall be cumulative and concurrent, and may be pursued singly, successively or together in Holder's discretion.**

Collection Costs. **Maker promises to pay on demand all reasonable out-of-pocket costs of and expenses of Holder in connection with the collection of amounts due hereunder, including, without limitation, attorney fees incurred in connection therewith, whether or not any lawsuit is ever filed with respect thereto.**

Full Recourse**. The obligations of Maker hereunder are full recourse.**

No Waiver of Rights by Holder**. No failure to accelerate the debt evidenced hereby by reason of default hereunder, acceptance of a partial or past due payment, or indulgences granted from time to time shall be construed (a) as a novation of this Note or as a reinstatement of the indebtedness evidenced hereby or as a waiver of such right of acceleration or of the right of Holder thereafter to insist on strict compliance with the**

terms of this Note, or (b) to prevent the exercise of such right of acceleration or any other right granted hereunder or by any applicable laws; and Maker hereby expressly waives the benefit of any statute or rule of law or equity now provided, or which may hereafter be provided, which would produce a result contrary to or in conflict with the foregoing. No extension of the time for the payment of this Note or any installment due hereunder, made by agreement with any person now or hereafter liable for the payment of this Note shall operate to release, discharge, modify, change, or affect the original liability of Maker under this Note, either in whole or in part, unless Holder agrees otherwise in writing. This Note may not be changed orally, but only by an agreement in writing signed by the party against whom enforcement of any waiver, change, modification, or discharge is sought.

***Waivers by Maker*. Presentment for payment, demand, protest and notice of demand, protest and nonpayment, and all other notices are hereby waived by Maker. Maker hereby further waives and renounces, to the fullest extent permitted by law, all rights to the benefits of any statute of limitations and any moratorium, reinstatement, marshaling, forbearance, valuation, stay, extension, redemption, appraisement, exemption, and homestead now or hereafter provided by the Constitution and laws of the United States of America and of each state thereof, both as to itself and in and to all of its property, real and personal, against the enforcement and collection of the obligations evidenced by this Note.**

***Limit of Validity*. The provisions of this Note and of all agreements between Maker and Holder, whether now existing or hereafter arising and whether written or oral, are hereby expressly limited so that in no contingency or event whatsoever, whether by reason of demand or acceleration of the maturity of this Note or otherwise, shall the amount paid, or agreed to be paid ("Interest"), to Holder for the use, forbearance, or retention of the money loaned under this Note exceed the maximum amount permissible under applicable law. If, from any circumstance whatsoever, performance or fulfillment of any provision hereof or of any agreement between Maker and Holder shall, at the time performance or fulfillment of such provision shall be due, exceed the limit for Interest prescribed by law or otherwise transcend the limit of validity prescribed by applicable law, then ipso facto the obligation to be performed or fulfilled shall be reduced to such limit and if, from any circumstance whatsoever, Holder shall ever receive anything of value deemed Interest by applicable law in excess of the maximum lawful amount, an amount equal to any excessive Interest shall be applied to the reduction of the principal balance owing under this Note in the inverse order of its maturity (whether or not then due) or at the option of Holder be paid over to Maker, and not to the payment of Interest. All Interest (including any amounts or payments deemed to be Interest) paid or agreed to be paid to Holder shall, to the extent permitted by applicable law, be amortized, prorated, allocated, and spread throughout the full period until payment in full of the principal balance of this Note so that the Interest thereof for such full period will not exceed the maximum amount permitted by applicable law. This paragraph will control all agreements between Maker and Holder.**

***Unconditional Payment*. Maker is and shall be obligated to pay principal, interest, and any and all other amounts that become payable hereunder absolutely and unconditionally and without any defense, recoupment, abatement, postponement, diminution, or deduction and without any reduction for counterclaim or setoff.**

***Miscellaneous*. This Note shall be interpreted, construed, and enforced according to the laws of the State of California. The terms and provisions hereof shall be binding on and inure to the benefit of Maker, Payee, and Holder, and their respective heirs, executors, legal representatives, successors, successors-in-title, and assigns, whether by voluntary action of the parties or by operation of law. As used herein, the terms "Maker," "Payee," and "Holder" shall be deemed to include their respective heirs, executors, legal representatives, successors, successors-in-title, and assigns, whether by voluntary action of the parties or by operation of law. If Maker consists of more than one person or entity, each shall be jointly and severally liable to perform the obligations of Maker under this Note. All personal pronouns used herein, whether used in the masculine, feminine, or neuter gender, shall include all other genders; the singular shall include the plural and vice versa. Titles of paragraphs are for convenience only and in no way define, limit, amplify, or describe the scope or intent of any provisions hereof. Time is of the essence with respect to all provisions of this Note. This Note contains the entire agreement between the parties hereto relating to the subject matter hereof, and all prior agreements relative hereto that are not contained herein are terminated. Any provision of this Note that is illegal, invalid, or unenforceable, shall be ineffective to the extent of such illegality, invalidity, or unenforceability without rendering illegal, invalid, or unenforceable the remaining provisions of this Note.**

The undersigned authorized party has executed and delivered this Note as of the date first written above.

MAKER:

_ _[*Name of Settlor*]_ _
2009 Dynasty Trust
Dated _ _[*date of execution*]_ _

By: __[*Signature*]__
_ _[*Typed name*]_ _**, Trustee**

Comment: This form is designed to be used in connection with a sale of property interests to a GST-exempt dynasty trust. See §13A.15. The transaction is intended to produce no gain or loss but will produce a taxable gift to the extent of the bargain element of the sale. For a form of secured installment promissory note, see §13A.17. For a form of secured annually renewable promissory note, see §13A.18.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13A Dynasty Trusts/§13A.17 C. Form: Secured Installment Promissory Note

§13A.17 C. Form: Secured Installment Promissory Note

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13A.17-1 Secured installment promissory note

SECURED INSTALLMENT PROMISSORY NOTE

_ _[*Date of execution*]_ _

$_ _[*Amount of promissory note*]_ _

FOR VALUE RECEIVED, the undersigned, _ _[*name of settlor or trustee*]_ _**, as Trustee of the** _ _[*Name of Settlor*]_ _ **2009 Dynasty Trust, dated** _ _[*date of execution of dynasty trust*]_ _ **(hereinafter referred to as "Maker"), hereby promises to pay to the order of** _ _[*name of settlor or trustee*]_ _**, as Trustee of the** _ _[*name of settlor's separate property subtrust*]_ _ **Trust under the** _ _[*name of settlor's revocable trust*]_ _ **Revocable Trust instrument, dated** _ _[*date of execution of settlor's revocable trust*]_ _ **(Separate Property of** _ _[*name of settlor*]_ _**) (hereinafter referred to as "Payee"; Payee and any subsequent holder hereof being hereinafter referred to as "Holder") at** _ _[*name of city*]_ _**, California (or such other place as Holder may direct from time to time), in lawful money of the United States of America and in immediately available funds, the principal sum of $**_ _[*amount*]_ _**, together with interest from the date hereof on the unpaid principal balance at the rate of** _ _[*number*]_ _ **percent per annum payable** _ _[*as follows: Interest only shall be due and payable*]_ _ **in 20 equal annual installments** _ _[*of principal and interest*]_ _ **commencing on the first anniversary date of this Note and continuing on each subsequent anniversary date. All outstanding principal and accrued but unpaid interest shall be payable in full on the** _ _[*ordinal number, e.g., 20th*]_ _ **anniversary date of this Note.**

Payments. _ _[*Interest shall be computed on the basis of a year of 365 days for the actual number of days elapsed/Each annual installment shall be in the amount of $*_ _[*amount*]_ _]_ _**. Should any interest not be paid when due hereunder, it shall be added to the principal and thereafter bear like interest as the principal, but such unpaid interest so compounded shall not exceed an amount equal to simple interest on the unpaid principal at the maximum rate permitted by law. All amounts due under this Note are payable in lawful money of the United States, without notice, demand, offset or deduction. For purposes of interest accrual, checks will constitute payment upon receipt, if paid in due course.** _ _[*A loan amortization schedule is attached hereto and incorporated herein by this reference.*]_ _

***Prepayments*. Maker reserves the right to prepay the outstanding principal amount of this Note in full or in part at any time during the term of this Note, without notice and without premium or penalty; provided, however, that any such prepayment of principal shall include all interest due on the principal so prepaid plus any unpaid late charges.**

[*Security*. The indebtedness evidenced by this Note and the obligations created hereby are secured by that certain _ _[*Security Agreement (the "Security Agreement") between Maker, as Debtor, and Holder, as Secured Party/Deed of Trust (the "Deed of Trust") executed by Maker as Trustor, with Chicago Title Company as Trustee, and naming Payee as Beneficiary and encumbering certain property described therein*]_ _**, of even date herewith. Notwithstanding the foregoing, Maker acknowledges and agrees that Holder shall not be required to exhaust the collateral covered by the** _ _[*Security Agreement/Deed of Trust*]_ _ **prior to pursuing any other remedies that Holder may have under the** _ _[*Security Agreement/Deed of Trust*]_ _ **or otherwise at law or in equity.]**

***Default*. It is hereby expressly agreed that should an Event of Default (as defined below) occur, then the indebtedness evidenced hereby, including all sums advanced or accrued hereunder, and all unpaid interest accrued thereon, shall, at the option of Holder and without notice to Maker, at once become due and payable and may be collected forthwith, whether or not there has been a prior demand for payment and regardless of the stipulated date of maturity.** _ _[*In the event that any payment is not received by Holder on the date when due (subject to any applicable grace period), then in addition to any default interest payments due hereunder, Maker shall*

also pay to Holder a late charge in an amount equal to 5 percent of the amount of such overdue payment, or if such increased rate of interest may not be collected under applicable law, then at the maximum rate of interest, if any, which may be collected from Maker under applicable law. So long as an Event of Default has occurred, regardless of whether or not there has been an acceleration of the indebtedness evidenced hereby, and at all times after maturity of the indebtedness evidenced hereby (whether by acceleration or otherwise), interest shall accrue on the outstanding principal balance of this Note at a rate (the "Default Rate") per annum equal to 4 percent plus the interest rate which would be in effect hereunder absent such default or maturity, or if such increased rate of interest may not be collected under applicable law, then at the maximum rate of interest, if any, which may be collected from Maker under applicable law, and such default interest shall be immediately due and payable. Maker acknowledges that it would be extremely difficult or impracticable to determine Holder's actual damages resulting from any late payment or default, and such late charges and default interest are reasonable estimates of those damages and do not constitute a penalty.]_ _ **The remedies of Holder in this Note** _ _[*or in the* _ _[*Security Agreement/Deed of Trust*]_ _]_ _**, or at law or in equity, shall be cumulative and concurrent, and may be pursued singly, successively, or together in Holder's discretion.**

***Event of Default*. An Event of Default shall be deemed to have occurred if:**

(i) any indebtedness under this Note is not paid when and as the same shall become due and payable, whether at maturity, by acceleration, or otherwise, and any such amount shall remain unpaid for a period of 5 days after the due date thereof;

(ii) default shall occur in the observance or performance of any covenant, obligation or agreement of the Maker under this Note _ _[*or the* _ _[*Security Agreement/Deed of Trust*]_ _]_ _**;**

(iii) Maker shall (A) apply for or consent to the appointment of a receiver, trustee, custodian, or liquidator of itself or any part of its property, (B) become subject to the appointment of a receiver, trustee, custodian, or liquidator for itself or any part of its property if such appointment is not terminated or dismissed within 30 days, (C) make an assignment for the benefit of creditors, (D) be adjudicated as bankrupt or insolvent, (E) institute any proceedings under the United States Bankruptcy Code or any other federal or state bankruptcy, reorganization, receivership, insolvency, or other similar law affecting the rights of creditors generally, or file a petition or answer seeking reorganization or an arrangement with creditors to take advantage of any insolvency law, or file an answer admitting the material allegations of a bankruptcy, reorganization, or insolvency petition filed against it, or (F) become subject to any proceedings under the United States Bankruptcy Code or any other federal or state bankruptcy, reorganization, receivership, insolvency, or other similar law affecting the rights of creditors generally, or have an order for relief entered against it in any proceeding under the United States Bankruptcy Code.

***Collection Costs.* Maker promises to pay on demand all reasonable out-of-pocket costs of and expenses of Holder in connection with the collection of amounts due hereunder, including, without limitation, attorney fees incurred in connection therewith, whether or not any lawsuit is ever filed with respect thereto.**

***Full Recourse*. The obligations of Maker hereunder are full recourse.**

***No Waiver of Rights by Holder*. No failure to accelerate the debt evidenced hereby by reason of default hereunder, acceptance of a partial or past due payment, or indulgences granted from time to time shall be construed (a) as a novation of this Note or as a reinstatement of the indebtedness evidenced hereby or as a waiver of such right of acceleration or of the right of Holder thereafter to insist on strict compliance with the terms of this Note, or (b) to prevent the exercise of such right of acceleration or any other right granted hereunder or by any applicable laws; and Maker hereby expressly waives the benefit of any statute or rule of law or equity now provided, or which may hereafter be provided, which would produce a result contrary to or in conflict with the foregoing. No extension of the time for the payment of this Note or any installment due hereunder, made by agreement with any person now or hereafter liable for the payment of this Note shall operate to release, discharge, modify, change, or affect the original liability of Maker under this Note, either in whole or in part, unless Holder agrees otherwise in writing. This Note may not be changed orally, but only by an agreement in writing signed by the party against whom enforcement of any waiver, change, modification, or discharge is sought.**

***Waivers by Maker*. Presentment for payment, demand, protest, and notice of demand, protest, and nonpayment and all other notices are hereby waived by Maker. Maker hereby further waives and renounces, to the fullest extent permitted by law, all rights to the benefits of any statute of limitations and any moratorium,**

reinstatement, marshaling, forbearance, valuation, stay, extension, redemption, appraisement, exemption, and homestead now or hereafter provided by the Constitution and laws of the United States of America and of each state thereof, both as to itself and in and to all of its property, real and personal, against the enforcement and collection of the obligations evidenced by this Note.

***Limit of Validity*. The provisions of this Note and of all agreements between Maker and Holder, whether now existing or hereafter arising and whether written or oral, are hereby expressly limited so that in no contingency or event whatsoever, whether by reason of demand or acceleration of the maturity of this Note or otherwise, shall the amount paid, or agreed to be paid ("Interest"), to Holder for the use, forbearance, or retention of the money loaned under this Note exceed the maximum amount permissible under applicable law. If, from any circumstance whatsoever, performance or fulfillment of any provision hereof or of any agreement between Maker and Holder shall, at the time performance or fulfillment of such provision shall be due, exceed the limit for Interest prescribed by law or otherwise transcend the limit of validity prescribed by applicable law, then ipso facto the obligation to be performed or fulfilled shall be reduced to such limit and if, from any circumstance whatsoever, Holder shall ever receive anything of value deemed Interest by applicable law in excess of the maximum lawful amount, an amount equal to any excessive Interest shall be applied to the reduction of the principal balance owing under this Note in the inverse order of its maturity (whether or not then due) or at the option of Holder be paid over to Maker, and not to the payment of Interest. All Interest (including any amounts or payments deemed to be Interest) paid or agreed to be paid to Holder shall, to the extent permitted by applicable law, be amortized, prorated, allocated, and spread throughout the full period until payment in full of the principal balance of this Note so that the Interest thereof for such full period will not exceed the maximum amount permitted by applicable law. This paragraph will control all agreements between Maker and Holder.**

***Unconditional Payment*. Maker is and shall be obligated to pay principal, interest, and any and all other amounts which become payable hereunder absolutely and unconditionally and without any defense, recoupment, abatement, postponement, diminution, or deduction and without any reduction for counterclaim or setoff.**

[*Giving of Notices*. Unless otherwise required by applicable law, any notice that must be given to Maker or Holder under this Note shall be sent in the manner described in the _ _[*Security Agreement/Deed of Trust*]_ _.]

***Miscellaneous*. This Note shall be interpreted, construed, and enforced according to the laws of the State of California. The terms and provisions hereof shall be binding upon and inure to the benefit of Maker, Payee, and Holder and their respective heirs, executors, legal representatives, successors, successors-in-title and assigns, whether by voluntary action of the parties or by operation of law. As used herein, the terms "Maker," "Payee," and "Holder" shall be deemed to include their respective heirs, executors, legal representatives, successors, successors-in-title and assigns, whether by voluntary action of the parties or by operation of law. If Maker consists of more than one person or entity, each shall be jointly and severally liable to perform the obligations of Maker under this Note. All personal pronouns used herein, whether used in the masculine, feminine, or neuter gender, shall include all other genders; the singular shall include the plural and vice versa. Titles of paragraphs are for convenience only and in no way define, limit, amplify, or describe the scope or intent of any provisions hereof. Time is of the essence with respect to all provisions of this Note. This Note contains the entire agreement between the parties hereto relating to the subject matter hereof, and all prior agreements relative hereto which are not contained herein are terminated. Any provision of this Note that is illegal, invalid, or unenforceable shall be ineffective to the extent of such illegality, invalidity, or unenforceability without rendering illegal, invalid, or unenforceable the remaining provisions of this Note.**

The undersigned authorized party has executed and delivered this Note as of the date first written above.

MAKER:

_ _[*Name of Settlor*]_ _
2009 Dynasty Trust
Dated _ _[*date of execution*]_ _

By: __[*Signature*]__
_ _[*Typed name*]_ _**, Trustee**

Comment: This form is designed to be used in connection with a sale of property interests to a GST-exempt dynasty

trust. See §13A.15. The transaction is intended to produce no gain or loss but will produce a taxable gift to the extent of the bargain element of the sale. For a form of secured annually renewable promissory note, see §13A.18. For a form of unsecured promissory note, see §13A.16. For a form of security agreement for a sale of LLC units to a trust, see §13A.19. For a form of deed of trust with assignment of rents securing a sale of real property to the trust, see §13A.20.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13A Dynasty Trusts/§13A.18 D. Form: Secured Annually Renewable Demand Promissory Note

§13A.18 D. Form: Secured Annually Renewable Demand Promissory Note

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13A.18-1 Secured annually renewable demand promissory note

SECURED ANNUALLY RENEWABLE DEMAND PROMISSORY NOTE

_ _[*Date of execution*]_ _

$_ _[*Amount of promissory note*]_ _

FOR VALUE RECEIVED, the undersigned, _ _[*name of settlor or trustee*]_ _, as Trustee of the _ _[*Name of Settlor*]_ _ 2009 Dynasty Trust, dated _ _[*date of execution of dynasty trust*]_ _ (hereinafter referred to as "Maker"), hereby promises to pay to the order of _ _[*name of settlor or trustee*]_ _, as Trustee of the _ _[*name of settlor's separate property subtrust*]_ _ Trust under the _ _[*name of settlor's revocable trust*]_ _ Revocable Trust instrument, dated _ _[*date of execution of settlor's revocable trust*]_ _ (Separate Property of _ _[*name of settlor*]_ _) (hereinafter referred to as "Payee"; Payee and any subsequent holder hereof being hereinafter referred to as "Holder") at _ _[*name of city*]_ _, California (or such other place as Holder may direct from time to time), in lawful money of the United States of America and in immediately available funds, the principal sum of $_ _[*amount*]_ _, together with interest from the date hereof on the unpaid principal balance at a rate per annum equal to the short-term applicable federal rate (compounded annually) in effect under Internal Revenue Code §1274(d), from the date hereof to the date of payment.

The interest rate for the period beginning on the date hereof and ending on December 1, 2009, shall be _ _[*number*]_ _ percent, and such rate shall be recalculated thereafter as of January 1 of every subsequent year. Interest shall be payable on or before December 31 of every year, commencing with the year 2009, and any unpaid interest shall be accumulated and added to principal.

The entire unpaid principal balance, together with all current and accumulated interest, shall be due and payable on demand; and it may be prepaid, in full or in part, at any time without notice and without premium or penalty; provided, however, that any such demand or prepayment may only be made during December of any year. All payments on this Note shall be applied first to current interest, then to accumulated interest, and finally to the remaining principal.

Maker shall be personally liable for all payments on this Note. _ _[*All principal and interest at any time outstanding under this Note is secured by that certain _ _[Deed of Trust, dated as of the date hereof, executed by Maker, as Trustor, with _ _[name of trustee]_ _, as Trustee, and naming Payee as Beneficiary and encumbering certain property described therein (the "Mortgage")/Stock Pledge Agreement, dated as of the date hereof, executed by Maker, as Debtor, and naming Payee as Secured Party*]_ _.]_ _

The remedies of Holder, as provided herein _ _[*or in the _ _[Mortgage/Stock Pledge Agreement]_ _ or in any other instrument securing this Note*]_ _**, shall be cumulative and concurrent, and may be pursued singularly, successively or together, at the sole discretion of Holder, and may be exercised as often as the occasion therefor shall arise. No act of omission or commission of Holder, including specifically any failure to exercise any right, remedy, or recourse, shall be deemed to be a waiver or release of the same, such waiver or release to be effected only through a written document executed by Holder and then only to the extent specifically recited therein. A waiver or release with reference to any demand hereunder shall not be construed as continuing, as a bar to, or as a waiver or release of, any subsequent right, remedy or recourse as to a subsequent demand.**

No renewal or modification of this Note made by agreement by Holder with any person or entity now or hereafter liable for the payment of this Note shall affect the liability of the undersigned under this Note, even if

the undersigned is not a party to such agreement.

Maker hereby waives protest or notice of protest and nonpayment, bringing of suit and diligence in taking any action to collect any sums owing hereunder _ _[*, and agrees that its liability on this Note shall not be affected by any release of or change in the _ _[Mortgage/Stock Pledge Agreement*]_ _ *or any other security for the payment of this Note*]_ _.

Maker promises to pay all collection expenses, court costs, and reasonable attorney fees which may be incurred in connection with the collection or enforcement of this Note or any part thereof.

As used herein, the terms "Maker," "Payee," and "Holder" shall be deemed to include their respective heirs, executors, successors, successors-in-title, legal representatives, and assigns, whether by voluntary action of the parties or by operation of law.

Any provision of this Note that is illegal, invalid or unenforceable shall be ineffective to the extent of such illegality, invalidity, or unenforceability without rendering illegal, invalid, or unenforceable the remaining provisions of this Note.

This Note shall be governed by and construed in accordance with the laws of the State of California.

The undersigned authorized party has executed and delivered this Note as of the date first written above.

MAKER:

_ _[*Name of Settlor*]_ _
2009 Dynasty Trust
Dated _ _[*date of trust*]_ _

By: __[*Signature*]__
_ _[*Typed name*]_ _**, Trustee**

Comment: This form is designed to be used in connection with a sale of property interests to a GST-exempt dynasty trust. See §13A.14. The transaction is intended to produce no gain or loss but will produce a taxable gift to the extent of the bargain element of the sale. For a form of secured installment promissory note, see §13A.17. For a form of unsecured promissory note, see §13A.16. For a form of security agreement for a sale of LLC units to a trust, see §13A.19. For a form of deed of trust with assignment of rents securing a sale of real property to the trust, see §13A.20.

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Source: Estate Planning/Drafting California Irrevocable Trusts/13A Dynasty Trusts/§13A.19 E. Form: Security Agreement for Limited Liability Company Units

§13A.19 E. Form: Security Agreement for Limited Liability Company Units

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13A.19-1 Security agreement for limited liability company (LLC) units

SECURITY AGREEMENT

This Security Agreement ("Security Agreement") is entered into on _ _[*date*]_ _ by _ _[*name of trustee*]_ _ ("Debtor"), and _ _[*name of settlor*]_ _ ("Secured Party").

RECITALS

A. Contemporaneously herewith Debtor is purchasing from Secured Party _ _[*number*]_ _ units (the "LLC Units") of _ _[*name of LLC*]_ _, LLC, a _ _[*Delaware/California*]_ _ limited liability company (the "LLC").

B. As part of the purchase by Debtor of the LLC Units, Secured Party and Debtor have executed an Assignment of LLC Units, dated _ _[*date of assignment*]_ _.

C. In conjunction with the purchase by Debtor of the LLC Units from Secured Party, Debtor has delivered to Secured Party a Secured Installment Promissory Note, dated _ _[*date of execution*]_ _, in the face principal amount of $_ _[*amount*]_ _ (the "Note").

D. As a condition to accepting the Note, Secured Party has required that Debtor's obligations under the Note be secured by the LLC Units, upon the terms and conditions provided herein.

NOW THEREFORE, in consideration of the foregoing and the further promises contained herein, Debtor and Secured Party agree as follows:

AGREEMENT

1. *Grant of Security Interest*. As security for the repayment of the Note and the performance of Debtor's obligations under the Note, Debtor hereby grants to Secured Party a security interest in the following (collectively the "Collateral"):

All of Debtor's right, title, and interest in and to the LLC Units, including (i) all income, gain, loss, credits, and capital contributions thereof, (ii) all of Debtor's right, title, and interest in and to the assets of the LLC, (iii) all of Debtor's right to share in the profits of the LLC, and (iv) Debtor's right to receive distributions which the LLC derives from its operations, the sale, refinancing, or other disposition of its assets, or the liquidation of its assets; and

All proceeds, increases, substitutions, replacements, additions, products, and accessions from the property described in this Section 1. The term "proceeds" includes all distributions and whatever is receivable or received when Collateral or proceeds thereof is sold, collected, exchanged, or otherwise disposed of, whether such disposition is voluntary or involuntary, and includes, without limitation, all rights to payment, including return premiums, with respect to any insurance relating thereto.

2. *Obligations Secured*. This Security Agreement and the security interests granted hereby secure the following obligations (herein individually and collectively called the "Obligations"):

Payment of the Note, including accrued interest and default and late payment charges; and

Any and all expenditures made and expenses incurred by Secured Party in connection with the enforcement of all obligations under the Note and this Security Agreement (including reasonable attorney fees, legal

expenses, and costs) together with interest per annum at the maximum legal rate permitted by law from the date of any and all such advances and expenditures or incurring of other expenses by Secured Party; and

Payment and performance of all other obligations, indebtedness, and liabilities of Debtor to Secured Party now existing or hereafter arising under this Security Agreement or the Note or any other agreement between Debtor and Secured Party.

3. *Debtor's Representations and Covenants*. To induce Secured Party to enter into this Security Agreement, Debtor represents and covenants to Secured Party, its successors and assigns, as follows:

(a) *Payment of Indebtedness*. Debtor will pay the principal sum of the Note secured hereby, together with interest thereon and default and late payment charges, at the time and in the manner provided in the Note.

(b) *Authority*. Debtor has the power and authority to grant the security interest in the LLC Units as provided herein and to perform its obligations hereunder.

(c) *Ownership/No Assignment*. Debtor owns the LLC Units free of all other encumbrances (except as described herein) and shall not assign or further encumber any of the LLC Units during the term of this Security Agreement, except as expressly permitted herein, without Secured Party's prior written consent.

(d) *Financing Statement*. Debtor agrees and covenants that it shall execute and deliver to Secured Party for filing with the appropriate governmental agencies all such financing statements and other documents and instruments necessary to perfect Secured Party's security interests in the Collateral.

4. *Delivery of LLC Agreement*.

(a) Concurrent herewith, Debtor has delivered to Secured Party and Secured Party has received and reviewed a copy of the Operating Agreement of the LLC, dated _ _[*date of LLC agreement*]_ _ (the "LLC Agreement").

(b) Nothing in this Security Agreement shall be deemed to relieve Debtor from its obligations as a member, as such obligations are set forth in the LLC Agreement or as otherwise conferred by law.

(c) Debtor shall execute and deliver to the Manager a letter in the form attached hereto as the first part of Exhibit A, notifying the LLC of the security interest granted to Secured Party and requesting the written consent to the grant of said security interest by the Manager in the form attached as the second part of the Exhibit A.

(d) Debtor and Secured Party agree to comply with the terms of Section _ _[*number*]_ _ of the LLC Agreement, entitled Pledge or Other Encumbrance of Units, the terms of which are incorporated herein by this reference.

5. *Rights of Secured Party*.

Secured Party, on 10 days' written notice to Debtor if Debtor fails to perform any of its obligations hereunder, may, but need not, perform such acts to preserve its rights and the value of the Collateral. Debtor hereby irrevocably appoints Secured Party as its attorney-in-fact (which appointment is coupled with an interest and therefore irrevocable) to do any such act, and to exercise such rights and powers as Debtor might exercise with respect to the Collateral in connection therewith. No failure to so act by Secured Party will relieve Debtor of Debtor's duties under this Security Agreement or in any way impair or discharge the Obligations, and no such failure to act will result in any liability to Debtor or any third party on the part of Secured Party.

(a) Secured Party does not assume any of the obligations or liabilities of Debtor arising under any of the Collateral, the LLC Agreement, or any agreement in respect thereto.

(b) Secured Party will have the right to reimbursement on 10 days' written demand for reasonable costs and expenses, including reasonable attorney fees, incurred in connection with the custody, preservation, and use of the Collateral and the exercise of Secured Party's rights hereunder, all of which costs and expenses are included in the Obligations secured by the Collateral.

(c) Secured Party may do any other act which, in its discretion, it deems necessary or appropriate, in connection with the preservation of the Collateral and Secured Party's rights therein.

6. *Disposition and Handling of Collateral and Proceeds Thereof*. Except as otherwise provided in the Note or this Security Agreement, as long as there is no Event of Default (as defined in Section 7, below), Debtor may, until receipt of contrary instructions from Secured Party, use, take advantage of, and have all the benefits of, the Collateral (including, but not limited to, the right to vote (to the extent expressly required by law or the LLC Agreement) and to receive distributions and recognize income, gain, loss, and credits with respect to the LLC Units, but not including the right, without Secured Party's consent, to assign or encumber the LLC Units. Secured Party, in its sole discretion, may terminate and revoke the rights of Debtor described in this Section upon any Event of Default (as defined in Section 7, below). Any attempted assignment or encumbrance of the LLC Units not otherwise consented to by Secured Party in writing is void and of no force or effect. The provisions of this Section are also subject to the terms of Section _ _[*number*]_ _ of the LLC Agreement, as provided in Section 4(d), above.

7. *Events of Default*. The following each shall be individually called an "Event of Default" and collectively called "Events of Default" for the purposes of this Security Agreement:

(a) The failure of Debtor to pay or perform any of the Obligations within 30 days when first due;

(b) The filing of any petition by or against Debtor for bankruptcy protection under the United States Code, as amended from time to time, or the failure of Debtor generally to pay its debts as they come due, or any other relief is sought by or against Debtor under any Federal or State law relating to insolvency, reorganization, receivership, liquidation, or relief for debtors;

(c) The breach of any warranty or representation or the failure to comply with any covenant made to Secured Party whether pursuant to this Security Agreement or any other agreement;

(d) The appointment of a receiver, trustee, custodian, or liquidator for Debtor or any of its assets; the insolvency of Debtor; or a general assignment by Debtor for the benefit of its creditors;

(e) Any attachment, garnishment, execution, levy, or similar action against Debtor on any property of Debtor;

(f) The failure of Debtor to pay or perform any obligation to any person or entity under any law or governmental regulation or under any written instrument or agreement; or

(g) Any act or event which would become an Event of Default after the passage of time or the giving of any notice, or both.

8. *Secured Party's Rights on Default*. At any time after the occurrence of any Event of Default, in addition to exercising any other rights and remedies granted to it by the Note, any other agreements or instruments, or other applicable law, Secured Party may do any of the following:

(a) Exercise as to the Collateral all rights, powers, and remedies of Debtor as an owner of the Collateral, including the right to receive distributions;

(b) Operate, consume, sell, or dispose of all or any part of the Collateral as Secured Party deems appropriate for the purpose of paying or performing any or all of the Obligations;

(c) Declare immediately due and payable any or all of the Obligations owing to Secured Party;

(d) In the discretion of Secured Party sell, assign, and deliver at Debtor's places of business or any other place permitted by law in such manner as Secured Party in its discretion may determine, all or any part of the Collateral at public or private sales for cash or on credit to any third party purchaser(s) or to Secured Party, or at public auction, which Debtor agrees constitute commercially reasonable methods of disposing of the Collateral;

(e) Foreclose or otherwise enforce Secured Party's security interest in the Collateral in any manner permitted by law or provided for in this Security Agreement;

(f) Apply any Collateral or other security available for satisfaction of the Obligations to the payment of any expenses incurred or paid by Secured Party in connection with any use, sale, transfer, or delivery of such Collateral, to the payment of any other costs, charges, attorney fees of Secured Party's separate counsel, or expenses incurred by Secured Party in connection with transactions related to this Security Agreement, the Note, and to the payment of any Obligations in such order, priority, and manner as Secured Party in its sole discretion may determine;

(g) Endorse, receive, and collect by legal action or otherwise all distributions, interest, principal, or other sums now or hereafter payable upon, on account of, or in connection with any of the Collateral; and

(h) Exercise any and all other rights powers and remedies which Debtor would have, but for this Security Agreement, in connection with the Collateral.

9. *Cumulative Rights*. The rights, powers, and remedies of Secured Party under this Security Agreement shall be in addition to all rights, powers, and remedies given to Secured Party by virtue of any statute or rule of law or any other agreement, all of which rights, powers, and remedies shall be cumulative and may be exercised successively or concurrently without impairing Secured Party's security interest in the Collateral. The exercise of any right or remedy by Secured Party shall not constitute a cure or waiver of default hereunder, invalidate any act done pursuant of any notice of default, or prejudice Secured Party in its exercise of any of its other rights or remedies, unless in the exercise of said rights and remedies all of the Obligations are fully satisfied.

10. *Miscellaneous*.

(a) *Indemnity and Expenses*. Debtor shall indemnify and hold Secured Party harmless from any damages, cost, liability, and reasonable legal or other expense, including without limitation attorney fees of separate counsel selected by Secured Party, which Secured Party may directly or indirectly suffer or incur by reason of the failure of Debtor to perform any of its Obligations to Secured Party or any of its obligations to any third party, as a consequence of the execution of this Security Agreement, the Note or any other document, or as a consequence of Secured Party taking the security called for herein, whether resulting from any legal action or proceeding brought by any third party (or derivatively by any shareholder of Debtor) or investigations by any government body or agency. Debtor shall also pay all expenses, including reasonable attorney fees of separate counsel selected by Secured Party, incurred by Secured Party in the preservation, realization, enforcement, interpretation, and exercise of any of its rights, powers, and remedies concerning the Collateral and the Obligations. In addition, in the event of legal action maintained by Secured Party to enforce any provision of this Security Agreement or the Note, Secured Party shall recover its reasonable costs and expenses incurred therein, including court costs and attorney fees.

(b) *Waivers by Debtor*. Except as expressly provided herein or in any other written agreement between Debtor and Secured Party, Debtor hereby waives presentment, protest, notice of protest, notice of dishonor, and notice of nonpayment with respect to any proceeds of Collateral to which Secured Party is entitled hereunder, and any defense arising by reason of any disability or other defense of any other person or by reason of the cessation from any cause whatsoever of the liability of any other person to Secured Party or Debtor. Debtor also waives any right to direct the application of payments or security for its Obligations hereunder, except as expressly required by the Note. Debtor waives any right to require Secured Party to proceed against any person or to exhaust any Collateral or to pursue any remedy in Secured Party's power.

(c) *No Third Parties Benefited; Assignment*. This Security Agreement is made and entered into for the sole protection and benefit of the parties hereto, their successors, and assigns, and no other person or persons shall have any right of action hereon. This Security Agreement shall be binding on Debtor and its successors, assigns, and legal representatives and any transferees of any interest in any Collateral. Secured Party may transfer any or all of the Obligations and any or all of the Collateral to any person or entity, and such transferee shall be vested with all the rights and powers of Secured Party hereunder with respect to such transferred Collateral and Obligations. Such transfer shall in no way whatsoever impair or affect the rights, privileges, powers, or remedies of Secured Party with respect to Obligations and Collateral not transferred. The transfer of any Collateral shall fully discharge and release Secured Party from any and all liability and responsibility with respect to such Collateral.

(d) *Governing Law*. This Security Agreement shall be governed by and be construed according to the laws

of the State of California.

(e) *Entire Agreement; Modification*. This Security Agreement contains or incorporates the entire agreement of the parties hereto with respect to the subject matter hereof and may only be modified or amended by a written instrument executed by all of the parties hereto.

(f) *Enforceability*. If any provision of this Security Agreement shall for any reason be unenforceable in any respect, such unenforceability shall not affect any other provision hereof. Until all Obligations have been paid or performed in full, all rights, privileges, powers, and remedies of Secured Party hereunder shall continue to exist and may be exercised by Secured Party notwithstanding the fact that any or all of the Obligations may have become barred or unenforceable by any statute of limitations (which statutes Debtor hereby waives).

(g) *No Waiver by Secured Party*. No failure by Secured Party to exercise and no delay by Secured Party in exercising any right, power, or privilege hereunder shall operate as a waiver thereof, nor shall any single or partial exercise of any right, power, or privilege hereunder preclude any other or further exercise thereof or the exercise by Secured Party of any other right, power, or privilege. No express waiver shall affect any default (or Event of Default) other than the default specified in the waiver, and said waiver shall be operative only for the time and to the extent therein stated. Waivers of any covenant, term, or condition contained herein shall be in writing and shall not be construed as a waiver of any subsequent breach of the same covenant, term, or condition. In order to avoid any possible disputes which might arise because of any misinterpretation by Debtor of Secured Party's actions or omissions, Debtor shall not assume or conclude that any act or omission by Secured Party was intended to induce or permit Debtor to fail to perform any Obligations to Secured Party, unless Secured Party delivers a written waiver or release of such Obligations to Debtor.

(h) *Survival of Warranties*. All representations, warranties, covenants, and agreements of Debtor contained herein shall survive the execution of this Security Agreement and shall continue in full force and effect until the full and final payment of all the Obligations.

(i) *Taxes*. Debtor hereby agrees to pay prior to delinquency all taxes, charges, liens, and assessments against any or all of the Collateral (including any taxes payable with respect to the execution of this Security Agreement), whether now existing or hereafter arising, except such as may be contested in good faith by appropriate proceedings prior to final judgment or determination; provided that Debtor shall establish appropriate reserves with respect to such contested obligations and shall pay all such contested obligations when and to the extent that a final judgment or determination is made thereof; provided that Debtor shall not be obligated to pay any tax owing by a partnership in which Debtor is a general partner. Debtor shall indemnify and hold Secured Party harmless against all such liabilities.

(j) *Termination*. This Security Agreement shall be a continuing agreement and shall apply to all Obligations and all other indebtedness and obligations of Debtor to Secured Party now existing or hereafter arising, including any arising in connection with successive transactions, related or unrelated, and notwithstanding that from time to time all Obligations and any other indebtedness and obligations may have been paid in full.

(k) *Notices*. Any notice or other communication provided herein shall be in writing and shall be deemed given and effective (i) when delivered personally, by fax or by overnight courier service, or (ii) 3 days after the postmark date if mailed by certified registered mail, postage prepaid, return receipt requested, if to the Secured Party addressed to it at the address stated below its signature, and if to Debtor addressed to it at the address stated below its signature, or to such other address as such party may designate from time to time in a writing notice to the other parties in accordance with the provisions of this section.

(l) *Time*. Time is of the essence of each and every provision of this Security Agreement.

(m) *Course of Conduct*. The prior or subsequent course of conduct by Debtor and Secured Party shall not directly or indirectly limit, impair, or otherwise adversely affect any of Secured Party's rights and remedies in connection with this Security Agreement or the Note, or detract from or otherwise affect the literal interpretation and effect thereof, because the parties agree that such agreements shall be amended only by written instruments executed by the parties.

(n) *Counterparts*. This Security Agreement may be executed in two or more counterparts, each of which shall be deemed an original, and all of which together shall constitute one and the same instrument.

IN WITNESS WHEREOF, the undersigned Debtor and Secured Party have caused this Security Agreement to be duly executed and delivered as of the date first written above.

Date: _ _ _ _ _ _ **DEBTOR:**
__[*Signature*]__
_ _[*Typed name*]_ _
_ _[*Address*]_ _

Date: _ _ _ _ _ _ **SECURED PARTY:**
__[*Signature*]__
_ _[*Typed name*]_ _, **Trustee of** _ _[*Name of trust*]_ _, **dated** _ _[*date of trust*]_ _

EXHIBIT A

_ _[*Date*]_ _

_ _[*Name of manager*]_ _, **Manager**
_ _[*Name of LLC or limited partnership*]_ _, **LLC**
_ _[*Address of LLC*]_ _

Re: Notice of Security Interest in Units of _ _[*name of LLC*]_ _, **LLC.**

To the Manager of _ _[*name of LLC/limited partnership*]_ _, **LLC:**

This will notify you that the undersigned has granted to _ _[*name of trustee*]_ _, **as Trustee of the** _ _[*name of settlor*]_ _ **20**_ _ **Dynasty Trust, dated** _ _[*date of trust*]_ _ **("Secured Party"), a security interest in the** _ _[*number*]_ _ **units (the "LLC Units") of** _ _[*name of LLC*]_ _, **LLC, a** _ _[*Delaware/California*]_ _ **limited liability company (the "LLC"), purchased by the undersigned from Secured Party on, and evidenced by an Assignment of the LLC Units dated** _ _[*date of assignment*]_ _.

This security interest in the LLC Units arises under a security agreement executed by Secured Party and the undersigned, as Debtor, on _ _[*date of security agreement*]_ _. **You are further notified that, pursuant to the California Commercial Code, the undersigned is deemed to have possession of the described property from the time that you receive this notice, and you are therefore instructed to hold that property subject to the directions of the undersigned.**

Please provide your written consent to the grant of a security interest in the LLC Units and the Security Agreement by signing the attached consent, as contemplated by Section _ _[*number*]_ _ **of the LLC Agreement, dated** _ _[*date of LLC agreement*]_ _.

Very truly yours,

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name of settlor*]_ _

13A.19-2 Written consent of the Manager of the LLC

WRITTEN CONSENT
OF THE MANAGER OF _ _[*NAME OF LLC*]_ _, **LLC**

Date: _ _[*Date of consent*]_ _

The undersigned, being the Manager of _ _[*name of LLC*]_ _, **LLC, a** _ _[*Delaware/California*]_ _ **limited liability company (the "LLC"), hereby consents to the adoption of the following recitals and resolutions:**

CONSENT TO GRANT OF SECURITY INTEREST IN LLC UNITS

WHEREAS, the Members entered into that certain Operating Agreement (the "LLC Agreement");

WHEREAS, Section _ _[*number*]_ _ of the LLC Agreement provides that a Member shall not assign or encumber any of his, her, or its LLC units unless, among other things, the Manager consents in writing to such assignment;

WHEREAS, the Manager has been notified of (a) the desire of _ _[*name of settlor*]_ _ ("Debtor") to grant a security interest in Debtor's _ _[*number*]_ _ Units (the "LLC Units") of the LLC as security for the performance of Debtor's obligations under a secured installment promissory note, dated _ _[*date of execution*]_ _ (the "Note"), made payable by Debtor to _ _[*name of trustee*]_ _, as Trustee of the _ _[*Name of trust*]_ _, dated _ _[*date of trust*]_ _ ("Secured Party"), and (b) the Security Agreement between Debtor and Secured Party, dated _ _[*date of security agreement*]_ _ (the "Security Agreement"), which evidences the grant of said security interest;

BE IT THEREFORE RESOLVED, that the Manager consents to (a) Debtor's grant a security interest in the LLC Units as security for the performance of Debtor's obligation under the Note, and (b) the Security Agreement.

EXECUTED as of the date first appearing above.

__[*Signature*]__
_ _[*Typed name*]_ _, **Manager**

Comment: This form is designed to be used in connection with a sale of limited liability company (LLC) units to a GST-exempt dynasty trust (see §13A.15) by the settlor in exchange for a secured installment promissory note (see §13A.17) or a secured annually renewable demand promissory note (see §13A.18). For a form of unsecured promissory note, see §13A.16. For a form of deed of trust with assignment of rents securing a sale of real property to the trust, see §13A.20.

This form can be adapted for use with a limited partnership by making the following substitutions: "percent limited partnership interest" for "units" ("Limited Partnership Interest" for "LLC Units"); "L.P." for "LLC" and "California limited partnership" for "Delaware/California limited liability company" after the entity name ("Partnership" for "LLC"); "Limited Partnership Agreement of the Partnership" for "Operating Agreement of the LLC" ("Partnership Agreement" for "LLC Agreement"); "General Partner" for "Manager"; and "Partners for Members."

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Source: Estate Planning/Drafting California Irrevocable Trusts/13A Dynasty Trusts/§13A.20 F. Form: Deed of Trust with Assignment of Rents

§13A.20 F. Form: Deed of Trust with Assignment of Rents

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13A.20-1 Deed of trust and assignment of rents

DEED OF TRUST WITH ASSIGNMENT OF RENTS

This DEED OF TRUST is made on _ _[*month and day*]_ _, 20_ _, by _ _[*name(s)*]_ _, herein _ _[*collectively*]_ _ called TRUSTOR, whose address is _ _[*address of trustor*]_ _; in favor of CHICAGO TITLE COMPANY, a California Corporation, herein called TRUSTEE; for the benefit of _ _[*name of beneficiary*]_ _, herein called BENEFICIARY. TRUSTOR irrevocably grants, transfers and assigns to TRUSTEE, in Trust, with Power of Sale, that property in _ _[*the City of _ _[name of city]_ _]_ _, County of _ _[*name of county*]_ _, State of California, commonly known as _ _[*address of property*]_ _, and described as:

[*Insert formal description of property*]

together with the rents, issues and profits thereof, subject, however, to the right, power and authority hereinafter given to and conferred upon BENEFICIARY to collect and apply such rents, issues and profits.

For the Purpose of securing (1) Payment of the sum of $_ _[*amount*]_ _ with interest thereon according to the terms of a Secured Installment Promissory Note of even date herewith made by TRUSTOR, payable to order of BENEFICIARY, and extensions or renewals thereof; (2) the performance of each agreement of TRUSTOR incorporated by reference or contained herein or reciting it is so secured; (3) Payment of additional sums and interest thereon which may hereafter be loaned to TRUSTOR, or his, her, or its successors or assigns, when evidenced by a promissory note or notes reciting that they are secured by this Deed of Trust.

A. To protect the security of this Deed of Trust, and with respect to the property above described, TRUSTOR agrees to:

(1) keep said property in good condition and repair; not to remove or demolish any building thereon; to complete or restore promptly and in good and workmanlike manner any building which may be constructed, damaged or destroyed thereon and to pay when due all claims for labor performed and materials furnished therefor to comply with all laws affecting said property or requiring any alterations or improvements to be made thereon; not to commit or permit waste thereof; not to commit, suffer, or permit any act upon said property in violation of law; to cultivate, irrigate, fertilize, fumigate, prune, and do all other acts which from the character or use of said property may be reasonably necessary, the specific enumerations herein not excluding the general;

(2) provide maintain and deliver to BENEFICIARY fire insurance satisfactory to and with loss payable to BENEFICIARY; provided, however, that the amount collected under any fire or other insurance policy may be applied by BENEFICIARY upon any indebtedness secured hereby and in such order as BENEFICIARY may determine, or at the option of BENEFICIARY the entire amount so collected or any part thereof may be released to TRUSTOR; provided further that such application or release shall not cure or waive any default or notice of default hereunder or invalidate any act done pursuant to such notice;

(3) appear in and defend any action or proceeding purporting to affect the security hereof or the rights or powers of BENEFICIARY or TRUSTEE; and to pay all costs and expenses, including cost of evidence of title and attorney fees in a reasonable sum, in any action or proceeding in which BENEFICIARY or TRUSTEE may appear, and in any suit brought by BENEFICIARY to foreclose this Deed of Trust;

(4) pay (a) at least ten days before delinquency, all taxes and assessments affecting said property, including assessments on appurtenant water stock; (b) when due all encumbrances, charges, and liens, with interest, on said property or any part thereof, which appear to be prior or superior hereto; and (c) all costs, fees and expenses of this Deed of Trust; provided, however, that should TRUSTOR fail to make any payment or to do

any act herein provided, then BENEFICIARY or TRUSTEE, but without obligation so to do and without notice or demand upon TRUSTOR and without releasing TRUSTOR from any obligation hereof, may (d) make or do the same in such manner and to such extent as either may deem necessary to protect the security hereof, BENEFICIARY or TRUSTEE being authorized to enter upon said property for such purposes; (e) appear in and defend any action or proceeding purporting to affect the security hereof or the rights or powers of BENEFICIARY or TRUSTEE; (f) pay, purchase, contest, or compromise any encumbrance, charge or lien which in the judgment of either appears to be prior or superior hereto; and (g) exercise any such powers, pay necessary expenses, employ counsel, and pay his, her, or its reasonable fees; and

(5) pay immediately and without demand all sums so expended by BENEFICIARY or TRUSTEE, with interest from date of expenditure at the amount allowed by law in effect at the date hereof, and to pay any statement provided for by the law in effect at the date hereof regarding the obligation secured hereby, for any amount demanded by BENEFICIARY not to exceed the maximum allowed by law at the time when said statement is rendered.

B. TRUSTOR agrees that:

(1) Any award of damages in connection with any condemnation for public use or injury to said property or any part thereof is hereby assigned and shall be paid to BENEFICIARY, who may apply or release such moneys received by him, her, or it in the same manner and with the same effect as above provided for disposition of proceeds of fire or other insurance.

(2) By accepting payment of any sum secured hereby after its due date, BENEFICIARY does not waive his, her, or its right either to require prompt payment when due of all other sums so secured or to declare default for failure so to pay.

(3) At any time or from time to time, without liability therefor and without notice, upon written request of BENEFICIARY and presentation of this Deed of Trust and said note for endorsement, and without affecting the personal liability of any person for payment of the indebtedness secured hereby, TRUSTEE may (a) reconvey any part of said property; (b) consent to the making of any map or plat thereof; (c) join in granting any easement thereon; or (d) join in any extension agreement or any agreement subordinating the lien or charge hereof.

(4) Upon written request of BENEFICIARY stating that all sums secured hereby have been paid, and upon surrender of this Deed of Trust and said note to TRUSTEE for cancellation and retention or other disposition as TRUSTEE in its sole discretion may choose and upon payment of its fees, (a) TRUSTEE shall reconvey, without warranty, the property then held hereunder, (b) the recitals in such reconveyance of any matters or facts shall be conclusive proof of the truthfulness thereof, and (c) the grantee in such reconveyance may be described as "the person or persons legally entitled thereto."

(5) As additional security, TRUSTOR hereby gives to and confers upon BENEFICIARY the right, power, and authority, during the continuance of this trust, to collect the rents, issues, and profits of said property, reserving unto TRUSTOR the right, prior to any default by TRUSTOR in payment of any indebtedness secured hereby or in performance of any agreement hereunder, to retain such rents, issues, and profits as they become due and payable; upon any such default, BENEFICIARY may at any time without notice, either in person, by agent, or by a receiver to be appointed by a court, and without regard to the adequacy of any security for the indebtedness hereby secured, enter upon and take possession of said property or any part thereof, in his, her, or its own name, sue for or otherwise collect such rents, issues, and profits, including those past due and unpaid and apply the same, less cost and expenses of operation and collection, including reasonable attorney fees, upon any indebtedness secured hereby and in such order as BENEFICIARY may determine; and the entering upon and taking possession of said property, the collection of such rents, issues, and profits, and the application thereof shall not cure or waive any default or notice of default hereunder or invalidate any act done pursuant to such notice.

(6) Upon default by TRUSTOR in payment of any indebtedness secured hereby or in any agreement hereunder, BENEFICIARY may declare all sums secured hereby immediately due and payable by delivery to TRUSTEE of written declaration of default and demand for sale and of written notice of default and of election to cause to be sold said property, which notice TRUSTEE shall cause to be filed for recordation; and BENEFICIARY also shall deposit with TRUSTEE this Deed of Trust, said note and all documents evidencing expenditures secured hereby.

After the lapse of such time as may then be required by law following the recordation of said notice of default, and notice of sale having been given as then required by law, TRUSTEE, without demand on TRUSTOR, shall sell said property at the time and place fixed by it in said notice of sale, either as a whole or as separate parcels, and in such order as it may determine, at public auction to the highest bidder for cash in lawful money in the United States, payable at time of sale. TRUSTEE may postpone sale of all or any portion of said property by public announcement at such time and place of sale, and from time to time thereafter may postpone such sale by public announcement at the time fixed by the preceding postponement. TRUSTEE shall deliver to such purchaser its deed conveying the property so sold, but without any covenant or warranty, express or implied. The recitals in such deed in any matters or facts shall be conclusive proof of the truthfulness thereof. Any person, including TRUSTOR, TRUSTEE, or BENEFICIARY as hereinafter provided, may purchase the property at such sale.

After deducting the costs, fees, and expenses of TRUSTEE and of this trust, including the cost of evidence of title in connection with the sale, TRUSTEE shall apply the proceeds of the sale to payment of: all sums expended under the terms hereof, not then repaid, with accrued interest with the amount allowed by law in effect at the date hereof; all other sums then secured hereby; and the remainder, if any, to the person or persons legally entitled thereto.

(7) BENEFICIARY, or any successor in ownership of any indebtedness secured hereby, may from time to time, by instrument in writing, substitute a successor or successors to any person named herein or acting hereunder as TRUSTEE, which instrument, executed by BENEFICIARY and duly acknowledged and recorded in the office of the recorder of the county or counties where said property is situated, shall be conclusive proof or proper substitution of such successor Trustee or Trustees, who shall, without conveyance from the predecessor Trustee, succeed to all its title, estate, rights, powers, and duties. Said instrument must contain the name of the original TRUSTOR, TRUSTEE and BENEFICIARY, the book and page where this Deed of Trust is recorded and the name and address of the new TRUSTEE.

(8) This Deed of Trust applies to, inures to the benefit of, and binds all parties hereto, their heirs, legatees, devisees, administrators, executors, successors, and assigns. The term Beneficiary shall mean the owner and holder, including pledgees, of the notes secured hereby, whether or not named Beneficiary herein. In this Deed of Trust, whenever the context so requires, the masculine gender includes the feminine and/or the neuter, and the singular number includes plural.

(9) TRUSTEE accepts the trust when this Deed of Trust, duly executed and acknowledged, is made a public record as provided by law. TRUSTEE is not obligated to notify any party hereto of pending sale under any other deed of trust or of any action or proceeding in which TRUSTOR, BENEFICIARY, or TRUSTEE shall be a party unless brought by TRUSTEE.

BENEFICIARY may charge for a statement regarding the obligation secured hereby, provided the charge thereof does not exceed the maximum allowed by law. TRUSTOR requests that a copy of any notice of default and any notice of sale hereunder be mailed to him, her, or it at his, her, or its address hereinbefore set forth.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _, **TRUSTOR**

State of California)
)
County of _ _[*name of county*]_ _)
_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _, **personally appeared** _ _[*name(s)*]_ _, **who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

13A.20-2 Request for full reconveyance

REQUEST FOR FULL RECONVEYANCE

DO NOT RECORD

TO CHICAGO TITLE COMPANY

The undersigned is the legal owner and holder of the note or notes, and all other indebtedness secured by the foregoing Deed of Trust. Said note or notes, together with all other indebtedness secured by said Deed of Trust have been fully paid and satisfied; and you are hereby requested and directed, on payment to you of any sums owing to you under the terms of said Deed of Trust, to cancel said note or notes above mentioned, and all other evidence of indebtedness secured by said Deed of Trust delivered to you herewith, together with the said Deed of Trust, and to reconvey, without warranty, to the parties designated by the terms of said Deed of Trust, all the estate now held by you under the same.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Please mail Deed of Trust, Note and Reconveyance to _ _[*name and address*]_ _**.**

Do not lose or destroy the Deed of Trust OR THE NOTE which it secures. Both must be delivered to the Trustee for cancellation before reconveyance will be made.

Comment: This form is designed to be used in connection with a sale of real property to a GST-exempt dynasty trust (see §13A.15) by the settlor in exchange for a secured installment promissory note (see §13A.17) or a secured annually renewable demand promissory note (see §13A.18). For a form of unsecured promissory note, see §13A.16.

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14

Grantor Retained Income Trusts (GRITs)

Marc M. Stern

I. OVERVIEW OF GRANTOR RETAINED INCOME TRUSTS (GRITs)
- A. Objectives of GRIT §14.1
- B. Advantages of GRIT §14.2
- C. Valuation Benefits of GRIT §14.3
- D. Selecting GRIT Term §14.4
- E. Lack of Statutory Requirements §14.5
- F. Permissible Provisions
  - 1. Trust Assets §14.6
  - 2. Fractional Interests §14.7

II. TAX CONSIDERATIONS
- A. Income Tax Issues §14.8
- B. Spousal Interests §14.9
- C. Repurchase/Exchange Strategy for Obtaining New Basis §14.10
- D. California Real Property Tax Considerations §14.11
- E. Integration Into Settlor's Estate Plan §14.12

III. CALCULATING VALUE OF GRIT GIFT §14.13

IV. WHEN TO USE GRIT §14.14

V. DRAFTING CONSIDERATIONS §14.15

VI. GRANTOR RETAINED INCOME TRUST PROVISIONS
- A. Form: Declaration of Transfer to Trustee §14.16
- B. Form: Trust Name §14.17
- C. Form: Trust Estate §14.18
- D. Form: Irrevocability of Trust §14.19
- E. Form: Trust Term §14.20
- F. Form: Operation During Trust Term §14.21
- G. Form: Limitation on Trust Distributions §14.22
- H. Form: Distribution if Settlor Survives Trust Term §14.23
- I. Form: Distribution if Settlor Fails to Survive Trust Term §14.24
- J. Form: Distributions on Termination §14.25
- K. Form: Trustees §14.26
- L. Form: Trustee Powers §14.27
- M. Form: Applicable Law §14.28
- N. Form: Description of Transferred Property §14.29

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I. OVERVIEW OF GRANTOR RETAINED INCOME TRUSTS (GRITs)

§14.1 A. Objectives of GRIT

The grantor retained income trust (GRIT) is an irrevocable trust in which the grantor or settlor retains the right to all trust income for a specified term. The design and objectives are those of the traditional "common law GRIT" before Congress began to legislate restrictions in this area.

- At the end of the specified term, the trust terminates and the corpus is distributed to the remainder beneficiaries.
- Alternatively, the trust might continue to function for the benefit of other beneficiaries, but the settlor must cease to have any interest or power that would cause the trust property to be included in the settlor's estate.
- In addition, the trust instrument will typically provide that, if the settlor dies during the trust term, the trust will terminate immediately and the trust estate will be distributed as appointed in the settlor's will or, if not so appointed, to the settlor's revocable trust or estate. This provision gives the settlor greater control over the transferred property. Also, the reversionary interest reduces the value of the remainder interest that is transferred and no longer subject to the settlor's control.

The benefit of the GRIT arrangement results from the computation of the value of the gift that is made on transfer to the trust. Assuming that IRC §2702 does not apply (see §14.2), the value of the gift is the value of the property transferred to the trust less the following:

- The value of an income interest for the shorter of the trust term or the life of the settlor; and
- The value of a reversionary right in the entire trust corpus if the settlor dies before the expiration of the trust term.

For purposes of this calculation, the two retained interests are valued under IRC §7520, using the Internal Revenue Service's actuarial tables and an assumed interest rate (rounded to the nearest 0.2 percent) equal to 120 percent of the federal midterm rate, compounded annually, in effect under IRC §1274(d)(1) for the month in which the gift is made. This calculation is identical to the calculation of the gift component of a qualified personal residence trust (QPRT), which is another trust not subject to the special valuation rules of IRC §2702 (see chap 17).

The GRIT arrangement takes advantage of the fact that the IRS's actuarial tables may overstate the value of the retained interest and therefore understate the value of the remainder gift. The tables assume that a specified yield will be earned during a designated term but lack a "lookback" mechanism to adjust values according to actual economic performance. Thus, for example, a gift of high technology stock that pays no dividends will be valued under the tables *as if* the stock paid a dividend of, say, 3.4 percent (the rate in effect for May 2010). The value of the retained income interest will be overvalued when measured against actual events, and the gift of the remainder will correspondingly be undervalued, thereby reducing the gift tax cost of the transfer. Conversely, if the gifted assets generate income greater than the amount calculated under the tables, the result will be an undervaluation of the retained interest and an overvaluation of the remainder interest. For this reason, assets generating little or no income but substantial appreciation are most suitable for GRITs.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.2 B. Advantages of GRIT

§14.2 B. Advantages of GRIT

Although IRC §2702 generally eliminates the advantages of using GRITs to benefit "members of the family" of the grantor-settlor, GRITs are still an available technique when members of the family of the settlor are *not* the settlor's intended remainder beneficiaries. (The special valuation rules of §2702 do not apply if the income beneficiary is the settlor's spouse, even if the remainder beneficiaries are members of the family, because the spouse does not have a "retained" interest in the trust as defined in the regulations. Treas Reg §20.2702-2(a)(3).) The special valuation rules of §2702 provide that the value of any retained interest that is not a qualified interest is zero. IRC §2702(a)(2)(A). Generally, only an annuity interest or a unitrust interest is a qualified interest. IRC §2702(b). This prevents the settlor from creating a trust that pays the settlor an amount that is less as a percentage of trust assets than the IRC §7520 interest rate used to value the retained interest. The special valuation rules of §2702 do not apply when the trust remainder beneficiaries are not members of the family of the settlor. IRC §2702(a)(1). Under IRC §2702(e), "member of the family" of an individual is the same as in IRC §2704(c)(2):

- The individual's spouse;
- Any ancestor or lineal descendant of the individual and the spouse of any such person;
- Any ancestor or lineal descendant of the individual's spouse and the spouse of any such person; and
- Any brother or sister of the individual and the spouse of any such sibling.

Persons not considered a "member of the family" of a settlor whom the settlor might want to benefit include friends, siblings of a spouse, nieces and nephews, and live-in companions (both same sex and opposite sex). Although registered domestic partners (Fam C §297.5) have all the rights and obligations of spouses under California law, they are not considered spouses for federal estate and gift tax purposes (see 1 USC §7) and therefore the settlor's partner is not considered a member of the family of the settlor under the special valuation rules. However, the children of registered domestic partners born or adopted during the marriage or partnership are generally considered the children of both partners under Fam C §7540, and the children of unregistered partners may be considered the natural children of both partners under the Uniform Parentage Act (UPA) (Fam C §§7600-7730). See *Elisa B. v Superior Court* (2005) 37 C4th 108, 33 CR3d 46. Therefore, the special valuation rules may apply to any trusts benefiting a partner's children. When the intended remainder beneficiaries include both members of the family of the settlor and non-family members, separate trusts are recommended: trusts for the family members (including the children of domestic partners) satisfying the requirements of IRC §2702, and trusts for the non-family members (including domestic partners) not subject to IRC §2702.

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§14.3 C. Valuation Benefits of GRIT

If the settlor survives the term, the GRIT method of valuing the gift will typically result in a greater transfer of wealth to the remainder beneficiaries than would occur if the settlor simply made a transfer, without retained interests of property, that had the same value as the gift determined under these rules.

EXAMPLE 1: In May 2010, *X*, whose age is 60 on the nearest birthday, transferred property worth $800,000 to a GRIT with a 7-year term. The GRIT is not subject to the IRC §2702 valuation rules because no remainder beneficiary is a member of *X*'s family. The value of the gift, using the IRC §7520 interest rate of 3.4 percent for May 2010, is 71.847 percent of $800,000, or $574,776. (The value of the retained income interest is 20.019 percent, or $160,152, and the value of the reversionary interest is 8.134 percent, or $65,072.) If the GRIT property increases in value at a rate of 5 percent annually in excess of the GRIT income paid to *X*, the remainder beneficiaries will receive assets worth $1,125,680 at the end of the 7-year term. Assuming that the asset is then sold by the beneficiaries and capital gains tax on the appreciation is paid, they will still have a fund of more than $1 million.

EXAMPLE 2: Instead of creating a GRIT, the client makes an outright gift of $574,776 (the gift component of the GRIT). For the donees to have property worth $1 million at the end of 7 years, the donees would need an investment that generates a rather unlikely after-tax rate of return of 8 percent per annum. If the return rate is a more realistic 6 percent after tax, the donees would have a fund of $864,250 at the end of 7 years. Thus, the GRIT has shifted approximately $135,000 of additional wealth out of the settlor's estate and into the hands of the donees.

The examples illustrate the benefits of a GRIT when the GRIT property appreciates in value. The GRIT arrangement illustrated here also takes advantage of the "freezing" of value available when assets are transferred out of the settlor's estate so that post-gift appreciation is removed from the estate. The examples also illustrate the leverage advantage of making a gift to a GRIT over making an outright transfer of the actuarial value of the remainder interest. The beneficiaries are entitled to the appreciation of the remainder component of the gift. Therefore, the GRIT arrangement allows all post-gift appreciation to be removed from the settlor's estate. Also, the client will probably find that an $800,000 gift to a GRIT is less onerous than an immediate gift of $574,776.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.4 D. Selecting GRIT Term

§14.4 D. Selecting GRIT Term

A GRIT can be established for any term desired, but the settlor is often motivated to reduce the tax cost of the transfer by providing for a long trust term. The longer the settlor retains an income interest in the GRIT, the smaller the value of the remainder gift. If the settlor fails to survive the GRIT's term, however, the entire GRIT corpus will be included in the settlor's estate because of the reversion provision and because of the retained income interest. IRC §2036; Treas Reg §20.2036-1(c). Thus, selecting the GRIT's term is something of a gamble, and the drafter must assist the settlor in selecting a term that is both long enough to provide a favorable reduced tax cost and short enough that the settlor is likely to survive the term to realize the favorable tax treatment of the GRIT.

If too long a trust term is selected, so that the settlor has no realistic likelihood of surviving it, the inclusion of the GRIT corpus in the settlor's gross estate may result in more severe taxes than would occur if the settlor had made an outright gift rather than creating the GRIT. The outright gift would have eliminated the transfer tax on the increased value of the transferred property between the date of the gift and the date of death. Compared with doing nothing, however, the only cost is the transaction costs associated with creating the GRIT. Furthermore, the advantage of the GRIT diminishes as the length of the term increases, because each year added to the term of the retained interest reduces the gift by fewer dollars than the addition of the previous year. The following table illustrates this fact:

Value of Gift (Remainder Value) per $100,000 of Fair Market Value of Assets Transferred by 60-Year-Old Grantor on Creation of GRIT, Calculated Using IRC §7520 Interest Rate of 3.4 Percent

Retained term of settlor's interest	*Value of remainder interest after expiration of trust term*	*Incremental reduction in value for additional year*
0	$100,000	NA
1	95,703	$4,293
2	91,499	4,204
3	87,384	4,115
4	83,357	4,027
5	79,418	3,961
6	75,584	3,834
7	71,847	3,737
8	68,195	3,652
9	64,621	3,594
10	61,119	3,502

The following table indicates the likelihood that the *settlor* will fail to survive a chosen term. These figures are derived from statistics that do not take into account gender, current health status, health and diet habits, or accessibility to health care services. The survival prospects of any particular individual may differ substantially.

Probability of Surviving Specified Number of Years After Given Age

Additional years	*Percentage after age 55*	*Percentage after age 65*	*Percentage after age 75*
1	99	98	96

2	99	97	92
3	98	95	88
4	97	93	83
5	96	91	79
6	95	89	74
7	94	86	69
8	93	84	64
9	92	81	59
10	90	79	53

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.5 E. Lack of Statutory Requirements

§14.5 E. Lack of Statutory Requirements

The common law GRIT is not covered by IRC §2702. Currently, no statutory or regulatory requirements apply to its operation. The typical GRIT governing instrument contains relatively few custom terms except provisions for the specified trust term and for distributing the remainder after the period of the settlor's retained interest expires.

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F. Permissible Provisions

§14.6 1. Trust Assets

Any property can be used to fund a GRIT. Treasury Regulation §20.7520-3(b)(2)(ii) provides, however, that the normal valuation principles of IRC §7520 may not be used in valuing the present value of an income interest unless:

> the effect of the… governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time. This degree of beneficial enjoyment is provided only if it was the transferor's intent, as manifested by the provisions of the governing instrument *and the surrounding circumstances*, that the trust provide an income interest for the income beneficiary during the specified period of time that is consistent with the value of the trust corpus and with its preservation. In determining whether a trust arrangement evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for in the administration of the subject trust. [Emphasis added.]

Thus, the IRS may argue that normal valuation principles should not be applied when trust terms preclude the settlor from receiving income from the GRIT commensurate with the "degree of beneficial enjoyment" generally accorded income beneficiaries. Similarly, if the assets transferred to the GRIT produce income less than the income commensurate with the degree of beneficial enjoyment generally accorded income beneficiaries, and those assets are not converted into assets generating the requisite amount of income, the IRS may challenge the entire structure or determine that the settlor's failure to require that the assets be so converted constitutes an additional gift. See *Eric F. Saltzman,* TC Memo 1994-641, rev'd on other grounds (2d Cir 1997) 131 F3d 87 (rejecting IRS argument that standard actuarial tables should not be used if GRIT property is unproductive).

For estate and gift tax purposes, the right to use property rent free is generally equated with an income interest. See, *e.g.,* IRC §2036(a)(1). Thus, a *settlor* could transfer a personal residence to a GRIT having non-family member remainder beneficiaries and retain the right to use the residence for a term certain without having to satisfy the onerous requirements of a personal residence trust or QPRT under Treas Reg §25.2702-5. See chap 17 on QPRTs.

The settlor could also transfer other assets to a GRIT, including real property other than the settlor's residence and stocks and bonds providing a relatively low income payout. For a discussion of the transfer of assets with high income yields, see §14.1.

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§14.7 2. Fractional Interests

The value of a gift attributable to a transfer to a GRIT is a fraction of the value of the contributed property. In addition, various lack-of-control and lack-of-marketability discounts may be applied in determining the value of the underlying transferred property if assets like undivided interests in real estate, shares of closely held stock, or limited partnership interests are transferred to the GRIT. See discussion in §2.23E. Such compounding allows the transfer tax value of a discounted asset to be further reduced to account for the settlor's retained interest.

Furthermore, fractional interests in an asset entirely owned by the settlor can be transferred to multiple GRITs (or other retained interest trusts) with different remainder beneficiaries, different dispositive terms, or different trust terms. This fractionalizing of an asset will probably generate an additional level of discounts from 15 percent to 45 percent, depending on the nature of the transferred asset. Additionally, the establishment of multiple GRITs allows the settlor to hedge the bet that he or she will survive the trust term; the settlor is not limited to establishing one GRIT on an "all or nothing" basis and then hope to survive that single GRIT's term.

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II. TAX CONSIDERATIONS

§14.8 A. Income Tax Issues

The settlor of a GRIT is entitled to receive the income from the trust during its term. When the term expires, the trust corpus will pass to non-family member beneficiaries. For income tax purposes, the GRIT will be considered a grantor trust as to ordinary income because the settlor is entitled to receive all the trust's income. IRC §677(a).

Although the settlor has no personal interest in the GRIT principal, the settlor will have a reversionary interest in the trust principal if he or she dies during the trust term. If the reversionary interest exceeds 5 percent, as it frequently will (in the example in §14.3, 60-year-old *X*'s reversionary interest in the 7-year GRIT was 8.134 percent), the GRIT will also be a grantor trust as to "principal income" or capital gains. IRC §673(a). Furthermore, if the reversionary interest exceeds 5 percent, the exception in IRC §674(b)(3) (power exercisable only by will) will not apply because the GRIT's principal income is accumulated for disposition by the settlor on his or her death before the trust term expires.

Although the settlor can use the income received from the GRIT to pay the income taxes attributable to the trust's ordinary income, the settlor will lack the funds to pay the income taxes attributable to the trust's capital gains. From an overall tax perspective, this produces a positive economic result because the settlor's estate is reduced by, in effect, paying the remainder beneficiaries' taxes. For a particular settlor, however, this result may be outweighed by the difficulties associated with paying large capital gains taxes without a source of funds to make the payments.

To alleviate the foregoing problem, the GRIT can provide for additional distributions to reimburse the settlor for any taxes paid on gains not received by the settlor. Because the regulations allow a grantor retained annuity trust (GRAT) to pay additional income in excess of the annuity amount to the settlor (Treas Reg §25.2702-3(b)(1)(iii)), this provision should not adversely affect the tax treatment of a common law GRIT. See §15.28.

A reimbursement clause or any other provision authorizing additional distributions from the GRIT to the settlor should not provide a settlor-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 settlor must realize, however, that retaining the right to receive additional distributions, unless required, will not reduce the GRIT remainder value for gift tax purposes.

It may be advisable to have the GRIT considered a grantor trust so that it is an eligible shareholder of an S corporation, a corporation as to which the shareholders have made an election under IRC §1362. Permissible shareholders of S corporation stock are limited to individuals, estates, grantor trusts, qualified subchapter S trusts (QSSTs), and electing small business trusts (ESBTs). IRC §§1361(b), (c)(2)(A)(v), (e). A QSST is a nongrantor trust that has a single individual as its current beneficiary and that either (1) requires all its income to be distributed to that individual or (2) actually distributes all its income to that individual. IRC §1361(d)(3). Although a GRIT appears to satisfy the definition of an ESBT, it may be simpler (at least in the near future until the implications of being an ESBT are fully understood) to make the GRIT a grantor trust so that its qualification to hold S corporation stock is certain. If the GRIT is not a grantor trust, the GRIT cannot satisfy the requirements of a QSST because the settlor's interest may terminate during the settlor's lifetime. See discussion of QSSTs and ESBTs in §§3.57-3.67.

If the settlor's reversionary interest in the GRIT does not exceed 5 percent, the GRIT will not be a grantor trust as to "principal income," and the trust's capital gains will be taxed to the trust. IRC §§673(a), 671. The major benefits of having the principal portion of a GRIT considered a grantor trust are to qualify the trust to hold S corporation stock and to allow the settlor to pay the taxes on any capital gains generated by the trust. If for any reason the settlor wants to have the trust treated as a grantor trust, this is best accomplished by allowing the settlor to reacquire GRIT assets by exchanging other assets of equivalent value. IRC §675(4)(C).

An unrelated tax issue is the loss of a stepped-up basis for the trust assets on the settlor's death if the settlor survives the trust term. IRC §1014. In this situation, the income tax basis of the trust assets will equal their basis in the settlor's hands immediately before the contribution, increased with respect to any gift tax payable attributable to the transfer, but in no case more than the fair market value of the transferred property. IRC §§1015(a), (d). This can be a

serious problem when assets transferred to the GRIT have a very low basis. See discussion in §14.10.

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§14.9 B. Spousal Interests

Because of the gift tax marital deduction requirements, it is generally not advisable to make a spouse a concurrent income beneficiary of a GRIT. Such a transfer will qualify for the marital deduction only if the requirements of a qualified terminable interest trust, as defined in IRC §2523(f)(2), are satisfied. One requirement is that the spouse have "a qualifying income interest for life." IRC §2523(f)(2)(B). The GRIT term has been selected, however, so that it is likely to terminate before the settlor's death. Thus, it is possible that the trust will also terminate before the spouse's death. Therefore, there is no guarantee that the spouse will receive a qualifying income interest for life, notwithstanding the spouse's age and the length of the trust term. Furthermore, a spouse cannot be a remainder beneficiary of the GRIT because, as a member of the settlor's family, such an interest would cause the special valuation rules of IRC §2702 to apply. The spouse can, however, be given an interest in the GRIT revocable by the settlor.

When a husband and wife hold joint or community property, the foregoing problem and attendant adverse tax consequences can be avoided by dividing the co-owned property so that each spouse holds half as separate property. Each spouse can then establish a separate GRIT to which his or her separate property is transferred. As discussed in §14.7, this approach may have the incidental effect of lowering the value of the transferred property because each spouse's gift involves only a fractional share of an asset, rather than the transfer of a 100-percent interest in the asset. These fractional shares of an asset are each likely to be valued at less than the prorata value of the undivided interest actually contributed to the GRITs. See *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248 (allowing a 15-percent discount on deceased spouse's one-half community property interest in certain property).

The primary drawback of dividing community property equally between spouses as their separate property is that the step-up in basis for both halves of the property will not be available if one spouse dies during the term of his or her GRIT. IRC §1014(b)(6). The establishment of a GRIT (even an ill-advised joint-spouse GRIT) precludes characterization of the trust property as community property because property held in trust can retain its character as community property *only* if the trust is revocable. Fam C §761(a).

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§14.10 C. Repurchase/Exchange Strategy for Obtaining New Basis

A potential deterrent to the use of a GRIT is the possibility that neither the settlor's estate nor the GRIT remainder beneficiaries will receive a new income tax basis for the trust assets on the settlor's death. IRC §1014. This problem may seriously affect a settlor who holds highly appreciated assets that are to be transferred to the GRIT.

To alleviate this problem, experienced practitioners often recommend that the settlor repurchase the GRIT assets shortly before its term expires. The IRS has identified this strategy with respect to the repurchase of a home from a personal residence trust (PRT) or qualified personal residence trust (QPRT) as an area of abuse because it believes that residences were allowed special treatment under IRC §2702 and the repurchase subverts congressional intent. Accordingly, the IRS has issued regulations that prohibit the settlor or the settlor's spouse from reacquiring a personal residence held by a PRT or QPRT during the term of the retained interest. Treas Reg §25.2702-5(b)(1), (c)(9).

Except in the case of residence trusts that depend on the IRC §2702(a)(3)(A)(ii) residence exception, repurchase strategies apparently remain viable for GRITs.

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§14.11 D. California Real Property Tax Considerations

The transfer of real property to a GRIT is a transfer for the benefit of the settlor that is not a change of ownership under Rev & T C §62(d), and, therefore, the transferred property will not be reassessed. The expiration of the GRIT term may trigger a reassessment unless the registered domestic partner transfer exclusion (Rev & T C §62(p)), or the parent-child (Rev & T C §63.1(a)(1)-(2)) or, in some cases, grandparent-grandchild (Rev & T C §63.1(a)(3)) transfer exclusion applies. Note that, while both parents generally must be deceased for the grandparent-grandchild exclusion to apply, a son-in-law or daughter-in-law who is a stepparent to the grandchild need not be deceased on the transfer date. Rev & T C §63.1(a)(3), (c)(3). Note also that the exclusion is limited to the full value of a residence plus $1 million in assessed value of other real property. In *Auerbach v Assessment Appeals Bd.* (2006) 39 C4th 153, 45 CR3d 774, the court held that the distribution of a 50-percent interest in commercial property from a trust to grandchildren of the settlor on the death of the settlor's son represented a change in ownership with respect to the full value of the property, including a new building constructed by the tenant at a cost of $20 million. The court held that the building was the property of the landlord because the term of the lease was less than 35 years. See Rev & T C §61(c). Accordingly, only 8 percent of both the building and the land (with a total value of $1 million) were excluded from reassessment by the grandparent-grandchild exclusion. This exclusion must be claimed within 3 years of the transfer to the children or before the children transfer the residence to a third person other than a parent or child, whichever occurs first. Rev & T C §63.1(e)(1)(B). The State Board of Equalization (SBE) takes the position that the transfer to the children occurs at the expiration of the settlor's retained interest rather than on the creation of the trust. However, the SBE guidelines are *not* binding on local assessors. In any event, a claim of exclusion may be filed within 6 months after a notice of supplemental or escape assessment was issued as a result of the transfer. Rev & T C §63.1(e)(1)(C).

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§14.12 E. Integration Into Settlor's Estate Plan

Use of a GRIT can create problems in carrying out the settlor's overall dispositive desires. If the settlor survives the GRIT term, the trust property will not be included in the settlor's gross estate and no estate tax will be apportioned to its assets. The transfer to the GRIT will give rise, however, to a taxable gift by the donor, which is considered in determining the estate taxes payable at the settlor's death. Because the gift arising from the transfer to the GRIT may consume a significant portion of the settlor's unified credit, it may be difficult to achieve other objectives of the settlor, such as equality among nieces and nephews and the issue of deceased nieces and nephews.

EXAMPLE: *Y* has an estate of $10 million. *Y* establishes a GRIT with property valued at $4 million and having a remainder value of $2 million. The GRIT provides that, on the expiration of *Y's* income interest, trust property will be distributed outright to those of *Y's* two nieces and two nephews who are living. A compensating gift is made in *Y's* revocable trust to the issue of any niece or nephew who predeceases the expiration of the GRIT term. Assume that *Y* and both nieces survive the expiration of the GRIT term, but both nephews predecease expiration of the GRIT term and that none of the assets appreciate in value.

Based on the foregoing facts, at the time of *Y's* death, each niece will have received $2 million from the GRIT at the expiration of its term. No transfer taxes were paid on assets that *Y* transferred to the GRIT because of the unified credit. *Y's* estate planning documents provide for compensating gifts of $2 million to the issue of each nephew. The estate tax on *Y's* remaining $6 million estate is approximately $3 million, however, so that less than $1.5 million is available for distribution to each nephew's issue.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.13 III. CALCULATING VALUE OF GRIT GIFT

§14.13 III. CALCULATING VALUE OF GRIT GIFT

The value of the gift that is made when a GRIT is created can be calculated by using the tables in IRS Publication 1457 or by using commercial estate planning computer software that incorporates the IRS tables. The practical necessity of using a computer program is illustrated by the IRS's sample calculations described in IRS Publication 1457. The following is the calculation for the value of a remainder interest for property worth $800,000 transferred to a trust in which a 60-year-old settlor retains an income interest for 7 years. The remainder interest factor also may be calculated by using the "quick and dirty" calculation in §17.24.

- The first step is to determine the applicable interest rate. Under IRC §7520, the applicable interest rate is the rate (rounded to the nearest 0.2 percent) equal to 120 percent of the federal midterm rate, compounded annually, in effect under IRC §1274(d) for the month in which the transfer to the GRIT occurs. In the example below, the interest rate used for this calculation is 3.4 percent.
- The second step is to calculate the right to receive the income for 7 years or for the settlor's life, whichever is less. The factors are for the settlor's age at inception and at the expiration of the trust term. Start with the N factor at age 60 from Table H (3.4) and subtract the N factor at age 67 from Table H (3.4). Divide the result by the D factor at age 60 from Table H (3.4). This equals the required annuity factor (5.888).

Required Annuity Factor:	5.888
Multiply by: Interest rate	.034
Equals (required income factor)**:**	.20019

- The third step is to calculate the value of the reversionary right to direct the distribution of the GRIT assets in the event the settlor dies before the end of the 7-year trust term. Start with the M factor at age 60 from Table H (3.4) and subtract the M factor at age 67 from Table H (3.4). Divide the remainder by the D factor at age 60 from Table H (3.4). The result of this calculation equals the reversion factor (0.08134).
- The fourth step is to calculate the remainder interest factor by subtracting the required income factor and the reversion factor from 1.00000.

Start with:	1.00000
Subtract: Required income factor	.20019
Equals:	.79981
Subtract: Reversion factor	.08134
Equals (remainder interest factor)**:**	.71847

- The fifth step is to determine the gift tax value of the remainder interest by multiplying the value of the property transferred to the GRIT by the remainder interest factor.

Start with: Value of property	$800,000
Multiply by: Remainder interest factor	.71847
Equals (remainder interest)**:**	$574,776

For further discussion of how to value the gift of income and remainder interests, see chap 6.

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§14.14 IV. WHEN TO USE GRIT

A GRIT can be an effective estate planning tool. The attorney should discuss the following issues with the client to determine if a GRIT is right for that client:

- Are none of the intended remainder beneficiaries "members of the family" of the settlor so that a GRIT is a viable option?
- Is the client willing to lose the step-up in basis and the ownership of assets? Ownership and basis may be minor concerns in some situations, *e.g.,* when an asset has a high basis after a spouse's death and the surviving spouse has no concern (although there is no prearrangement) that the remainder beneficiaries will make the assets available to him or her after the GRIT term expires.
- What is the opportunity cost, not just on paper but in terms of probable behavior? Will a GRIT discourage the client from making annual exclusion gifts? Will funding the GRIT with particular assets preclude the settlor's transfer of other assets that should be transferred, such as interests in a family business? Or will no opportunity be sacrificed, because the client would otherwise do nothing?
- Is the client likely to survive the term?
- Is the property transferred to the GRIT reasonably certain to appreciate?

The array of possible answers to these questions illustrates why GRITs are not for everyone. Although practitioners should not recommend GRITs in all situations, they may an appropriate part of some clients' estate plan.

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§14.15 V. DRAFTING CONSIDERATIONS

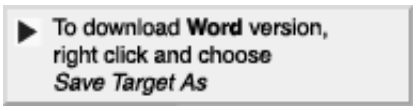
Although the dispositive provisions of a GRIT are not governed by the Internal Revenue Code or the Regulations under the Code, the typical GRIT instrument follows established guidelines. It contains few custom provisions other than those pertaining to names, dates, trust term, property description, and the disposition at the end of the trust term. If the disposition at the end of the term involves a trust, the terms of the continued trust may be incorporated into the GRIT instrument, but many practitioners prefer to use a separate trust instrument. A separate trust instrument emphasizes the fact that the "continued" trust is really a very different trust in its dispositive scheme and tax consequences.

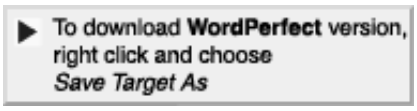
Regardless of whether a continuing trust or a second trust is used, it is important that the distributive provisions not include any provisions that might cause the original transfer to the GRIT to be an incomplete gift under Treas Reg §25.2511-2(b). In particular, to avoid any claim by the IRS that the GRIT corpus should be included in the settlor's estate under IRC §2036 after the trust term has expired, the settlor should generally not have retained interests in or powers over the GRIT other than the retained income interest. Specifically, the settlor should not be given any discretionary powers with respect to the GRIT corpus after the trust term expires.

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VI. GRANTOR RETAINED INCOME TRUST PROVISIONS

§14.16 A. Form: Declaration of Transfer to Trustee





14.16-1 Declaration of transfer to trustee

I, _ _[*name of settlor*]_ _ (called the "settlor"), hereby transfer and deliver to _ _[*name of trustee*]_ _, as trustee, the property described in Schedule A, attached to this instrument.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.17 B. Form: Trust Name

§14.17 B. Form: Trust Name

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14.17-1 Trust name

ARTICLE ONE
Trust Name

The trust created by this instrument may be referred to as the _ _[*name(s) of settlor, e.g., John J. Smith*]**_ _ Grantor Retained Income Trust.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.18 C. Form: Trust Estate

§14.18 C. Form: Trust Estate

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14.18-1 Trust estate

ARTICLE TWO
Trust Estate

All property subject to this instrument from time to time, including the property listed in Schedule A, is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.

Comment: The trust instrument need not prohibit additional contributions to the GRIT. The tax attributable to the additional contributions, however, will be determined according to the period remaining in the trust term when the additional contributions are made.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.19 D. Form: Irrevocability of Trust

§14.19 D. Form: Irrevocability of Trust

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14.19-1 Irrevocability of trust

ARTICLE THREE
Irrevocability of Trust

This trust is irrevocable and may not be altered or amended.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.20 E. Form: Trust Term

§14.20 E. Form: Trust Term

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14.20-1 Trust term

ARTICLE FOUR
Trust Term

This trust is effective immediately and terminates on the death of the settlor or the expiration of a period of _ _[*number*]_ _ years from the date of this trust, whichever occurs first. The period before termination is hereafter referred to as the trust term.

Comment: For a discussion of considerations involved in selecting the term, see §14.4.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.21 F. Form: Operation During Trust Term

§14.21 F. Form: Operation During Trust Term

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14.21-1 Operation during trust term

ARTICLE FIVE
Operation During Trust Term

A. During the trust term, the trustee shall distribute to the settlor the net income of the trust estate not less frequently than annually.

[*If appropriate, add the following option*]

[*Option: Distribution of amount equal to taxes on trust income*]

If the settlor is taxed on trust income not distributed to the settlor, an amount from such income equal to the settlor's taxes on that income shall be distributed to the settlor not less frequently than annually.

Comment: For a discussion of distributions to a settlor as reimbursement for payment of capital gains taxes, see §14.7.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.22 G. Form: Limitation on Trust Distributions

§14.22 G. Form: Limitation on Trust Distributions

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14.22-1 Limitation on trust distributions

B. The trustee shall make no distribution to any person other than the settlor during the trust term. provided, however, that this provision does not limit the trustee's ability to make distributions for trust expenses.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.23 H. Form: Distribution if Settlor Survives Trust Term

§14.23 H. Form: Distribution if Settlor Survives Trust Term

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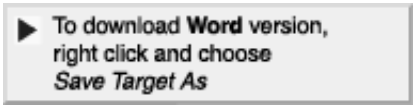
14.23-1 Distribution if settlor survives trust term

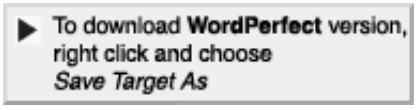
B. If the settlor survives the expiration of the trust term, the trustee shall pay the settlor all remaining income due the settlor as set forth herein. Any amounts remaining after such payment shall be distributed in accordance with Article Six.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.24 I. Form: Distribution if Settlor Fails to Survive Trust Term

§14.24 I. Form: Distribution if Settlor Fails to Survive Trust Term





14.24-1 Distribution if settlor fails to survive trust term

C. If the settlor fails to survive the trust term, the trustee shall distribute the accrued and undistributed income and the principal of the trust estate in any manner that the settlor directs in the settlor's Will, including in favor of the settlor's creditors or estate. Any portion of the trust estate not effectively directed by the settlor in the settlor's Will shall be distributed to _ _[*the estate of the settlor/the trustee of that revocable trust known as* _ _[*identify*]_ _]_ _.

Comment: For further discussion, see §14.1.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.25 J. Form: Distributions on Termination

§14.25 J. Form: Distributions on Termination

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14.25-1 Distributions on termination

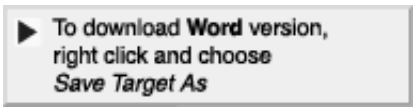
ARTICLE SIX
Distributions on Trust Termination

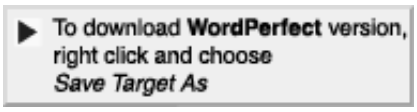
On expiration of the trust term, this trust shall terminate and be distributed as follows: _ _[*Specify distribution to non-family members.*]_ _

Comment: If the settlor survives the term, see §14.15 for further discussion. See discussion in §4.29 regarding the inadvisability of using the GRIT remainder for traditional generation-skipping transfer tax planning if the settlor survives the trust term. The drafter should also remember that the perpetuities period begins when the GRIT is established and not at the expiration of the trust term.

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§14.26 K. Form: Trustees





14.26-1 Trustees

ARTICLE SEVEN
Trustees

A. If at any time the _ _[*person/institution*]_ _ named as trustee fails to qualify or ceases to act as trustee, the _ _[*persons/institutions*]_ _ listed below shall serve as successor trustees in the order named:

First: _ _[*Name of successor trustee*]_ _

Second: _ _[*Name of second successor trustee*]_ _

_ _[*If the nominated successor also fails to qualify or ceases to act, _ _[name*]_ _ *shall have the power to name a successor trustee.*]_ _

B. The trustee shall be entitled to reasonable compensation from time to time for services rendered to the trust.

Comment: If a power to name a successor trustee is given to the settlor, the power should expire at the end of the term of the retained interest unless the drafter is certain that the trustee does not hold any powers after the term that would cause inclusion in the settlor's estate if held by the settlor. See §14.15.

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§14.27 L. Form: Trustee Powers

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14.27-1 Trustee powers

ARTICLE EIGHT
Trustee Powers

To carry out the purposes of the trust created by this instrument and subject to any limitations stated elsewhere in this instrument, the trustee shall have the following powers in addition to those conferred by California Trust Law:

A. To retain, purchase, or otherwise acquire underproductive property, provided that the retention or acquisition of that property does not adversely affect the settlor's income interest in the trust estate as a whole during the trust term.

B. To manage, control, grant options on, sell, convey, exchange, partition, divide, improve, and repair trust property.

C. To lease trust property.

D. To borrow money and to encumber trust property by mortgage, deed of trust, pledge, or otherwise.

E. To initiate or defend, at the expense of the trust, any litigation relating to the trust or any property of the trust estate.

F. To carry at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.

G. To partition, allot, and distribute the trust estate on final distribution in undivided interests or in kind, or partly in money and partly in kind, at reasonable values determined by the trustee, and to sell any property the trustee considers necessary for division or distribution. The trustee may, in the trustee's discretion, make a nonprorata division between beneficiaries if the respective assets distributed to the beneficiaries have equivalent or proportionate fair market values. The income tax bases of assets distributed nonprorata need not be equivalent and may vary to a greater or lesser amount, as determined by the trustee in the trustee's discretion.

Comment: Although the trustee is given broad powers to deal with GRIT assets, the power in Section A dealing with the retention and acquisition of underproductive property is specifically limited so as not to jeopardize the GRIT's tax attributes. See §14.6.

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.28 M. Form: Applicable Law

§14.28 M. Form: Applicable Law

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14.28-1 Applicable law

ARTICLE NINE
Applicable Law

The laws of the State of California shall govern the validity, construction, interpretation, and administration of this trust.

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of Trustee*]__
_ _[*Typed Name*]_ _

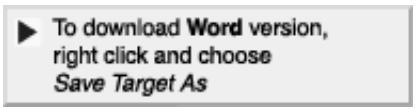
__[*Signature of Settlor*]__
_ _[*Typed Name*]_ _

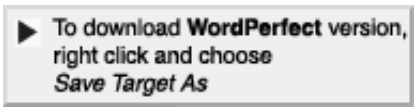
[*Acknowledgment; see §8.12*]

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Source: Estate Planning/Drafting California Irrevocable Trusts/14 Grantor Retained Income Trusts (GRITs)/§14.29 N. Form: Description of Transferred Property

§14.29 N. Form: Description of Transferred Property





14.29-1 Description of transferred property

SCHEDULE A
Property Transferred and Delivered to the Trustee

_ _[*Describe property*]_ _

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15

Grantor Retained Annuity Trusts (GRATs)

Marc M. Stern

I. OVERVIEW OF GRANTOR RETAINED ANNUITY TRUSTS (GRATs)
- A. Objectives and Design of GRAT §15.1
- B. Valuation Benefits of GRAT §15.2
- C. Expressing Annuity Amount §15.3
- D. Selecting GRAT Term
  - 1. General Considerations §15.4
  - 2. "Zeroed-Out" GRAT §15.5
  - 3. *Walton* GRATs §15.6
  - 4. "Rolling" GRATs §15.6A
  - 5. ETIP Problem for GRATs §15.6B
  - 6. Sale of GRAT Remainder Interest §15.6C
- E. GRAT Requirements and Permissible Provisions §15.7
  - 1. Assets Used to Fund GRAT §15.8
  - 2. Required Governing Instrument Provisions §15.9
  - 3. Fractional Interests §15.10

II. TAX CONSIDERATIONS
- A. Income Tax Issues §15.11
- B. Spousal Interests §15.12
- C. Repurchase/Exchange Strategy for Obtaining New Basis §15.13
- D. California Real Property Tax Considerations §15.14
- E. Integration Into Settlor's Grantor's Estate Plan §15.15
- F. Qualifying for Marital Deduction If Settlor Dies During GRAT Term §15.15A

III. CALCULATING VALUE OF GRAT GIFT §15.16

IV. WHEN TO USE GRAT §15.17

V. DRAFTING CONSIDERATIONS §15.18

VI. GRANTOR RETAINED ANNUITY TRUST PROVISIONS
- A. Form: Declaration of Transfer to Trustee §15.19
- B. Form: Trust Name §15.20
- C. Form: Trust Estate §15.21
- D. Form: Irrevocability of Trust §15.22
- E. Form: Trust Term §15.23
- F. Form: Operation During Trust Term §15.24
  - 1. Form: Payment for Each Year of Trust §15.25
  - 2. Form: Annuity Amount §15.26
  - 3. Form: Short Taxable Year §15.27
  - 4. Form: Trust Income §15.28
  - 5. Form: Limitation on Trust Distributions §15.29
  - 6. Form: Commutation Prohibited §15.30
- G. Form: Distribution on Expiration of Trust Term §15.31
- H. Form: Distributions on Termination §15.32
- I. Form: Trustees §15.33
- J. Form: Trustee Powers §15.34
- K. Form: Applicable Law §15.35
- L. Form: Statement of Intent §15.36
- M. Form: Description of Transferred Property §15.37
- N. Form: GRAT Client Memorandum §15.38

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I. OVERVIEW OF GRANTOR RETAINED ANNUITY TRUSTS (GRATs)

§15.1 A. Objectives and Design of GRAT

The grantor retained annuity trust (GRAT) is an irrevocable trust in which the grantor/settlor retains the right to an annuity for a specified term. The objectives resemble those of the traditional "common law GRIT" before Congress began to legislate restrictions in this area.

- At the end of the term, the trust terminates and the corpus is distributed to the remainder beneficiaries.
- Alternatively, the trust might continue to function for the benefit of other beneficiaries, but the settlor must cease to have any interest or power that would cause the trust property to be included in the settlor's estate.
- In addition, the trust instrument will typically provide that, if the settlor dies during the trust term, the portion of the trust includable in the settlor's gross estate will be distributed as appointed in the settlor's will or, if not so appointed, to the settlor's revocable trust or estate.

A GRAT provides the settlor with a qualified annuity interest. Because the special valuation rules of IRC §2702 are thus satisfied by the settlor's retention of a qualified interest, the remainder beneficiaries may be "members of the family" of the settlor. In IRC §2702(e), "member of the family" of an individual is defined in the same way as in IRC §2704(c)(2):

- The individual's spouse;
- Any ancestor or lineal descendant of the individual and the spouse of any such person (but see §15.6B on GRATs for grandchildren and other skip persons);
- Any ancestor or lineal descendant of the individual's spouse and the spouse of any such person; and
- Any brother or sister of the individual and the spouse of any such sibling.

The benefit of the GRAT arrangement results from the computation of the value of the gift that is made on transfer to the trust. Although IRC §2702 applies, the settlor retains a qualified annuity interest so that the value of the gift is the value of the property transferred to the trust less the present actuarial value of that retained annuity interest. For purposes of this calculation, the retained annuity interest is valued under IRC §7520, using the IRS's actuarial tables and an assumed interest rate (rounded to the nearest 0.2 percent) equal to 120 percent of the federal midterm rate, compounded annually, in effect under IRC §1274(d)(1) for the month in which the gift is made. The GRAT differs from a charitable remainder annuity trust (CRAT) in that:

- The annuity payable to the settlor from the GRAT need not be a fixed amount (for discussion of amounts payable under a CRAT, see chap 18); and
- The retained annuity from a GRAT may vary from year to year, both increasing and decreasing, provided that the increase from one year to the next may not exceed 120 percent (Treas Reg §25.2702-3(b)(1)(ii)(A)-(B)).

The GRAT arrangement takes advantage of the fact that the IRS's actuarial tables may result in the undervaluation of a remainder interest after a qualified annuity interest terminates. The tables assume that a specified annuity will be paid during a designated term. A GRAT must actually pay out that annuity amount. If the actual yield of the GRAT exceeds the amount assumed in the tables, the excess will inure to the benefit of the remainder beneficiaries. There is no "lookback" mechanism to adjust values according to actual economic performance. Outperforming the tables will be difficult to achieve, however, because the discount rate used in the tables is based on the before-tax rate of return of federal debt obligations. Often, the settlor will create multiple GRATs in hopes that at least some of the GRATs will outperform the tables. See §15.5.

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§15.2 B. Valuation Benefits of GRAT

If the settlor survives the term, the GRAT method of valuing the gift will typically result in a greater transfer of wealth to the remainder beneficiaries than would occur if the settlor simply made a transfer, without a retained interest in the property, that had the same value as the gift determined under these rules.

EXAMPLE 1: In May 2010, *X,* whose age is 60 on the nearest birthday, transferred property worth $800,000 to a GRAT paying the settlor $27,200 at the end of each year for a 7-year term. The GRAT is subject to the IRC §2702 valuation rules because one or more remainder beneficiaries is a member of *X*'s family. The value of the gift, using the IRC §7520 interest rate of 3.4 percent for May 2010, is $633,063. The annuity multiplier for an annuity payable for 7 years is 6.1374. Multiplication yields a value of the retained annuity interest of $166,937, which is then subtracted from the value of the property transferred to the GRAT ($800,000). See §15.16. If the GRAT property increases in value at a rate of 5 percent each year in excess of the 3.4-percent income necessary to satisfy *X*'s annuity payment, the remainder beneficiaries will receive assets worth $1,161,311 at the end of the 7-year term. Assuming that the asset is then sold by the beneficiaries and capital gains tax on the appreciation is paid, they will still have a fund of more than $1 million.

EXAMPLE 2: Instead of creating a GRAT, the client makes an outright gift of $633,063 (the gift component of the GRAT). For the donees to have property worth $1 million at the end of 7 years, the donees would need an investment that generates an after-tax rate of return of 7 percent per year. If the return rate is a more conservative 5 percent after tax, the donees would have a fund of $890,783 at the end of 7 years. Thus, the GRAT has shifted approximately $100,000 of additional wealth out of the settlor's estate and into the donees' hands.

The examples illustrate the benefits of a GRAT when the GRAT property, including "excess" income, increases in value at a rate in excess of the discount rate incorporated in the IRS's actuarial tables. The GRAT arrangement illustrated here also takes advantage of the "freezing" of value available when the assets are transferred out of the settlor's estate so that post-gift appreciation is also removed from the estate. The example also illustrates the leverage advantage of making a transfer to a GRAT over making an outright gift of the value of the remainder interest. Because the beneficiaries are entitled to both the appreciation of the remainder component of the trust and the excess earnings of the income component, the GRAT arrangement allows removal of a greater amount of appreciation from the settlor's estate. Also, the client will probably find that an $800,000 transfer to a GRAT is less onerous than an immediate gift of $633,063.

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.3 C. Expressing Annuity Amount

§15.3 C. Expressing Annuity Amount

The benefits of describing the annuity payment as a percentage of the property initially transferred to a GRAT can be illustrated as follows:

EXAMPLE 1: Assume that in the example in §15.2 the GRAT is funded with a partnership interest and the annuity payment is expressed as the fixed sum of $27,200. If the value of the interest is determined on audit to be $1,200,000, the value of the retained annuity is unaffected. The gift value will therefore be increased by the amount of the increase in the value of the interest ($400,000) to $1,033,063.

EXAMPLE 2: Assume, instead, that the annuity payment is expressed as 3.4 percent of the initial fair market value of property transferred to the trust. Then the determination on audit that the value of the interest was $1,200,000 *does* affect the value of the retained annuity. (This determination increases the annuity payment from $27,200 to $40,800.) The value of the gift will remain equal to 79.133 percent of the initial value of property transferred to the GRAT and will increase to only $949,595 (79.133 percent of $1,200,000). This gift value is approximately $80,000 less than the gift value that results if the annuity is expressed as a fixed dollar amount.

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D. Selecting GRAT Term

§15.4 1. General Considerations

A GRAT can be established for any term desired, but the settlor 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 settlor, the smaller the value of the remainder gift. If, however, the settlor fails to survive the GRAT's term, all or most of the GRAT corpus will be included in the settlor's estate because of the retained annuity interest under IRC §2036. See Treas Reg §20.2036-1(c) (providing methodology for determining portion of GRAT includable in settlor's estate). The regulations clarify that the value of the GRAT will be included under IRC §2036 rather than IRC §2039 (which might otherwise result in inclusion of the entire trust in the estate no matter how small the annuity amount). Treas Reg §20.2039-1(e)(1). For example, Treas Reg §20.2036-1(c)(2)(ii) provides a lengthy method for calculating the portion of a GRAT that is included in the grantor's estate if the GRAT provides for annual increases in the annuity amount. However, the complex calculations do not change the fact that the amount included will be 100 percent in typical cases. Thus, selecting the GRAT's term is something of a gamble, and the drafter must assist the settlor in selecting a term that is long enough to provide a favorable reduced tax cost and short enough that the settlor is likely to survive the term to realize the favorable tax treatment of the GRAT.

If too long a trust term is selected, so that the settlor has no realistic likelihood of surviving it, the inclusion of all or a substantial portion of the GRAT corpus in the settlor's gross estate may result in more severe taxes than would have occurred if the settlor had made an outright gift rather than creating the GRAT. The outright gift would have eliminated the transfer tax on the increased value of the transferred property between the date of the gift and the date of death. Compared with doing nothing, however, the only cost is the transaction costs associated with creating the GRAT because all of the GRAT corpus would have been included in the settlor's gross estate anyway. 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 than the addition of the previous year. This is illustrated by the table below.

Another approach is to create a GRAT with a term measured by the settlor's life rather than a term of years, if the settlor's life expectancy is less than the life expectancy assumed by the mortality tables under IRC §7520, and simultaneously sell the remainder interest for its full actuarial value. This will protect the GRAT from inclusion in the settlor's estate under the full and adequate consideration exception in IRC §2036 and allows the settlor to transfer the assets to the GRAT at zero gift tax cost. This produces a transfer tax savings because the proceeds of the sale of the remainder interest, which are included in the settlor's estate, are less than the value of the assets transferred to the GRAT. However, this requires that the settlor does not have more than a 50 percent chance of dying within 1 year so that the mortality tables can still be used to value the remainder interest, as provided by Treas Reg §25.7520-3(b)(3). See discussion in §15.6C.

To maximize the transfer tax benefits of the GRAT, it is often best to have a relatively short GRAT term of 2 or 3 years with a high payout. For a 2-year GRAT, this high payout will generally exceed 50 percent of the value of the property initially contributed to the GRAT. Not only does a short-term GRAT enhance the settlor's chances of surviving the term, but a short-term GRAT also enables the remaindermen to receive the benefit of any short-term appreciation without reduction due to any longer-term depreciation. If the settlor is accurately able to predict a positive business cycle, the increase in value of assets during the short term will inure almost exclusively to the remaindermen. If instead the value of the transferred property decreases, then all or substantially all of the trust property will be returned to the settlor. In addition, a series of short-term GRATs funded with volatile assets is likely to transfer more assets to the remaindermen than a single long-term GRAT funded with the same assets, because the increase in the value of assets during good periods will not be offset by the decrease in value during bad periods. Rather, during bad periods, the GRAT will simply not succeed in passing any assets to the remaindermen. Another approach is to give the settlor a power to substitute assets of equivalent value (exercisable either in a fiduciary capacity or in a nonfiduciary capacity subject to the trustee's duty under local law to ensure that the exchanged properties have equivalent value, as provided

in Rev Rul 2008-22, 2008-16 Int Rev Bull 796) that may be used to remove the volatile asset if the value of the asset increases in the early years of a long-term GRAT. See, *e.g.,* IRS Letter Ruling 200846001.

On the other hand, the longer term has an advantage if the GRAT will be funded with assets that are likely to produce an insufficient cash flow to make large annuity payments. In that case, a long-term graduated GRAT with annuity payments that are scheduled to increase by 20 percent per year (see §15.26) may be preferred. The longer term has an additional advantage in a low interest rate environment of locking in the rate used to calculate the percentage annuity payment needed to zero out the GRAT. The longer term also eliminates the risk of a change in the law during the term of the GRAT. For further discussion of the competing considerations, see McCaffrey, *The Care and Feeding of GRATs—Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring*, Estate Planning 2006, chap 7 (Cal CEB 2006). See also Oshins, Jones & Lunn, *The Opportunity GRAT 'OPGRAT' Can Reward Success and Minimize Adverse Tax Risks*, 33 Est Plan 13 (Mar. 2006).

EXAMPLE: A settlor establishes a GRAT with a 2-year term. After the first GRAT term expires, the settlor establishes a second 2-year GRAT. If there is rapid appreciation for 2 years after the establishment of the first GRAT, followed by 2 years of rapid depreciation after the establishment of the second GRAT, a better transfer tax result will occur than if a single 4-year GRAT had been established. All appreciation in the first 2-year GRAT's assets will pass to the trust remainder beneficiaries, and the trust assets of the second 2-year GRAT will be returned to the settlor. If a single 4-year GRAT had been created, a portion of the appreciation in the first 2 years would need to have been distributed to the settlor in the last 2 years because of the depreciation in the trust's assets. Trust assets returned to the settlor can be used to fund a series of 2-year GRATs ("rolling" GRATs). See §15.6A. The GRATs can also be designed to have a generation-skipping transfer (GST) tax transferor other than the settlor ("cascading" GRATs). See §15.6B.

Value of Gift per $100,000 of Fair Market Value of the Assets Transferred on Creation of GRAT Paying Grantor Annuity of $3,400, Calculated Using an IRC §7520 Interest Rate of 3.4 Percent		
Retained term of settlor's interest	*Value of remainder interest after expiration of trust term*	*Incremental reduction in value for additional year*
0	$100,000	NA
1	NA	NA
2	93,532	NA
3	90,456	3,076
4	87,482	2,974
5	84,605	2,877
6	81,823	2,782
7	79,133	2,690
8	76,531	2,602
9	74,014	2,517
10	71,580	2,434

The following table indicates the likelihood that the settlor will fail to survive a chosen term. These figures are derived from statistics that do not take into account gender, current health status, health and diet habits, and accessibility to health care services. The survival prospects of any particular individual may differ substantially.

Probability of Surviving Specified Number of Years After Given Age			
Additional years	*Percentage after age 55*	*Percentage after age 65*	*Percentage after age 75*

1	99	98	96
2	99	97	92
3	98	95	88
4	97	93	83
5	96	91	79
6	95	89	74
7	94	86	69
8	93	84	64
9	92	81	59
10	90	79	53

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§15.5 2. "Zeroed-Out" GRAT

If the annuity amount is high enough, the value of the remainder interest in the GRAT is zero. The result is commonly known as a "zeroed-out" GRAT or *Walton* GRAT (see §15.6).

EXAMPLE: Assume the same facts in the example in §15.2, except that the annuity is increased from $27,200 to $130,348. The annuity multiplier for seven payments is 6.1374 so that the value of the retained annuity is $800,000, leaving the gift element valued at zero.

This example suggests a planning strategy in which the settlor creates a number of short-term, high-payout GRATs, each with a gift tax value of zero. Short-term GRATs are used to reduce the risk that the grantor will die during the term and increase the likelihood that at least some of the GRATs will outperform the assumed IRC §7520 interest rate for the term of the GRAT. Nothing is lost if a GRAT is exhausted by the annuity—except the cost of creating the GRAT — and any assets remaining in any of the GRATs at the end of the term will pass to the remaindermen with no gift tax cost. However, proposed amendments to IRC §2702 included in the Supplemental Appropriations Act (HR 4899), passed by the House of Representatives on July 1, 2010, would require that a GRAT have a term of at least 10 years and a nondecreasing annuity that produces a gift tax value greater than zero.

PRACTICE TIP: If the settlor's goal is to minimize the gift element, the drafter should consider expressing the annuity payment as a percentage of the value of the property initially contributed to the trust, especially if the contributed property does not have an objectively determinable value. If the annuity amount is expressed as a percentage of the value of the property initially contributed to the GRAT, the present value of the retained interest will equal a fraction of the initially contributed property, not simply a fixed dollar amount. Thus, if the IRS is successful in increasing the value of the property contributed to the GRAT, the gift will equal the same fraction of the larger value. If the fraction is the smallest fraction possible, the value of the gift will simply equal the value of the property transferred to the GRAT multiplied by this fraction. Even if the value of the contributed property is increased on audit, the gift element remains the minimum amount possible. If the annuity payment is expressed as a fixed dollar amount, any increase in value of the contributed property causes an increase in the value of the gift on a dollar-for-dollar basis.

The IRS ordinarily will not issue an advance ruling concerning the GRAT if the amount of the annuity is more than 50 percent of the initial net fair market value of the trust. Rev Proc 2010-3, §4.01(53), 2010-1 Int Rev Bull 110.

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§15.6 3. *Walton* GRATs

The IRS previously took the view in a regulation under IRC §2702 that a retained annuity for a term of years is a "qualified interest" only to the extent of the right to receive payments for the specified term or until the settlor's earlier death, even if the trust provides that any payments due a deceased settlor are to be made to the settlor's estate. Because a retained interest must be qualified in order to reduce the gift tax value of a transfer to a GRAT, the consequence of the IRS position was to increase the value of the taxable gift by the value of the right of the settlor's estate to receive the settlor's remaining annuity payments in the event of the settlor's death. This regulation was held invalid by the Tax Court in *Audrey J. Walton* (2000) 115 TC 589, acq 2003-44 Int Rev Bull 964. As promised in Notice 2003-72, 2003-2 Cum Bull 964, the IRS has conformed the regulation to the decision. See Treas Reg §25.2702-3(e), Examples 5-6. In the example in §15.5, *Walton* allows the value of the retained annuity to be calculated using the annuity multiplier of 6.1374 rather than 6.0931. As a result, the remainder interest gift is zero for an annuity of $130,348 or more.

The decision in *Walton* suggests that new zeroed-out GRATs should similarly provide for a fixed-term annuity with payments being made to the settlor's estate in the event of the settlor's death. Prudence dictates taking the word "estate" literally—a provision for payment to the settlor's revocable trust may not be sufficient.

In some cases, drafters attempt to provide that zeroed-out GRAT assets are to pass in a manner qualifying for the marital deduction in the event the settlor fails to survive the term. This makes sense in zeroed-out scenarios in which the value of the initial gift is low and it is relatively certain that virtually all of the remaining GRAT will be included in the settlor's estate in the event of death during the annuity term. In view of the *Walton* decision, this should be accomplished with a combination of (1) a testamentary devise to the spouse (or marital deduction trust) of any annuity payments that will be made to the estate, and (2) a GRAT provision that provides for distributing the entire GRAT remainder to the same person or marital deduction trust if the settlor has failed to survive. (Under the treasury regulations, this cannot be accomplished by giving the spouse a revocable interest in the remaining annuity payments rather than a testamentary devise, because a revocable spousal interest is not a qualified interest if it is contingent on the death of another person. Treas Reg §25.2702-3(d)(2), (e), Examples 8-9. See §15.15.) Although the devise of the annuity payments alone will not qualify for the IRC §2056 marital deduction because it is a transfer of a terminable interest, and the transfer of the GRAT remainder alone will not qualify by itself because it is a transfer of a future interest, the transfer of the combined interests would appear to satisfy the statute. See §15.15A. For further discussion of these issues, see Caulfield, *The Quest for Zeroed-Out GRATS:* Walton *Says It Can Be Done*, 28 Est Plan 251 (2001).

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§15.6A 4. "Rolling" GRATs

As discussed in §15.4, the use of short-term GRATs helps to ensure that any appreciation in trust assets during the term passes to the remainder beneficiaries and is not returned to the settlor if there is later depreciation of the assets. This technique can be combined with the *Walton* GRAT described in §15.6 by creating a series of short-term, zeroed-out GRATs ("rolling" GRATs) to be funded with the same assets to ensure that any appreciation of the assets passes to the remainder beneficiaries whenever it occurs.

- First, the annuity amount of a 2-year GRAT is set high enough that the value of the retained interest is nearly equal to the fair market value of the property transferred, so that there is little or no taxable gift.
- Second, the settlor transfers any assets distributed by the trust to satisfy the annuity payment obligation (all of the assets if there is no appreciation during the term) to another zeroed-out 2-year GRAT with the same remainder beneficiaries, and so on.

If and when the assets appreciate, all the appreciation will pass to the remainder beneficiaries of the current GRAT. This technique may be especially useful for assets such as undeveloped real property that may remain unproductive for many years and then may suddenly appreciate in value when a development plan is approved or the property is sold.

One drawback of this technique is the cost of creating additional GRATs. Another is the possibility that zeroed-out GRATs may be disallowed in the future, perhaps by a statutory amendment to require that a GRAT must have at least a 10-percent remainder interest as currently required for charitable remainder trusts. See chap 18.

A separate series of GRATs may be used for each type or class of assets to prevent the failure of some of the assets to appreciate from affecting those assets that do appreciate in value. Short-term GRATs also may be used with withdrawal powers and contingent trusts ("cascading" GRATs) to allow at least some of the appreciation of trust assets to pass free of generation-skipping transfer (GST) tax to lower-generation remainder beneficiaries. See §15.6B.

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§15.6B 5. ETIP Problem for GRATs

One disadvantage of GRATs, including short-term "zeroed-out" GRATs or *Walton* GRATs and "rolling" GRATs (see §§15.5-15.6A), is that they generally cannot have remainder beneficiaries who are skip persons for purposes of the generation-skipping transfer (GST) tax, such as grandchildren, because the settlor's GST exemption cannot be allocated to the trust before the close of the estate tax inclusion period (ETIP) during which the value of the trust property may still be included in the estate of the settlor. IRC §2642(f). This does not occur until the end of the trust term, after the assets may have appreciated, because the trust assets will generally be included in the settlor's estate under IRC §2036 if the settlor dies during the trust term. See chap 4.

However, the trust will not be subject to GST tax if the trust provides that, at the end of the trust term, the settlor's child or other non-skip person has the right to withdraw the trust assets for a period of time (*e.g.*, 30 days), with the assets to remain in trust for a further period if the assets are not withdrawn, and then to be distributed to the settlor's grandchildren or other skip persons at the end of the period. The transfer to grandchildren at the termination of the child's interest is not a GST by the settlor because the child is now the transferor of the trust. IRC §2652(a). This type of trust is sometimes called a "cascading" GRAT (although that term is often used synonymously with a "rolling" GRAT as described in §15.6A) because the trust assets pour into a second trust and then pour out of that trust to the remainder beneficiaries. Note that the settlor remains the GST tax transferor to the extent that the lapsed power does not exceed the greater of $5000 or 5 percent of trust assets, however, because the lapse to that extent does not cause inclusion of the GRAT property in the child's estate under IRC §2041. See §4.10. Furthermore, the child's GST exemption must be applied to the remainder of the trust based on date-of-death values if the GRAT property is intended to remain exempt beyond the generation of the settlor's grandchildren. For these reasons, this technique is not a very efficient solution to the GST tax problem created by the ETIP rule. A more promising alternative may be a sale (or gift) of the GRAT remainder interest to a GST-exempt trust. See §15.6C.

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§15.6C 6. Sale of GRAT Remainder Interest

Another solution to the GST tax problem created by the ETIP rule (see §15.6B) is a sale of the GRAT remainder by the non-skip person remainder beneficiary (*e.g.*, the settlor's child) to a GST-exempt trust. If the beneficiary receives fair market value for the GRAT remainder (as determined under the valuation tables in IRC §7520), there should be no taxable gift in the transaction with the consequence that the settlor remains the GST tax transferor of the GRAT property, and there should be no taxable termination when the GRAT property is distributed to the trust because the trust is exempt. See chap 4. This result requires that the settlor allocate sufficient GST exemption to the trust to fully exempt the purchase of the GRAT remainder, but this amount should be minimal if the GRAT is designed as a "zeroed-out" GRAT and the sale is made shortly after the inception of the GRAT. For further discussion of this technique, see Handler & Oshins, *GRAT Remainder Sale to a Dynasty Trust*, 138 Tr & Est 20 (Dec. 1999).

Advocates of an alternative technique involving the sale of assets to a GST-exempt dynasty trust designed as an intentionally defective grantor trust (IDGT) as described in chap 13A have expressed some reservations about this technique, noting that the IRS has disallowed an arguably similar transfer of a remainder interest in a charitable lead annuity trust (CLAT) as described in chap 18A, ruling that the remainder beneficiary was only the GST tax transferor of the present value of the remainder interest. See IRS Letter Ruling 200107015. One commentator has also questioned whether the grantor's retained annuity interest is a qualified interest under the special valuation rules (see §2.25) for purposes of the transfer of the remainder interest because otherwise the remainder beneficiary will be considered to have made a net gift equal to the value of the entire GRAT property less the consideration received in exchange for the remainder interest. See Blattmachr, *Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth*, 47 Tax Management Memorandum No. 2, p 14 (Jan. 23, 2006).

However, these concerns appear to be addressed to a related technique involving a taxable gift of the remainder interest in which the remainder beneficiary (rather than the settlor) allocates GST exemption to the gift. In this context, the concern with changing the GST tax transferor does not arise if there is no intention to exempt the GRAT property beyond the generation of the settlor's grandchild. Furthermore, if the sale of the GRAT remainder is subject to the special valuation rules (because the settlor retains an interest in the property both before and after the sale of the remainder, even though the sale is not made by the settlor), then by the same token it would appear that the settlor's retained annuity interest should be a qualified interest under IRC §2702. Nevertheless, it is possible that the IRS could still try to collapse the two transactions (gift to GRAT and sale of GRAT remainder) and disallow the allocation of the settlor's GST exemption to the trust making the purchase. These considerations militate against using a GRAT to make transfers to grandchildren and other skip person beneficiaries.

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.7 E. GRAT Requirements and Permissible Provisions

§15.7 E. GRAT Requirements and Permissible Provisions

The requirements and permissible terms for a GRAT are regulated by Treas Reg §25.2702-3(b)-(d). As a result, the typical GRAT governing instrument contains relatively few custom terms except for the provisions relating to the annuity to be paid to the settlor and the distribution of the remainder after the period of the settlor's retained interest expires.

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§15.8 1. Assets Used to Fund GRAT

Any property can be used to fund a GRAT, even unproductive property. Treas Reg §25.7520-3(b)(2)(v), Example (3). In establishing the GRAT, however, the actual payment of the annuity must be considered. The regulations require that the annuity actually be paid to the settlor for a given year no later than the date by which the trustee is required to file the trust's federal income tax return for that year, without regard to extensions, or 105 days after the anniversary date of the creation of the trust. Treas Reg §25.2702-3(b)(4). The regulations provide that the GRAT must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity obligation. Treas Reg §25.2702-3(d)(6). If the GRAT assets are unproductive or underproductive, the trustee must invade principal to satisfy the annual payment requirement. Depending on the nature of the GRAT assets, this could require the return of property to the settlor at a value deeply discounted from the prorata fair market value of the property. See §15.4.

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.9 2. Required Governing Instrument Provisions

§15.9 2. Required Governing Instrument Provisions

In general, the required provisions of Treas Reg §25.2702-3(b), (d) create a trust subject to the following rules:

- The GRAT must provide the settlor with an irrevocable right to receive a fixed amount. The annuity amount must be payable to or for the benefit of the person holding the term interest each year of the term. A right of withdrawal, even if cumulative, does not create a qualified interest. The annuity payment may be made after the close of a calendar year, but can be made no later than the due date of the trust's federal income tax return for that year (determined without extensions). Treas Reg §25.2702-3(b)(1).
- The fixed amount of the annuity can be expressed either as a dollar amount or as a percentage of the value of the property initially transferred to the GRAT, but it may never be more than 120 percent of the prior year's annuity payment. Treas Reg §25.2702-3(b)(1)(ii).
- If the annuity amount is expressed as a percentage of the trust's initial value, the GRAT must contain provisions to adjust for the proper annuity amount that should have been paid consistent with the requirements of Treas Reg §1.664-2(a)(1)(iii) (Treas Reg §25.2702-3(b)(2)).
- The GRAT must contain provisions to adjust for the proper prorated annuity amount that should be paid in a short taxable year (Treas Reg §25.2702-3(b)(3)).
- The annuity amount must be paid no later than the due date of the income tax return of the trust (without regard to extensions) or 105 days after the anniversary date of the creation of the trust. Treas Reg §25.2702-3(b)(4).
- Additional contributions to the GRAT are prohibited. Treas Reg §25.2702-3(b)(5).
- To prevent circumvention of the GRAT rules, the trust must
- Satisfy the requirements of a GRAT in all respects;
- Meet the definition of and operate exclusively as a GRAT at all times (Treas Reg §25.2702-3(d)(1));
- Provide that payment of the unitrust amount is not subject to any contingency other than the survival of the settlor or, in the case of a revocable interest described in Treas Reg §25.2702-2(a)(6) (see §15.12), the settlor's right to revoke the interest of the settlor's spouse (Treas Reg §25.2702-3(d)(2));
- Prohibit distributions to anyone other than the settlor during the trust term (Treas Reg §25.2702-3(d)(3));
- Have a stated term (Treas Reg §25.2702-3(d)(4));
- Prohibit a commutation of the settlor's interest (a premature termination in which the settlor receives the present value of the remaining annuity interest and the remainder beneficiaries receive the rest of the trust assets). Treas Reg §25.2702-3(d)(5); and
- Prohibit the trustee from issuing promissory notes or other instruments in satisfaction of the annuity obligation (Treas Reg §25.2702-3(d)(6)).

The stated term may be for a term of years, the settlor's lifetime, or the shorter (but not the longer) of a term of years and the settlor's lifetime. Treas Reg §25.2702-3(d)(4). If an annuity for a term of years is to be paid to the settlor's estate if the settlor fails to survive the term, the regulations provide that the qualified interest is the right to receive an annuity for the term of years. Treas Reg §25.2702-3(e), Examples 5, 6. The regulation conforms to the decision in *Audrey J. Walton* (2000) 115 TC 589, acq 2003-44 Int Rev Bull 964. See §15.6.

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§15.10 3. Fractional Interests

The value of a gift attributable to a transfer to a GRAT is less than the value of the contributed property. In addition, various lack-of-control and lack-of-marketability discounts may be applied in determining the value of the underlying transferred property if assets like undivided interests in real estate, shares of closely held stock, or limited partnership interests are transferred to the GRAT. See discussion in §2.23E. Such compounding allows the transfer tax value of a discounted asset to be further reduced to account for the settlor's retained interest.

Furthermore, fractional interests in an asset entirely owned by the settlor can be transferred to multiple GRATs (or other retained interest trusts) with different remainder beneficiaries, different dispositive terms, or different trust terms. This fractionalizing of an asset will probably generate an additional level of discounts from 15 percent to 45 percent, depending on the nature of the transferred asset. Additionally, the establishment of multiple GRATs allows the settlor to hedge the bet that he or she will survive the trust term: the settlor is not limited to establishing one GRAT on an "all or nothing" basis and then hope to survive that single GRAT's term.

In a "zeroed-out" GRAT (see §15.5), however, the benefit of the discount is lost if the annuity must be paid out wholly in kind with discounted assets.

EXAMPLE 1: A 2-year GRAT funded with $1 million in assets and an IRC §7520 rate of 5 percent would require an annuity of $537,808 to achieve a zero gift tax value. If the same assets are contributed to a limited liability company (LLC) and LLC units with a discounted value of $700,000 are transferred to the GRAT, the required annuity would be $376,465. But if the same assets also must be used to make the payments, assets with an undiscounted value of $537,808 would be needed to make the $376,465 payment. If the assets in the GRAT appreciate at a rate of 5 percent, nothing will be left for the remainder beneficiary after the payments are made to the grantor, regardless of whether the GRAT is funded with discounted assets.

Even if the assets in the GRAT appreciate at a rate greater than 5 percent, the value of assets left to the remainder beneficiary will be the same with or without the discount, as long as the annuity payments are made solely with discounted assets. If the assets in the GRAT in Example 1 appreciate at a rate of 10 percent, assets with a value of $80,603 will be left to the remainder beneficiary if the GRAT is funded with undiscounted assets, and LLC units with a discounted value of $56,423 and an asset value of $80,603 will be left to the remainder beneficiary if the GRAT is funded with LLC units.

Thus, in a "zeroed-out" GRAT, the discount is beneficial only to the extent that the assets produce a cash flow that can be used to make at least part of the annuity payment. On the other hand, the discount may allow the GRAT to produce a benefit even if income from assets contributed to the GRAT does not exceed the IRC §7520 rate.

EXAMPLE 2: If the LLC units with a discounted value of $700,000 and an underlying asset value of $1 million contributed to the GRAT in Example 1 produce income of 5 percent that can be distributed to the grantor, then the first annuity payment can be made with $50,000 in cash and $326,465 in LLC units with an asset value of $466,380, and the second payment can be made with $26,680 in cash from the remaining $533,620 in assets and $349,785 in LLC units with an asset value of $499,633, leaving the beneficiary with $23,750 in LLC units with an asset value of $33,929. In contrast, if $1 million of undiscounted assets were contributed to the GRAT, the beneficiary would be left with nothing after a first payment of $50,000 in cash and $487,808 in assets followed by a second payment of $25,609 in cash and the remaining assets of $512,192.

Even larger benefits can be achieved if the assets can be sold during the term of the GRAT. In Example 2, the beneficiary could be left with as much as $231,523 in LLC units with an asset value of $330,750 if all the assets of the LLC are sold for cash at the beginning of the first year and the proceeds are invested at 5 percent and used to make the annuity payments, with the capital gain tax, if any, paid by the grantor (see §15.11). Of course, the IRS may attempt to disallow the valuation discount if the sale of assets can be seen as part of a prearranged plan. For further discussion of valuation discounts, see §§2.23-2.23E.

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II. TAX CONSIDERATIONS

§15.11 A. Income Tax Issues

The settlor 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 IRC §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 IRC §677(a)(2).

Furthermore, the settlor has an interest in the GRAT principal because of the settlor's reversionary interest in the trust principal if he or she dies during the trust term, even though this reversionary interest has no value for gift tax purposes under IRC §2702. If the reversionary interest exceeds 5 percent, as it frequently will (in the 7-year GRIT in §14.3, equivalent to the example in §15.2, 60-year-old *X*'s reversionary interest is 8.134 percent):

- The GRAT will also be a grantor trust as to "principal income" or capital gains (IRC §673(a)); and
- The exception in IRC §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.

Although the settlor can use the income received from the GRAT to pay the income taxes attributable to the trust's ordinary income, if the trust's income exceeds the annuity payment, the settlor 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. From an overall tax perspective, this produces a positive economic result because the settlor's estate is reduced by, in effect, paying the remainder beneficiaries' taxes. For a particular settlor, however, this result may be outweighed by the difficulties associated with paying large 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 settlor, either all income or sufficient income to reimburse the settlor for any taxes paid on income not received by the settlor. The regulations authorize distribution to the settlor 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 IRC §2702. Treas Reg §25.2702-3(b)(1)(iii). Income is not defined in either IRC §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 settlor concerned about a tax liability in excess of income may include a reimbursement clause without adversely affecting the trust's status as a GRAT.

A reimbursement clause or any other provision authorizing additional distributions from the GRAT to the settlor should not provide a settlor-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 settlor 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.

It may be advisable to have the GRAT considered a grantor trust so that it is an eligible shareholder of an S corporation, a corporation as to which the shareholders have made an election under IRC §1362. Permissible shareholders of S corporation stock are limited to individuals, estates, grantor trusts, qualified subchapter S trusts (QSSTs), and electing small business trusts (ESBTs). IRC §1361(b), (c)(2)(A)(v), (e). A QSST is a nongrantor trust that has a single individual as its current beneficiary during the beneficiary's lifetime and that either (1) requires all its income to be distributed to that individual or (2) actually distributes all its income to that individual. IRC §1361(d)(3). Although a GRAT appears to satisfy the definition of an ESBT, it may be simpler (at least in the near future until the implications of being an ESBT are fully understood) to make the GRAT a grantor trust so that its qualification to hold S stock is certain. 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. See discussion of QSSTs and ESBTs in §§3.57-3.67.

If the settlor's reversionary interest in the GRAT does not exceed 5 percent, the GRAT will not be a grantor trust as to all "principal income." Because capital gains income in a given year may be distributed to the settlor or accumulated for distribution to the settlor to satisfy the annuity amount in a future year, principal income may still be taxed to the settlor under IRC §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.

Besides ensuring qualification of a GRAT to hold S corporation stock and allowing the settlor 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, 1985-1 Cum Bull 184, that the settlor 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:

- Appreciated assets can be distributed to the settlor 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* (2d Cir 1940) 114 F2d 217.
- The settlor can sell property to or purchase property from the trust without income tax consequences.
- The settlor can lend money to the GRAT without generating additional income from the 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* (1984) 465 US 330, 79 L Ed 2d 343, 104 S Ct 1086. The settlor should only loan funds to a GRAT in extraordinary circumstances. If the loan is used, or the IRS believes that it has been used, to make a required annuity payment, the trust may cease to qualify as a GRAT. See §15.8.

If the settlor 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 settlor to reacquire GRAT assets by exchanging other assets of equivalent value. IRC §675(4)(C).

An unrelated tax issue is the loss of a stepped-up basis for the trust assets on the settlor's death if the settlor survives the trust term. IRC §1014. In this situation, the income tax basis of the trust assets will equal their basis in the settlor's hands immediately before the contribution, increased with respect to any gift tax payable attributable to the transfer, but in no case more than the fair market value of the transferred property. IRC §1015(a), (d). The consequences may be serious if assets with a very low basis are transferred to the GRAT. See §15.13.

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§15.12 B. Spousal Interests

Because of the gift tax marital deduction requirements, it is generally not advisable to make a spouse a beneficiary of a GRAT. (For a narrow exception to this generalization, see §15.6.) The transfer will qualify for the marital deduction only if the requirements of a qualified terminable interest trust, as defined in IRC §2523(f)(2), are satisfied. One requirement is that the spouse have a qualifying income interest for life. IRC §2523(f)(2)(B). The GRAT term has been selected, however, so that it is likely to terminate before the settlor's death. Thus, it is possible that the trust will also terminate before the spouse's death. Therefore, there is no guarantee that the spouse will receive a qualifying income interest for life, regardless of the spouse's age and the length of the trust term. The Ninth Circuit has held that a spouse's revocable right to receive the remaining annuity payments if the settlor fails to survive the term is a qualified interest. See *Schott v Commissioner* (9th Cir 2003) 319 F3d 1203. This would allow the gift element of the transfer to be reduced by the value of the spouse's revocable annuity interest. The treasury regulations take the contrary position that a revocable spousal interest is a qualified interest only if the interest is not subject to any contingency other than either the survival of the holder or the settlor's right to revoke. Treas Reg §§25.2702-2(a)(6), 25.2702-3(b), (d)(2). Court decisions from other jurisdictions have ruled in favor of the regulation position. See *Cook v Commissioner* (7th Cir 2001) 269 F3d 854; *Estate of Claude C. Focardi*, TC Memo 2006-56. This position is clarified in Treas Reg §25.2702-3(e), Examples 8-9, which conclude that if the spouse receives a revocable annuity for a fixed term of years after the settlor's death, that annuity is a qualified interest; but if the spouse receives only a revocable annuity for the balance of a fixed term that remains after the settlor's death, the interest is not qualified because it is contingent on the death of another person. The planning implications of *Schott* are negligible in most cases, however, because better results can be obtained by using a *Walton* GRAT as described in §15.6. In the *Schott* scenario, the value of the gift to the GRAT is the value of the property transferred reduced by the right to the annuity for the shorter of the trust term or the life of the surviving annuitant. In a *Walton* GRAT, the gift is equal to the value of the transferred property reduced by the right to the annuity for the trust term—eliminating any increase in the value of the gift that results if the right to the annuity is contingent on the survival of either the grantor or the spouse.

However, the use of a revocable spousal annuity could achieve transfer tax savings in a particular case if, at the time of creation of the GRAT, the spouse has less than the average life expectancy for a person of his age—provided that the spouse has less than a 50-percent chance of dying within 1 year, so that IRC §7520 can still be used to value the spouse's revocable annuity interest, as provided by Treas Reg §25.7520-3(b)(3). In that case, the mortality assumptions used to value the revocable annuity interest will overstate the value of the retained interest, which would be treated as an incomplete gift for gift tax purposes, and understate the value of the remainder gift. See §6.37 (high-yield annuity).

EXAMPLE: Settlor's 50-year old spouse has a condition that decreases life expectancy substantially. Settlor creates a $1 million GRAT that will pay the spouse $100,000 per year for life with remainder to Settlor's children. If the IRC §7520 interest rate in the month of the transfer to the trust is 5.6 percent, the value of the revocable annuity interest is $948,000, and the value of the remainder interest is $52,000. If the property produces a rate of return of 5.6 percent and the spouse dies within 2 years, property worth almost $910,000 can pass to Settlor's children at a gift tax cost of only $52,000. For further discussion, see McCaffrey, *The Care and Feeding of GRATs—Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring*, Estate Planning 2006 §7.21 (Cal CEB 2006).

When a husband and wife hold joint or community property, the foregoing problem and attendant adverse tax consequences can be avoided by dividing the co-owned property so that each spouse holds half as separate property. Each spouse can then establish a separate GRAT to which his or her separate property is transferred. As discussed in §15.10, this approach may have the incidental effect of lowering the value of the transferred property because each spouse's gift involves only a fractional share of an asset, rather than the transfer of a 100-percent interest in the asset. These fractional shares of an asset are each likely to be valued at less than the prorata value of the undivided interest

actually contributed to the GRATs. See *Propstra v U.S*. (9th Cir 1982) 680 F2d 1248 (allowing a 15-percent discount on deceased spouse's one-half community property interest in certain property).

The primary drawback of dividing community property equally between spouses as their separate property is that the step-up in basis for both halves of the property will not be available if one spouse dies during the term of his or her GRAT. IRC §1014(b)(6). The establishment of a GRAT (even an ill-advised joint-spouse GRAT) precludes characterization of the trust property as community property because property held in trust can retain its character as community property *only* if the trust is revocable. Fam C §761. If the basis step-up is important, settlor's characterizing the GRAT as a grantor trust may be useful. The settlor can repurchase or exchange high-basis assets held by the settlor with low-basis assets of equivalent fair market value held by the GRAT shortly before the trust term expires without adverse income tax consequences. See §15.13.

A pitfall to avoid when creating a GRAT for a married settlor is gift splitting under IRC §2513. See §17.15 for further discussion of this issue.

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§15.13 C. Repurchase/Exchange Strategy for Obtaining New Basis

A potential deterrent to the use of a GRAT is the possibility that neither the settlor's estate nor the GRAT remainder beneficiaries will receive a new income tax basis for the trust assets on the settlor's death. IRC §1014. This problem can be serious when a settlor transfers highly appreciated assets to the GRAT.

To alleviate this problem, experienced practitioners commonly recommend that the settlor repurchase the GRAT assets shortly before the GRAT term expires. The IRS has identified this strategy with respect to the repurchase of a home from a qualified personal residence trust (QPRT) as an area of abuse because it believes that residences were allowed special treatment under IRC §2702 and the repurchase subverts congressional intent. Accordingly, the IRS has issued regulations that prohibit the settlor or the settlor's spouse from reacquiring a personal residence held by a QPRT during the QPRT term. Treas Reg §25.2702-5(b)(1), (c)(9). For a GRAT, the repurchase strategy apparently continues to be a viable option.

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§15.14 D. California Real Property Tax Considerations

The real property tax consequences of a GRAT include the following:

- The initial transfer to the trust is a transfer for the benefit of the settlor that is not a change of ownership under Rev & T C §62(d), and thus a reassessment is avoided.
- The expiration of the settlor's term interest in the trust may trigger a reassessment unless the parent-child (Rev & T C §63.1(a)(1)-(2)), (and in some cases, the grandparent-grandchild (Rev & T C §63.1(a)(3)) transfer exclusion applies. (Transfers to registered domestic partners are also excluded from reassessment under Rev & T C §62(p). However, settlors are less likely to create GRATs for them because they are also eligible for common law GRITs. See chap 14.) The parent-child exclusion must be claimed within 3 years of the transfer to the children or before the children transfer the residence to a third person other than a parent or child, whichever occurs first. Rev & T C §63.1(e)(1)(B). The State Board of Equalization (SBE) takes the position that the transfer to the children occurs at the expiration of the settlor's retained interest rather than on the creation of the trust. However, the SBE guidelines are *not* binding on local assessors. If not sooner filed, a claim of exclusion may be filed within 6 months after a notice of supplemental or escape assessment was issued as a result of the transfer. Rev & T C §63.1(e)(1)(C).

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§15.15 E. Integration Into Settlor's Estate Plan

Use of a GRAT can create problems in carrying out the settlor's overall dispositive desires. If the settlor does not survive the GRAT term, the trust property may be included in the settlor's estate. This poses particular problems for married settlors. See §15.15A.

If the settlor survives the GRAT term, the trust property will not be included in the settlor's gross estate and no estate tax will be apportioned to its assets. The transfer to the GRAT will give rise, however, to a taxable gift by the donor, which is considered in determining the estate taxes payable at the settlor's death. Because the gift arising from the transfer to the GRAT may consume a significant portion of the settlor's unified credit, it may be difficult to achieve the settlor's other objectives, such as equality among children and the issue of deceased children.

EXAMPLE: *Y* has an estate of $5 million. *Y* establishes a GRAT with property valued at $3 million and having a remainder value of $1.5 million. The GRAT provides that, on the expiration of *Y*'s annuity interest, trust property will be distributed outright to those of *Y*'s three children who are living. A compensating gift is made in *Y*'s revocable trust to the issue of any child who predeceases the expiration of the GRAT term. *Y* and two children survive the expiration of the GRAT term, but one child dies before the term expires. The GRAT generates sufficient income to pay the annuity, and none of its assets appreciates in value during the settlor's retained term.

Based on the foregoing facts, at the time of *Y*'s death, each of the two surviving children will have received $1.5 million from the GRAT at the expiration of its term. No transfer taxes were paid with respect to *Y*'s transfer to the GRAT because of the unified credit. *Y*'s estate planning documents provide for a compensating gift of $2 million to the issue of the deceased child. The estate tax on *Y*'s remaining $2-million estate is approximately $800,000, and only approximately $1.2 million is available for distribution to the deceased child's issue.

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§15.15A F. Qualifying for Marital Deduction If Settlor Dies During GRAT Term

If the settlor dies during the term of the retained annuity, it is likely that the entire GRAT will be included in the settlor's estate for estate tax purposes because of the existence of the retained annuity interest. Accordingly, it is often desirable to try to obtain a marital deduction for the GRAT if the settlor has a surviving spouse. This requires careful planning. Simply devising to the spouse the annuity payments that will be received by the settlor's estate is insufficient because those payments by themselves constitute a terminable interest that does not qualify for the marital deduction.

The simplest approach is to provide in the GRAT that, if the settlor dies during the term survived by a spouse, (1) the GRAT will pay, annually or more frequently, to the settlor's estate the greater of the annuity amount or trust income, and (2) the remainder interest will be distributed to the spouse at the end of the GRAT term. See optional language in form 15.31-1. The will must devise the periodic payments to the spouse. Alternatively, the will can devise the same payments to a QTIP trust, with the GRAT paying the remainder to the same QTIP trust, provided that the QTIP trust makes clear that the GRAT trust income received by the QTIP trust from the estate retains its character as "income" when received by the QTIP.

An attempt to qualify for the marital deduction should not take the form of simply terminating the GRAT on the settlor's death and distributing the remaining assets to the spouse. If this approach were used, the annuity retained by the settlor might be viewed as an interest for the lesser of a term of years or the settlor's earlier death, rather than an interest for a term of years. The result would be a reduction in the value of the retained interest and an increase in the gift made on the creation of the GRAT. See Treas Reg §25.2702-3(e), Example 1.

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.16 III. CALCULATING VALUE OF GRAT GIFT

§15.16 III. CALCULATING VALUE OF GRAT GIFT

The value of the gift that is made when a GRAT is created can be calculated by using the actuarial tables in IRS Publication 1457 or by using commercial estate planning computer software that incorporates the IRS tables. The practical necessity of using a computer program is illustrated by the sample calculations described in IRS Publication 1457.

EXAMPLE: The following is the calculation for the value of a remainder interest for property worth $800,000 transferred to a trust in which a 60-year-old settlor retains an annuity of $100,000 for 7 years. The value of the remainder interest does not depend on the age of the settlor.

- The first step is to determine the applicable interest rate. Under IRC §7520, the applicable interest rate is the rate (rounded to the nearest 0.2 percent) equal to 120 percent of the federal midterm rate, compounded annually, in effect under IRC §1274(d) for the month in which the transfer to the GRAT occurs. In the following example, the interest rate used for this calculation is 3.4 percent.
- The second step is to determine the Table B term certain factor for a 7-year term. This equals the annuity factor (6.1374).

Start with:	
Annuity payment	$100,000
Divide by:	
Initial trust value	$800,000
Equals (amount of annuity as percentage of initial trust value)**:**	12.5%

(If above percentage is less than or equal to applicable interest rate, special high-payout valuation *is not* required)

Continue (if above percentage is greater than applicable interest rate)**:**

Annuity payment	$100,000
Multiply by:	
Table B factor for 7-year trust term	6.1374
Equals:	$613,740

(If above amount is less than or equal to trust fund, special high-payout valuation *is not* required)

(If above amount is greater than trust fund, special high-payout valuation *is* required unless the annuity will be paid to the settlor's estate if the settlor dies before the end of the term)

NOTE: In the above example, an annuity of $130,348 for 7 years will result in zero taxable gift, because the value of the annuity is equal to $800,000. However, the value of an annuity of $130,348 for the shorter of 7 years or the life of a settlor age 60 is only $767,474, taking into account the possibility that the fund may be exhausted before the death of the settlor as required by Rev Rul 77-454, 1977-2 Cum Bull 351. See §6.36. Under the regulations, the shorter period must be used to value the retained annuity for a term of years unless the trust provides that the annuity will be paid to the settlor's estate in the event that the settlor dies before the end of the trust term. In this case, the required annuity factor for the shorter period is 5.8879 and the value of the annuity for the shorter period would be $588,790. See §15.6.

Required Annuity Factor:	6.1374

Multiply by:	
Annuity payable	$100,000
Equals (present value of annuity)**:**	$613,740

- The third step is to determine the gift tax value of the remainder interest by subtracting the present value of the annuity from the value of the property transferred to the GRAT:

Start with:	
Value of GRAT property	$800,000
Subtract:	
Annuity present value	$613,740
Equals (remainder interest)**:**	$186,260

For further discussion of valuing the gift of income and remainder interests, see chap 6.

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§15.17 IV. WHEN TO USE GRAT

A GRAT can be an effective estate planning tool. The attorney should discuss the following issues with the client to determine if a GRAT is right for that client:

- Is the client willing to lose the step-up in basis and the ownership of assets? Ownership and basis may be minor concerns in some situations, such as when an asset has a high basis after the death of a spouse and there is no concern (although there is no prearrangement) that the remainder beneficiaries will make the assets available to the settlor after the GRAT term expires.
- What is the opportunity cost, not just on paper but in terms of probable behavior? Will creating a GRAT make it less likely that the client will make annual exclusion gifts? Will funding the GRAT with particular assets preclude the settlor's transfer of other assets that should be transferred, such as interests in a family business? Or, is no opportunity sacrificed, because the client would otherwise do nothing?
- Is there a satisfactory probability that the client can survive the term?
- Is it a reasonable probability that the property transferred to the GRAT will appreciate during the term?

Although the GRAT is not for everyone, in many situations it will be an appropriate part of a client's estate plan. No one seriously suggests that a GRAT is a substitute for a sound gift-giving program that takes full advantage of the annual exclusions and removes from the estate both current wealth and future income and appreciation. The decision to use a GRAT assumes that the settlor can do so without forgoing better planning opportunities, keeping in mind that a planning opportunity is not "better" if the client is not willing to take advantage of it. Assuming this is the case, the contemporary GRAT appears to be an appropriate weapon in the planner's arsenal that may be attractive to clients who understand or perhaps are even attracted by the gambling aspect of the technique. Other clients may appreciate the possibility of structuring the transaction in a way that will return the original assets back to the settlor.

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§15.18 V. DRAFTING CONSIDERATIONS

The dispositive provisions of a GRAT are largely governed by the Treasury Regulations. Treas Reg §§25.2702-3(b), (d). The typical GRAT instrument contains few custom provisions other than those pertaining to names, dates, trust term, annuity amount payable, property description, and the disposition at the end of the trust term. If the disposition at the end of the term involves a trust, the terms of the continued trust may be incorporated into the GRAT instrument, but many practitioners prefer to use a separate trust instrument. A separate trust instrument emphasizes the fact that the "continued" trust is really a very different trust in terms of disposition scheme and tax consequences. Regardless of whether a continuing trust or a second trust is used, it is important that the distributive provisions not include any provisions that might cause the original transfer to the GRAT to be an incomplete gift under Treas Reg §25.2511-2(b).

Aside from the need to comply with the regulations, many practitioners go out of their way to avoid custom GRAT provisions on the theory that the provisions can create tax risks without any actual benefit. In particular, to avoid any claim by the IRS that the GRAT corpus should be included in the settlor's estate under IRC §2036 after the trust term has expired, the settlor should generally not have retained interests in the GRAT other than the permissible qualified annuity interest. Specifically, the settlor should not be given any rights with respect to the GRAT corpus after the trust term expires.

Practitioners should avoid spendthrift clauses that would prohibit the settlor or the remaindermen from transferring their interests in the GRAT, for two reasons. First, in *Shackleford v U.S.* (9th Cir 2001) 262 F3d 1028, the court held that transferability restrictions may be taken into account in valuing annuity payments received by lottery winners, despite the rules for valuing annuities in IRC §7520. The IRS may try to use the decision to decrease the value of a retained interest in a GRAT if the settlor has no power to transfer the right to future annuity payments. See §2.22. Second, there may be good transfer tax reasons for arranging for the settlor or the remaindermen to sell or otherwise dispose of interests in a GRAT. For further discussion, see McCaffrey, *The Care and Feeding of GRATs—Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring*, Estate Planning 2006, chap 7 (Cal CEB 2006).

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VI. GRANTOR RETAINED ANNUITY TRUST PROVISIONS

§15.19 A. Form: Declaration of Transfer to Trustee

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15.19-1 Declaration of transfer to trustee

I, _ _[*name of settlor*]_ _ (called the "settlor"), hereby transfer and deliver to _ _[*name of trustee*]_ _, as trustee, the property described in Schedule A attached to this instrument.

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§15.20 B. Form: Trust Name

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15.20-1 Trust name

ARTICLE ONE
Trust Name

The trust created by this instrument may be referred to as the _ _[*full name(s) of settlor(s), e.g., John J. Smith*]**_ _ Grantor Retained Annuity Trust.**

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§15.21 C. Form: Trust Estate

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15.21-1 Trust estate

ARTICLE TWO
Trust Estate

A. *Administration of Trust Estate*. All property subject to this instrument from time to time, including the property listed in Schedule A, is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.

B. *Additional Contributions Prohibited*. No additions may be made to the trust estate during the trust term.

Comment: A prohibition on additional contributions to the GRAT is required by Treas Reg §25.2702-3(b)(5).

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§15.22 D. Form: Irrevocability of Trust

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15.22-1 Irrevocability of trust

ARTICLE THREE
Irrevocability of Trust

This trust is irrevocable and may not be altered or amended.

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§15.23 E. Form: Trust Term

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15.23-1 Trust term

ARTICLE FOUR
Trust Term

This trust is effective immediately and terminates _ _[*number*]_ _ years after the date of this trust. The period before termination is hereafter referred to as the trust term.

Comment: For a discussion of considerations involved in selecting the term, see §15.4.

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.24 F. Form: Operation During Trust Term

§15.24 F. Form: Operation During Trust Term

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15.24-1 Operation during trust term

ARTICLE FIVE
Operation During Trust Term

During the trust term, the trustee shall distribute to the settlor an annuity at the times and in the amounts set forth in this Article Five. If the settlor is not then living, the trustee shall distribute the required annuity amount to the settlor's estate.

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.25 1. Form: Payment for Each Year of Trust

§15.25 1. Form: Payment for Each Year of Trust

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15.25-1 Payment for each year of trust

[*Use one of the following alternatives*]

[*Alternative 1: Payment for each taxable year*]

A. *Payment of Annuity Amount*. The settlor's right to receive the annuity amount shall begin on the date of this document. The trustee may not issue a note, other debt instrument, option, or similar financial arrangement in satisfaction of the annuity amount. The annuity amount shall be payable to the settlor _ _[*annually/semi-annually/quarterly/monthly*]_ _ for each taxable year of the trust term. The annuity amount may be paid after the close of the taxable year as long as the payment is made no later than the date by which the trustee is required to file the federal income tax return of the trust for the year (without regard to extensions) or, if no return is required to be filed because the trust is a grantor trust, the date by which the trustee would be required to file a return if one were required.

[*Alternative 2: Payment based on anniversary date*]

A. *Payment of Annuity Amount*. The settlor's right to receive the annuity amount shall begin on the date of this document. The trustee may not issue a note, other debt instrument, option, or similar financial arrangement in satisfaction of the annuity amount. The annuity amount shall be payable to the settlor _ _[*annually/semi-annually/quarterly/monthly*]_ _ for each year of the trust term from the date of this document. The annuity amount may be paid after the anniversary date of this document as long as the payment is made no later than 105 days after the anniversary date.

Comment: The use of one of these provisions is mandatory, and the payment requirement may not be satisfied by allowing the settlor to withdraw the annuity amount. Treas Reg §§25.2702-3(b)(1)(i), 25.2702-3(b)(4).

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.26 2. Form: Annuity Amount

§15.26 2. Form: Annuity Amount

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15.26-1 Annuity amount

[*Use one of the following alternatives*]

[*Alternative 1: Fixed annuity expressed as a dollar amount*]

B. *Determination of Annuity Amount*. The annuity amount shall equal the sum of _ _[*specify fixed dollar amount*]**_ _.**

[*Alternative 2: Fixed annuity expressed as a percentage of property contributed to GRAT*]

B. *Determination of Annuity Amount*. The annuity amount shall equal _ _[*number*]**_ _ percent of the initial value of the property contributed to this trust as finally determined for federal tax purposes. If this value is incorrectly determined by the trustee then, within a reasonable time after the value is set for federal tax purposes, the trustee shall pay to the settlor (in the case of undervaluation), or the settlor shall repay to the trustee (in the case of overvaluation), an amount equal to the difference between the amount that the trustee should have paid to the settlor and the amount actually paid to the settlor.**

[*Alternative 3: Varying annuity*]

B. *Determination of Annuity Amount*. The annuity amount shall be the following amounts in the following years of the trust term:

Year 1: _ _[*Specify fixed dollar amount or percentage of initial trust value*]**_ _;**

Year 2 and following: _ _[*Specify fixed dollar amount or same or increased percentage of initial contribution or increased percentage of previous year's payment*]**_ _.**

Comment: If the settlor desires certainty in the amount to be received during the trust term, Alternative 1 should be used. Furthermore, if the property initially contributed to the GRAT has an objectively determinable value, expressing the annuity as a fixed dollar amount may facilitate the client's understanding of the document.

When the annuity amount is expressed as a percentage of the trust's initial value, as in Alternative 2, the provision must include language that will correct distributions if an erroneous annuity amount has been distributed because the value of the property contributed to the trust was incorrectly determined. Usually the annuity amount should be expressed as a fraction of the property contributed to the GRAT when the value of the property initially funding the trust is not objectively determinable (such as real estate, closely held stock, or partnership interests) and the client wants to minimize the value of the remainder interest given away. Treas Reg §§25.2702-3(b)(2), 1.664-2(a)(1)(iii). By expressing the annuity amount in this manner, the value of the remainder interest subject to gift tax will equal a fraction of the property initially contributed. The fraction will not change even if the IRS successfully re-values the property contributed to the GRAT on audit. See §15.3.

In Alternative 3, the annuity amount need not remain constant during the trust term. The only limitation is that the annuity amount payable in any year may not exceed 120 percent of the amount payable in the previous year. Treas Reg §25.2702-3(b)(1)(ii). Because this is the only limitation on the annuity amount, apparently the annuity amount can be decreased from one year to the next and the percentage change in the annuity amount from one year to the next need not be constant.

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.27 3. Form: Short Taxable Year

§15.27 3. Form: Short Taxable Year

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15.27-1 Short taxable year

C. *Proration of Annuity Amount*. If a taxable year of the trust is for a period of less than 12 months, including the taxable year in which the trust terminates, the annuity amount shall be the amount otherwise determined for the year, multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

Comment: This provision is mandatory. Treas Reg §§25.2702-3(b)(3). The trust normally will have a short taxable year in the year the annuity begins unless the starting date of the annuity is the first day of a taxable year (*i.e.,* January 1 of a given year). Similarly, the trust normally will have a short taxable year in the year in which the trust term terminates unless the termination date is the last day of a taxable year (*i.e.,* December 31 of a given year).

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§15.28 4. Form: Trust Income

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15.28-1 Trust income

[D]. *Payment of Income to Settlor*. All income of the trust shall be distributed to the settlor no less frequently than annually.

[*If appropriate, add the following option*]

[*Option: Distribution of amount equal to taxes on trust income*]

If the settlor is taxed on trust income not distributed to the settlor, an amount from such income equal to the settlor's taxes on that income shall be distributed to the settlor not less frequently than annually.

Comment: This provision is authorized, but not required, by Treas Reg §25.2702-3(b)(1)(iii). It is not recommended. The provision results in payment to the settlor of trust income in excess of the annuity amount. It has little effect in most GRATs because the annuity amount usually exceeds trust income. Although the distribution of income in excess of the annuity amount to the settlor increases the value of the settlor's retained interest and thereby reduces the value of the remainder interest, its value is zero for gift tax purposes because an income interest is not a qualified interest under IRC §2702. This provision can also be modified to require distribution of capital gains taxes payable by the settlor attributable to GRAT assets. See §15.11.

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.29 5. Form: Limitation on Trust Distributions

§15.29 5. Form: Limitation on Trust Distributions

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15.29-1 Limitation on trust distributions

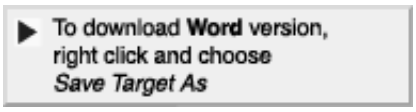
[E]. *No Payments to Other Beneficiaries*. The trustee shall make no distribution to any person other than the settlor or the settlor's estate during the trust term, provided, however, that this provision does not limit the trustee's ability to make distributions for trust expenses.

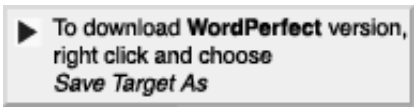
Comment: This provision is mandatory. Treas Reg §25.2702-3(d)(3).

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.30 6. Form: Commutation Prohibited

§15.30 6. Form: Commutation Prohibited





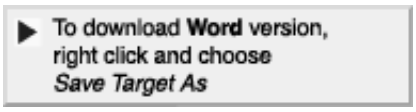
15.30-1 Commutation prohibited

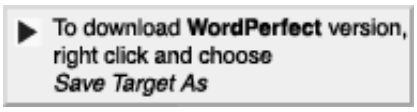
[F]. *Commutation Prohibited*. Commutation (prepayment) of the interest of the settlor is prohibited.

Comment: This provision is mandatory. Treas Reg §25.2702-3(d)(5).

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§15.31 G. Form: Distribution on Expiration of Trust Term





15.31-1 Distribution on expiration of trust term

[G]. ***Payment to Settlor or Settlor's Estate*****. If the settlor survives the expiration of the trust term, the trustee shall pay the settlor all remaining amounts due under the obligation to pay the annuity as set forth herein. If the settlor fails to survive the trust term, the trustee shall pay all remaining amounts due under the obligation to pay the annuity as set forth herein _ _**[*together with/to the settlor's estate. If the settlor is survived by the settlor's spouse, the trustee shall distribute to the settlor's estate annually the income of the trust in excess of the annuity, if any, from the date of death until the expiration of the trust term and the trustee shall pay the portion of the trust estate includable in the settlor's gross estate to the settlor's spouse. If the settlor is not survived by the settlor's spouse, the trustee shall pay*]**_ _ the portion of the trust estate includable in the settlor's gross estate to the settlor's estate. Any amounts remaining after such payment shall be distributed in accordance with Article Six.**

Comment: To determine the amount of the GRAT includable in a deceased settlor's estate, see Rev Rul 82-105, 1982-1 Cum Bull 133. For further discussion, see §15.4. Unlike a GRIT or QPRT, the settlor's reversion if he or she fails to survive the trust term is not a qualified interest and therefore does not reduce the value of the gift in the case of a GRAT. The optional language is designed to permit the trust to qualify for the marital deduction if the settlor dies during the trust term. See discussion in §15.15A.

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§15.32 H. Form: Distributions on Termination

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15.32-1 Distributions on termination

ARTICLE SIX
Distributions on Trust Termination

On expiration of the trust term, this trust shall terminate and be distributed as follows: _ _[*Specify distribution to family members and others.*]_ _

Comment: If the settlor survives the term, the distribution can be made outright or in further trust, but the settlor should not be the trustee of the trust or have any interest in it. See ETIP discussion in §4.29 regarding the inadvisability of traditional generation-skipping transfer tax planning with the GRAT remainder if the settlor survives the trust term.

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§15.33 I. Form: Trustees

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15.33-1 Trustees

ARTICLE SEVEN
Trustees

A. *Nomination of Successor Trustees*. If at any time the _ _[*person/institution*]_ _ named as trustee fails to qualify or ceases to act as trustee, the _ _[*persons/institutions*]_ _ listed below shall serve as successor trustees in the order named:

First: _ _[*Name of successor trustee*]_ _

Second: _ _[*Name of second successor trustee*]_ _

_ _[*If the nominated successor also fails to qualify or ceases to act, _ _[name]_ _ shall have the power to name a successor trustee.*]_ _

B. *Compensation of Trustee*. The trustee shall be entitled to reasonable compensation for services rendered to the trust.

Comment: If a power to name a successor trustee is given to the settlor, the power should expire at the end of the term of the retained interest unless the drafter is certain that the trustee does not hold any powers after the term that would cause inclusion in the settlor's estate if held by the settlor. See §14.15.

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§15.34 J. Form: Trustee Powers

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15.34-1 Trustee powers

ARTICLE EIGHT
Trustee Powers

To carry out the purposes of the trust created by this instrument and subject to any limitations stated elsewhere in this instrument, the trustee shall have the following powers in addition to those conferred by California Trust Law:

A. To retain, purchase, or otherwise acquire underproductive property.

B. To manage, control, grant options on, sell, convey, exchange, partition, divide, improve, and repair trust property.

C. To lease trust property.

D. To borrow money and to encumber trust property by mortgage, deed of trust, pledge, or otherwise.

E. To initiate or defend, at the expense of the trust, any litigation relating to the trust or any property of the trust estate.

F. To carry insurance of the kinds and in the amounts the trustee considers advisable, at the expense of the trust, to protect the trust estate and the trustee personally against any hazard.

G. To partition, allot, and distribute the trust estate on final distribution in undivided interests or in kind, or partly in money and partly in kind, at valuations determined by the trustee, and to sell any property the trustee considers necessary for division or distribution. The trustee may, in the trustee's discretion, make a nonprorata division between beneficiaries if the respective assets distributed to the beneficiaries have equivalent or proportionate fair market values. The income tax bases of assets distributed nonprorata need not be equivalent and may vary to a greater or lesser amount, as determined by the trustee in the trustee's discretion.

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.35 K. Form: Applicable Law

§15.35 K. Form: Applicable Law

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15.35-1 Applicable law

ARTICLE NINE
Applicable Law

The laws of the State of California shall govern the validity, construction, interpretation, and administration of this trust.

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.36 L. Form: Statement of Intent

§15.36 L. Form: Statement of Intent

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15.36-1 Statement of intent

ARTICLE TEN
Statement of Intent

It is the settlor's intent that this trust shall provide the settlor with a qualified annuity interest under Treasury Regulation §25.2702-3(b) and (d). All provisions of this instrument shall be interpreted according to this intention. Unless prohibited by the Code, Treasury Regulations, or any revenue rulings, revenue procedures, notices, or other administrative pronouncements by the Internal Revenue Service, the trustee shall have the power, without application to any court, to amend the provisions of this document to comply with any additional requirements for qualification as a Grantor Retained Annuity Trust under Internal Revenue Code §2702.

Executed at _ _[*city*]_ _ , California, on _ _[*date*]_ _.

__[*Signature of trustee*]__
_ _[*Typed name*]_ _
Trustee

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

[*Acknowledgment; see §8.12*]

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.37 M. Form: Description of Transferred Property

§15.37 M. Form: Description of Transferred Property

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15.37-1 Description of transferred property

SCHEDULE A

Property Transferred and Delivered to the Trustee

_ _[*Describe property*]_ _

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Source: Estate Planning/Drafting California Irrevocable Trusts/15 Grantor Retained Annuity Trusts (GRATs)/§15.38 N. Form: GRAT Client Memorandum

§15.38 N. Form: GRAT Client Memorandum

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GRANTOR RETAINED ANNUITY TRUST

***Purpose of GRAT*. A grantor retained annuity trust (GRAT) is a trust that pays an annuity to the grantor for a specified term of years. At the end of the term, the property remaining in the trust will be distributed to the grantor's children or to another continuing trust. The purpose of a GRAT is that any income and appreciation generated by the trust assets during the term in excess of the IRS's assumed interest rate at the time the trust is created will pass to the remainder beneficiaries free of any gift or income taxes. The value of the grantor's interest in the assets is "frozen" at the current value plus an annual return calculated at the IRS's assumed interest rate.**

***Estate and Gift Tax Benefit*. The transfer of property to a GRAT is a completed gift for gift tax purposes. The amount of the gift, however, can be structured to be nearly zero. This is done by adjusting the annuity amount and the trust term so that the present value of the retained annuity interest is almost equal to the value of the property plus the IRS's assumed interest rate. *Example:* If $1,000,000 is transferred to a GRAT with a $119,600 (11.96 percent) annuity for a term of 10 years at the May 2010 assumed interest rate of 3.4 percent, the taxable gift would be $300.**

***Income Tax*. The GRAT is a "grantor trust," meaning that all of the trust income is taxed to the grantor directly. This is helpful from an estate planning perspective because it means that income taxes do not diminish the trust property.**

***Annuity Amount*. The annuity amount must be paid to the grantor on an annual basis. If the income earned by the trust assets is not sufficient to pay the annuity, as is usually the case, principal can be used. Because of the grantor trust status, there are no income tax consequences of distributing appreciated assets to the grantor. Alternatively, the trust could borrow funds from a third party, unrelated to the grantor, to pay the annuity. However, the trustee cannot borrow funds to pay the annuity from the grantor or pay the annuity with promissory notes.**

***Graduated Annuity*. The annuity amount may start low and increase each year by 20 percent. Although the payout rate in the later years may be higher than it would be with a fixed payout rate, this alternative should be used for long-term (*e.g.,* 10-year) GRATs because the reduced payout rate in the early years more than makes up for the larger payments required in later years.**

***Termination*. At the end of the trust term, any remaining trust property is paid to the grantor's children or a family trust. If the cumulative return generated by the trust assets during the term of the trust has exceeded the IRS's assumed interest rate at the start of the trust, there will be assets to distribute. If the GRAT earns 0 percent income but the trust principal grows at 8 percent per year in the above example, the amount distributable after payment of the $119,600 annuity to the grantor for 10 years would be $426,332 per $1 million of initial value contributed to the GRAT. Note that this amount is distributable free of tax even though there was almost no taxable gift when the GRAT was created.**

Using an increasing annuity payment yields an even better result. In the above example, the annuity payout rate could start as low as 4.836 percent and increase by 20 percent each year. With an increasing annuity, the amount distributable at the end of the term in this example would be $533,702 per $1 million of initial funding. The annuity amount for each year is shown in the following table:

Year	Payout Rate	Annuity Amount
1	4.8360	$ 48,360

2	**5.8032**	**58,032**
3	**6.9638**	**69,638**
4	**8.3566**	**83,566**
5	**10.0279**	**100,279**
6	**12.0335**	**120,335**
7	**14.4402**	**144,402**
8	**17.3282**	**173,282**
9	**20.7939**	**207,939**
10	**24.9526**	**249,526**

***Discountable Assets*. Value shifting can be achieved even if the GRAT does not earn an annual total return (income plus appreciation) greater than the IRS assumed rate at inception, if the GRAT is funded with assets (*e.g.,* stock in a closely-held company, limited partnership interests) that can be discounted for lack of marketability and lack of control. In the above example, if the funding assets could be discounted by 40 percent, and if the GRAT earned a return equal to the IRS §7520 rate (3.4 percent for May 2010) for a term of 2 years, then the amount distributable at the end of the term, after payment of a $315,390 annuity (not an increasing annuity because of the short term) to the grantor for 2 years, would be $427,652.**

***Valuation*. There is no "valuation risk" with a GRAT in which the annuity amount is defined as a percentage of the initial value of trust assets. The annuity payout is self-adjusting, so that if the assets placed in the trust were determined by the IRS to be of greater value than claimed, the effect would simply be to increase the annuity amount. Also, if the trust assets did not increase in value sufficiently to cause a tax-free transfer of assets to the remainder beneficiaries, there would at least be no downside (other than transaction costs), and the grantor would be no worse off than if the trust had not been created.**

***Death Before End of Term*. If the grantor dies before the end of the trust term, a portion or all of the trust will be included in the grantor's estate for estate tax purposes. The included portion should be that fraction of the trust estate that would be required to be invested at the IRS's assumed interest rate (as of the date of death) to produce annual income equal to the annuity payment, but the IRS asserts that the entire trust is includable. Even in that case, however, the grantor would be no worse off than if the trust had not been created.**

Comment: This form is based on a sample client memorandum that originally appeared in the February 2005 issue of The Marin Lawyer. It is used with the permission of the author, Theodore A. Hellman of Hanson Bridgett, San Francisco. For a sample QPRT memorandum, see §17.67.

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16

Grantor Retained Unitrusts (GRUTs)

Marc M. Stern

I. OVERVIEW OF GRANTOR RETAINED UNITRUSTS (GRUTs)
- A. GRUT Objectives and Design §16.1
- B. GRUT Valuation Benefits §16.2
- C. Selecting GRUT Term §16.3
- D. GRUT Requirements and Permissible Terms §16.4
  - 1. Assets Used to Fund GRUT §16.5
  - 2. Required Governing Instrument Provisions §16.6
  - 3. Fractional Interests §16.7

II. TAX CONSIDERATIONS
- A. Income Tax Issues §16.8
- B. Spousal Interests §16.9
- C. Repurchase/Exchange Strategy for Obtaining New Basis §16.10
- D. California Real Property Tax Considerations §16.11
- E. Integration Into Settlor's Estate Plan §16.12

III. CALCULATING VALUE OF GRUT GIFT §16.13

IV. WHEN TO USE GRUT §16.14

V. DRAFTING CONSIDERATIONS §16.15

VI. GRANTOR RETAINED UNITRUST PROVISIONS
- A. Form: Declaration of Transfer to Trustee §16.16
- B. Form: Trust Name §16.17
- C. Form: Trust Estate §16.18
- D. Form: Irrevocability of Trust §16.19
- E. Form: Trust Term §16.20
- F. Form: Operation During Trust Term §16.21
  - 1. Form: Payment for Each Year of Trust §16.22
  - 2. Form: Unitrust Amount §16.23
  - 3. Form: Correcting Distributions §16.24
  - 4. Form: Short Taxable Year §16.25
  - 5. Form: Trust Income §16.26
  - 6. Form: Limitation on Trust Distributions §16.27
  - 7. Form: Commutation Prohibited §16.28
  - 8. Form: Distribution on Expiration of Trust Term §16.29
- G. Form: Distributions on Termination §16.30
- H. Form: Trustees §16.31
- I. Form: Trustee Powers §16.32
- J. Form: Applicable Law §16.33
- K. Form: Statement of Intent §16.34
- L. Form: Description of Transferred Property §16.35

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I. OVERVIEW OF GRANTOR RETAINED UNITRUSTS (GRUTs)

§16.1 A. GRUT Objectives and Design

The grantor retained unitrust (GRUT) is an irrevocable trust in which the grantor/settlor retains the right to a unitrust interest, a fixed percentage of the fair market value of the trust, redetermined annually, for a specified term. The objectives resemble those of the traditional "common law GRIT" before Congress began to legislate restrictions in this area.

- At the end of the specified term, the trust terminates and the corpus is distributed to the remainder beneficiaries.
- Alternatively, the trust might continue to function for the benefit of other beneficiaries, but the settlor must cease to have any interest or power that would cause the trust property to be included in the settlor's estate.
- In addition, the trust instrument will typically provide that, if the settlor dies during the trust term, the portion of the trust includable in the settlor's gross estate will be distributed as appointed in the settlor's will or, if not so appointed, to the settlor's revocable trust or estate.

A GRUT provides the settlor with a qualified unitrust interest. Because the special valuation rules of IRC §2702 are thus satisfied by the settlor's retention of a qualified interest, the remainder beneficiaries may be "members of the family" of the settlor. In IRC §2702(e), "member of the family" of an individual is defined in the same way as in IRC §2704(c)(2):

- The individual's spouse;
- Any ancestor or lineal descendant of the individual and the spouse of any such person;
- Any ancestor or lineal descendant of the individual's spouse and the spouse of any such person; and
- Any brother or sister of the individual and the spouse of any such sibling.

The benefit of the GRUT arrangement results from the computation of the value of the gift that is made on transfer to the trust. Although IRC §2702 applies, the settlor retains a qualified unitrust interest so that the value of the gift is the value of the property transferred to the trust less the present actuarial value of that retained unitrust interest for the trust term. (The IRS previously took the position in a regulation that the qualified interest was limited to the unitrust interest for the shorter of the trust term and the settlor's lifetime, but the regulation was declared invalid in *Audrey J. Walton* (2000) 115 TC 589, acq 2003-44 Int Rev Bull 964.) The nature of the unitrust is not affected by the applicable interest rate under IRC §7520 except with respect to the adjustment necessary if the payment is not made annually at the beginning of the year. See §§6.30-6.31. The adjustment factor is valued using the IRS's actuarial tables and an assumed interest rate (rounded to the nearest 0.2 percent) equal to 120 percent of the federal midterm rate, compounded annually, in effect under IRC §1274(d)(1) for the month in which the gift is made. The GRUT differs from a charitable remainder unitrust (CRUT) in that:

- The unitrust payable to the settlor from the GRUT need not be a fixed percentage (for discussion of amounts payable under a CRUT, see chap 18).
- The retained unitrust interest from a GRUT can vary from year to year, both increasing and decreasing, provided that the increase from one year to the next does not exceed 120 percent. Treas Reg §25.2702-3(c)(1)(ii).

Because the settlor's retained unitrust interest is a fixed percentage of the trust value, redetermined annually, it is impossible to zero-out a GRUT. Accordingly, the benefit associated with zeroed-out GRATs is not available in a GRUT. See chap 15.

PRACTICE TIP: GRUTs are seldom used because the transfer tax benefits of a GRUT are inferior to the benefits of a GRAT (see chap 15), or the benefits of a common-law GRIT (see chap 14) or the equivalent benefits of a QPRT (see chap 17). However, a settlor who wishes to share in the future appreciation of transferred property may want to consider a GRUT.

The calculation of the gift element of a GRUT differs from the calculation of the gift element of a GRIT in two respects:

- First, the retained interest is valued as a unitrust interest rather than as an income stream provided by a GRIT.
- Second, there is no reduction for the contingent reversion if the settlor fails to survive the trust term, because the settlor's reversionary interest is not a qualified interest except to the extent of the unitrust interest and therefore is valued at zero under IRC §2702(a)(2).

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§16.2 B. GRUT Valuation Benefits

If the settlor survives the term, the GRUT method of valuing the gift will typically result in a greater transfer of wealth to the remainder beneficiaries than would occur if the settlor simply made a transfer, without a retained interest in the property, that had the same value as the gift determined under these rules.

EXAMPLE 1: In May 2010, *X,* whose age is 60 on the nearest birthday, transferred property worth $800,000 to a GRUT paying the settlor 3.4 percent of the trust's value at the end of each year during a 7-year term. The GRUT is subject to the IRC §2702 valuation rules because one or more remainder beneficiaries is a member of *X*'s family. The value of the gift is 78.49 percent of the value of the property transferred to the GRUT, or $627,957. See §16.13. If we assume that GRUT property increases in value at a rate of 8 percent annually (both income and appreciation), the remainder beneficiaries will receive assets worth $1,096,000 at the end of the 7-year term. Note that because the settlor shares in the GRUT appreciation or depreciation, the benefits to the remainder beneficiaries under the GRUT are not as great as those under the GRAT. Assuming that the asset is then sold by the beneficiaries and capital gains tax on the appreciation is paid, they will still have a fund of $1 million.

EXAMPLE 2: Instead of creating a GRUT, the client makes an outright gift of $627,957 (the gift component of the GRUT). For the donees to have a fund of $1 million free and clear at the end of 7 years, the donees would need an investment that generates an after-tax return of 7 percent per annum. If the return rate is a more conservative 5 percent after tax, the donees would have a fund of $883,598 at the end of 7 years. Thus, the GRUT has shifted approximately $100,000 of additional wealth out of the settlor's estate and into the hands of the donees.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.3 C. Selecting GRUT Term

§16.3 C. Selecting GRUT Term

A GRUT can be established for any term desired, but the settlor is often motivated to reduce the tax cost of the transfer by providing for a long trust term. The longer the period that a unitrust interest in the GRUT is retained by the settlor, the smaller the value of the remainder gift. If the settlor fails to survive the GRUT's term, however, all or most of the GRUT corpus will be included in the settlor's estate because of the retained unitrust interest under IRC §2036. Treas Reg §20.2036-1(c) (providing method to determine portion of GRUT includable in settlor's estate). Thus, selecting the GRUT's term is something of a gamble, and the drafter must assist the settlor in selecting a term that is both long enough to provide a favorable reduced tax cost and short enough that the settlor is likely to survive the term to realize the favorable tax treatment of the GRUT.

If too long a trust term is selected, so that the settlor has no realistic likelihood of surviving it, the inclusion of all or a substantial portion of the GRUT corpus in the settlor's gross estate may result in more severe taxes than would have occurred if the settlor had made an outright gift rather than creating the GRUT. The outright gift would have eliminated the transfer tax on the increased value of the transferred property between the date of the gift and the date of death.

Compared with doing nothing, however, the only cost is the transaction costs associated with creating the GRUT because all of the GRUT corpus would have been included in the settlor's gross estate anyway, although the gift tax paid on the GRUT will be wasted if estate tax repeal becomes permanent. The advantage of the GRUT diminishes as the length of the term increases, because each year added to the term of the retained unitrust interest reduces the gift by fewer dollars than the addition of the previous year. This is illustrated by the following table:

Value of Gift per $100,000 of Fair Market Value of the Assets Transferred on Creation of GRUT Paying Settlor Unitrust Amount of 3.4 Percent Annually

Retained term of settlor's interest	*Value of remainder interest after expiration of trust term*	*Incremental reduction in value for additional year*
0	$100,000	NA
1	96,600	$3,400
2	93,316	3,284
3	90,143	3,173
4	87,078	3.065
5	84,117	2,961
6	81,257	2,860
7	78,495	2,762
8	75,826	2,669
9	73,248	2,578
10	70,757	2,491

The following table indicates the likelihood that the settlor will fail to survive a chosen term. These figures are derived from statistics that do not take into account gender, health status, health and diet habits, or accessibility to health care services. The survival prospects of any particular individual may differ substantially.

Probability of Surviving Specified Number of Years After Given Age

	Percentage	*Percentage*	*Percentage*

Additional years	*after age 55*	*after age 65*	*after age 75*
1	99	98	96
2	99	97	92
3	98	95	88
4	97	93	83
5	96	91	79
6	95	89	74
7	94	86	69
8	93	84	64
9	92	81	59
10	90	79	53

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.4 D. GRUT Requirements and Permissible Terms

§16.4 D. GRUT Requirements and Permissible Terms

The requirements and permissible terms for a GRUT are regulated by Treas Reg §25.2702-3(c)-(d). As a result, the typical GRUT governing instrument contains relatively few custom terms except for the provisions relating to (1) the unitrust interest to be paid to the settlor and (2) the distribution of the remainder after the period of the settlor's retained interest expires.

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§16.5 1. Assets Used to Fund GRUT

Any property can be used to fund a GRUT, even unproductive property. Treas Reg §25.7520-3(b)(2)(v), Example (4). In establishing the GRUT, however, the actual payment of the unitrust interest must be considered. The regulations require that the unitrust interest actually be paid to the settlor for a given year no later than the date by which the trustee is required to file the trust's federal income tax return for the trust for that year, without regard to extensions or 105 days after the anniversary date of the creation of the trust. Treas Reg §25.2702-3(c)(4). The regulations provide that the GRUT must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the unitrust obligation. Treas Reg §25.2702-3(d)(6). If the GRUT assets are unproductive or underproductive, the trustee must invade principal to satisfy the annual payment requirement. Depending on the nature of the GRUT assets, this could require the return of property to the settlor at a value deeply discounted from the prorata fair market value of the property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.6 2. Required Governing Instrument Provisions

§16.6 2. Required Governing Instrument Provisions

In general, the required provisions of Treas Reg §25.2702-3(c)-(d) create a trust subject to the following rules:

- The GRUT must provide the settlor with an irrevocable right to receive a fixed percentage of the net fair market value of the trust assets, determined annually. The net fair market value of the trust assets must be determined according to Treas Reg §25.2522(c)-3(c)(2)(vii). The unitrust amount must be payable to or for the benefit of the settlor each year of the term. A right of withdrawal, even if cumulative, does not create a qualified interest. The unitrust payment may be made after the close of a calendar year, but can be made no later than the due date of the trust's federal income tax return for that year (determined without extensions as if the trustee were required to file a return). Treas Reg §25.2702-3(c)(1), (4).
- The percentage of the trust property to be paid each year may never increase by more than 120 percent of the prior year's unitrust payment. The GRUT must contain provisions to adjust for:
- The proper unitrust amount that should have been paid consistent with the requirements of Treas Reg §1.664-3(a)(1)(iii) (Treas Reg §25.2702-3(c)(2)); and
- The proper prorated unitrust amount that should be paid in a short taxable year (Treas Reg §25.2702-3(c)(3)).
- To prevent circumvention of the GRUT rules, the trust must:
- Satisfy the requirements of a GRUT in all respects,
- Meet the definition of and operate exclusively as a GRUT at all times (Treas Reg §25.2702-3(d)(1));
- Provide that payment of the unitrust amount is not subject to any contingency other than the survival of the settlor, or for a revocable interest described in Treas Reg §25.2702-2(a)(6) (see §16.9), the settlor's right to revoke the qualified interest of the settlor's spouse (Treas Reg §25.2702-3(d)(2));
- Prohibit distributions to anyone other than the settlor during the trust term (Treas Reg §25.2702-3(d)(3));
- Have a stated term (Treas Reg §25.2702-3(d)(4));
- Prohibit a commutation of the settlor's interest (a premature termination in which the settlor receives the present value of the remaining unitrust interest and the remainder beneficiaries receive the rest of the trust assets) (Treas Reg §25.2702-3(d)(5)); and
- Prohibit the trustee from issuing promissory notes or other debt instruments in satisfaction of the unitrust obligation (Treas Reg §25.2702-3(d)(6)).

The stated term may be for a term of years, the settlor's lifetime, or the lesser (but not the greater) of a term of years and the settlor's lifetime. Treas Reg §25.2702-3(d)(4).

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§16.7 3. Fractional Interests

The value of a gift attributable to a transfer to a GRUT is a fraction of the value of the contributed property. In addition, various lack-of-control and lack-of-marketability discounts may be applied in determining the value of the underlying transferred property if assets like undivided interests in real estate, shares of closely held stock, or limited partnership interests are transferred to the GRUT. See discussion in §2.23E. Such compounding allows the transfer tax value of a discounted asset to be further reduced to take into consideration the settlor's retained interest.

Furthermore, fractional interests in an asset entirely owned by the settlor can be transferred to multiple GRUTs (or other retained interest trusts) with different remainder beneficiaries, different dispositive terms, or different trust terms. This fractionalizing of an asset will probably generate an additional level of discounts from 15 percent to 45 percent, depending on the nature of the transferred asset. Additionally, the establishment of multiple GRUTs allows the settlor to hedge the bet that he or she will survive the trust term; the settlor is limited to establishing a single GRUT on an "all or nothing" basis and then hope to survive that single GRUT's term.

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II. TAX CONSIDERATIONS

§16.8 A. Income Tax Issues

The settlor of a GRUT is entitled to receive a unitrust payment from the trust during its term. When the term expires, the trust corpus will pass to remainder beneficiaries irrevocably specified in the GRUT instrument. For income tax purposes, the GRUT should be considered a grantor trust as to both ordinary income and "principal income" under IRC §677(a), because it is possible that the current year's ordinary and principal income might be needed to satisfy the unitrust payment in a future year. Furthermore, the settlor has an interest in the GRUT principal because of the settlor's reversionary interest in the trust principal if he or she dies during the trust term, even though this reversionary interest has no value for gift tax purposes under IRC §2702. See discussion in §15.11.

Although the settlor can use the income received from the GRUT to pay the income taxes attributable to the trust's income, if the trust's income exceeds the unitrust payment, the settlor may lack funds to pay the taxes attributable to the undistributed trust income or to pay the income taxes attributable to the trust's undistributed income. From an overall tax perspective, this produces a positive economic result because the settlor's estate is reduced by, in effect, paying the taxes of the remainder beneficiaries. For a particular settlor, however, this result may be outweighed by the difficulties associated with paying large income taxes without a source of funds to make the payments.

To alleviate the foregoing problem, the GRUT can provide for additional distributions of trust income to the settlor, either all income or sufficient income to reimburse the settlor for any taxes paid on income not received by the settlor. The Treasury Regulations authorize distribution to the settlor of GRUT income that accrues in addition to the amount to satisfy the unitrust payment, although the right to receive excess income is not a qualified interest and therefore has no value under IRC §2702. Treas Reg §25.2702-3(b)(1)(iii). Income is not defined in either IRC §2702 or the Treasury Regulations under that section. Presumably, income includes both ordinary and principal income. See IRC §643(b) (income refers to income of all types except for certain purposes under IRC §§651-668). Thus, a settlor concerned about a tax liability in excess of income may include a reimbursement clause without adversely affecting the trust's status as a GRUT.

A reimbursement clause or any other provision authorizing additional distributions from the GRUT to the settlor should not provide a settlor-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 settlor must realize, however, that retaining the right to receive additional distributions, even if required, will not reduce the GRUT remainder value for gift tax purposes.

As indicated earlier in this section, the GRUT will be considered a grantor trust. Thus it is an eligible shareholder of an S corporation, a corporation as to which the shareholders have made an election under IRC §1362.

Besides ensuring qualification of the trust to hold S corporation stock and allowing the settlor to pay the taxes on any undistributed trust income, additional benefits to having the trust considered a grantor trust result from the IRS's position in Rev Rul 85-13, 1985-1 Cum Bull 184, that the settlor and his or her grantor trust are a single entity for income tax purposes and there can not be tax transactions between the two. For example:

- Appreciated assets can be distributed to the settlor from the GRUT to satisfy the unitrust 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 unitrust amount will give rise to gain. *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217.
- The settlor can sell property to or purchase property from the trust without income tax consequences.
- The settlor can lend money to the GRUT without generating additional income from the 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* (1984) 465 US 330, 79 L Ed 2d 343, 104 S Ct 1086. The settlor should only loan funds to a GRUT in extraordinary circumstances. If the loan is used, or the IRS believes that it has been used, to make a required unitrust payment, the trust may cease to qualify as a GRUT. See §16.5.

An unrelated tax issue is the loss of a stepped-up basis for the trust assets on the settlor's death if the settlor survives the trust term. IRC §1014. In this situation, the income tax basis of the trust assets will equal their basis in the settlor's hands immediately before the contribution, increased with respect to any gift tax payable attributable to the transfer, but in no case more than the fair market value of the transferred property. IRC §§1015(a), (d). The consequences may be serious if assets with a very low basis are transferred to the GRUT. See discussion in §16.10.

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§16.9 B. Spousal Interests

Because of the gift tax marital deduction requirements, it is generally *not* advisable to make a spouse a concurrent income beneficiary of a GRUT. The transfer will qualify for the marital deduction only if the requirements of a qualified terminable interest trust, as defined in IRC §2523(f)(2), are satisfied. One requirement is that the spouse have a qualifying income interest for life. IRC §2523(f)(2)(B). The GRUT term has been selected, however, so that it is likely to terminate before the settlor's death. Thus, it is possible that the trust will also terminate before the spouse dies. Therefore, there is no guarantee that the spouse will receive a qualifying income interest for life, notwithstanding the spouse's age and the length of the trust term. The Ninth Circuit has held that a spouse's revocable right to receive the remaining unitrust payments if the settlor fails to survive the term is a qualified interest. See *Schott v Commissioner* (9th Cir 2003) 319 F3d 1203. This would allow the gift element of the transfer to be reduced by the value of the spouse's revocable unitrust interest. The regulations take the contrary position that a revocable spousal interest is a qualified interest only if the interest is not subject to any contingency other than either the survival of the holder or the settlor's right to revoke. Treas Reg §§25.2702-2(a)(6), 25.2702-3(d)(2). This position is clarified in Treas Reg §25.2702-3(e), Examples 8-9, which conclude that if the spouse receives a revocable annuity for a fixed term of years after the settlor's death, that annuity is a qualified interest; but if the spouse receives only a revocable annuity for the balance of a fixed term that remains after the settlor's death, the interest is not qualified because it is contingent on the death of another person. Court decisions from other jurisdictions have ruled in favor of the regulation position. See *Cook v Commissioner* (7th Cir 2001) 269 F3d 854; *Estate of Claude C. Focardi*, TC Memo 2006-56. There is little reason to use such a provision, however, because better results can be achieved by providing that the unitrust amount is payable to the settlor's estate if the settlor dies during the term. This results in a gift equal to the value of the transferred property reduced by the right to a unitrust payment for the trust term, eliminating any increase in the value of the gift that results if the unitrust payment is contingent on survival of either the settlor or the spouse. See *Audrey J. Walton* (2000) 115 TC 589, acq 2003-44 Int Rev Bull 964.

When a husband and wife hold joint or community property, the foregoing problem and attendant adverse tax consequences can be avoided by dividing the co-owned property so that each spouse holds half as separate property. Each spouse can then establish a separate GRUT to which his or her separate property is transferred. As discussed in §16.7, this approach may have the incidental effect of lowering the value of the transferred property because each spouse's gift involves only a fractional share of an asset, rather than the transfer of a 100-percent interest in the asset. These fractional shares of an asset are each likely to be valued at less than the prorata value of the undivided interest actually contributed to the GRUTs. See *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248 (allowing a 15-percent discount on deceased spouse's one-half community property interest in certain property).

The primary drawback of dividing community property equally between spouses as their separate property is that the step-up in basis for both halves of the property will not be available if one spouse dies during the term of his or her GRUT. IRC §1014(b)(6). The establishment of a GRUT (even an ill-advised joint-spouse GRUT) precludes characterization of the trust property as community property because property held in trust can retain its character as community property *only* if the trust is revocable. Fam C §761. If the basis step-up is important, the settlor's characterizing the GRUT as a grantor trust will be useful. The settlor can repurchase or exchange high-basis assets held by the settlor with low-basis assets of equivalent fair market value held by the GRUT shortly before the trust term expires without adverse income tax consequences. See §16.10.

A pitfall to avoid when creating a GRUT for a married settlor is gift splitting under IRC §2513. See §17.15 for further discussion of this issue.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.10 C. Repurchase/Exchange Strategy for Obtaining New Basis

§16.10 C. Repurchase/Exchange Strategy for Obtaining New Basis

A potential deterrent to the use of a GRUT is the possibility that neither the settlor's estate nor the GRUT remainder beneficiaries will receive a new income tax basis for the trust assets on the settlor's death. IRC §1014. This problem can be serious when a settlor transfers highly appreciated assets to the GRUT.

To alleviate this problem, experienced practitioners commonly recommend that the settlor repurchase the GRUT assets shortly before the term expires. The IRS has identified this strategy with respect to the repurchase of a home from a QPRT as an area of abuse because it believes that residences were allowed special treatment under IRC §2702 and the repurchase subverts congressional intent. Accordingly, the IRS has issued regulations that prohibit the settlor or the settlor's spouse from reacquiring a personal residence held by a QPRT during the QPRT term. Treas Reg §25.2702-5(b)(1), (c)(9). For a GRUT, the repurchase strategy apparently continues to be a viable option.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.11 D. California Real Property Tax Considerations

§16.11 D. California Real Property Tax Considerations

The real property tax consequences of a GRUT include the following:

- The initial transfer to the trust is a transfer for the benefit of the settlor that is not a change of ownership under Rev & T C §62(d), and thus a reassessment is avoided.
- The expiration of the settlor's term interest in the trust may trigger a reassessment unless the parent-child (Rev & T C §63.1(a)(1)-(2)) (and in some cases, the grandparent-grandchild (Rev & T C §63.1(a)(3)) transfer exclusion applies. (Transfers to registered domestic partners are also excluded from reassessment under Rev & T C §62(p), but settlors are unlikely to create GRUTs for them because they are also eligible for common law GRITs, which have superior transfer tax benefits. See chap 14.) The parent-child exclusion must be claimed within 3 years of the transfer to the children or before the children transfer the residence to a third person other than a parent or child, whichever occurs first. Rev & T C §63.1(e)(1)(B). The State Board of Equalization (SBE) takes the position that the transfer to the children occurs at the expiration of the settlor's retained interest rather than on the creation of the trust. However, the SBE guidelines are *not* binding on local assessors. If not sooner filed, a claim of exclusion may be filed within 6 months after a notice of supplemental or escape assessment was issued as a result of the transfer. Rev & T C §63.1(e)(1)(C).

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§16.12 E. Integration Into Settlor's Estate Plan

Use of a GRUT can create problems in carrying out the settlor's overall dispositive desires. If the settlor survives the GRUT term, the trust property will not be included in the settlor's gross estate and no estate tax will be apportioned to its assets. The transfer to the GRUT will give rise, however, to a taxable gift by the donor, which is considered in determining the estate taxes payable at the settlor's death. Because the gift arising from the transfer to the GRUT may consume a significant portion of the settlor's unified credit, it may be difficult to achieve the settlor's other objectives, such as equality among children and the issue of deceased children.

EXAMPLE: *Y* has an estate of $6 million. *Y* establishes a GRUT with property valued at $3 million and having a remainder value of $1.5 million. The GRUT provides that, on the expiration of *Y*'s unitrust interest, trust property will be distributed outright to such of *Y*'s two children who are then living. A compensating gift is made in *Y*'s revocable trust to the issue of either child who predeceases the expiration of the GRUT term. *Y* and one child survive the expiration of the GRUT term, but the other child dies before the GRUT term expires. The GRUT generates sufficient income to pay the unitrust interest and none of its assets appreciates in value during the settlor's retained term.

Based on the foregoing facts, at the time of *Y*'s death, the surviving child will have received $3 million from the GRUT at the expiration of its term. No transfer taxes were paid with respect to *Y*'s transfer to the GRUT because of the unified credit. *Y*'s estate planning documents provide for a compensating gift of $3 million to the issue of the deceased child. The estate tax on *Y*'s remaining $3 million estate is approximately $1.4 million, and only approximately $1.6 million is available for distribution to the deceased child's issue.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.13 III. CALCULATING VALUE OF GRUT GIFT

§16.13 III. CALCULATING VALUE OF GRUT GIFT

The value of the gift that is made when a GRUT is created can be calculated by using the tables in IRS Publication 1458 or by using commercial estate planning computer software that incorporates the IRS tables. Using a computer program is a practical necessity because 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 settlor's earlier death, as required by Treas Reg §25.2702-3(e), Example 5. The practical necessity of using a computer program is further illustrated by the complexity of the computation. The following is the calculation for the value of a remainder interest for property worth $800,000 transferred to a trust in which a 60-year-old settlor retains a unitrust interest of 3.4 percent of the trust value, redetermined annually, for 7 years, and an alternative calculation reported in §16.2 based on the assumption that Treas Reg §25.2702-3(e), Example 5, does not apply. The value of the reminder interest in the alternative calculation does not depend on the age of the settlor.

The first step is to determine the applicable interest rate. Under IRC §7520, the applicable interest rate is the rate (rounded to the nearest 0.2 percent) equal to 120 percent of the federal midterm rate, compounded annually, in effect under IRC §1274(d) for the month in which the transfer to the GRAT occurs. In the example below, the interest rate used for this calculation will be 3.4 percent (the IRC §7520 interest rate for May 2010). For a GRUT, this first step is relevant to determining the adjusted payout rate only if the payout is not made annually at the end of each year with the valuation date less than one month before the first payment date.

Alternative Calculation: Under *Audrey J. Walton* (2000) 115 TC 589, acq 2003-44 Int Rev Bull 964, the unitrust remainder factors in the second step are not used. See §15.6. Under *Walton,* the value of the GRUT gift is calculated by multiplying the term certain unitrust remainder factor for the right to receive the unitrust interest for 7 years by the value of the property transferred to the GRUT:

Start with:	
Value of GRUT property	$800,000
Multiply by:	
Unitrust remainder factor	.784946
Equals (remainder interest)**:**	$627,957

The second step is to calculate the unitrust remainder factor for the right to receive the unitrust interest for the period of 7 years or for the settlor's life, whichever is less. Factors are for the settlor's age at inception and at the expiration of the trust term.

Start with:	
Payout rate	.034
Divide by:	
Retention rate (1 − 0.034)	.966
Equals ("interest" rate)**:**	.03284
Retention rate for 7-year term is 0.966^7, which equals 0.78495	
Continue:	
Table 2000CM at age 67 (see §6.10)	79,530
Divide by:	
Table 2000CM at age 60	87,595
Equals:	.90793
Multiply by:	
Retention rate for term	.78495

Equals factor 1: .71268

1. Years	0	1	2	3	4	5	6
2. Retention rate for period	.96600	.93316	.90143	.87078	.84417	.81257	.78495
3. TABLE 2000CM for age plus year	87595	86681	85691	84620	83465	82224	80916
4. TABLE 2000CM for age plus year plus 1	86681	85691	84620	83465	82224	80916	79530
5. Row 3 - Row 4	914	990	1071	1155	1241	13083	1386
6. Row 5 ´ Row 2	882.9	923.8	965.4	1005.8	1047.6	1062.8	1087.9

Because the settlor's retained term is 7 years, the above table has entries for years 0 through the term less 1 year, or 6. If the retained term is for a longer period, the table will require additional columns.

Add:
Entries from row 6 of table 6976.2

Divide by:
Table 2000CM at age 60 87,595

Equals: .07964

Multiply by:
Adjustment factor (1 + (.03284 "interest" ¸ 2)) 1.01642

Equals factor 2: .08095

Add:
Factor 1 .71268

Equals (total transferred interest)**:** .79363

Subtract:
1 − 0.79363

Equals (total retained interest)**:** .20637

The third step is to determine the gift tax value of the remainder interest by multiplying the unitrust remainder factor by the value of the property transferred to the GRUT:

Start with:
Value of GRUT property $800,000

Multiply by:
Unitrust remainder factor .79493

Equals (remainder interest)**:** $634,902

For further discussion of valuing the gift of income and remainder interests, see chap 6.

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§16.14 IV. WHEN TO USE GRUT

In deciding whether to use a GRUT, the attorney should discuss the following questions with the client:

- Is the client willing to lose the step-up in basis and the ownership of assets? Ownership and basis may be minor concerns in some situations, such as when an asset has a high basis after the death of a spouse and there is no concern (although there is no prearrangement) that the remainder beneficiaries will make the assets available to the settlor after the GRUT term expires.
- What is the opportunity cost, not just on paper but in probable behavior? Will creating a GRUT make it less likely that the client will make annual exclusion gifts? Will funding the GRUT with particular assets preclude the settlor's transfer of other assets that should be transferred, such as interests in a family business? Or, is no opportunity sacrificed, because the client would otherwise do nothing?
- Is there a satisfactory probability that the client can survive the term?
- Is it a reasonable probability that the property transferred to the GRUT will appreciate during the term?

Although the GRUT is not for everyone, in many situations it may be an appropriate part of a client's estate plan. A GRUT is particularly appropriate for the settlor who anticipates that the value of GRUT assets will increase and wants to share in that increased value.

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§16.15 V. DRAFTING CONSIDERATIONS

The dispositive provisions of a GRUT are largely governed by the Internal Revenue Code Regulations. Treas Reg §25.2702-3(c)-(d). The typical GRUT instrument contains few custom provisions other than those pertaining to names, dates, trust term, annuity amount payable, property description, and the disposition at the end of the trust term. If the disposition at the end of the term involves a trust, the terms of the continuing trust may be incorporated into the GRUT instrument, but many practitioners prefer to use a separate trust instrument. A separate trust instrument emphasizes the fact that the "continued" trust is really a very different trust in terms of disposition scheme and tax consequences. Regardless of whether a continuing trust or a second trust is used, it is important that the distributive provisions not include any provisions that might cause the original transfer to the GRUT to be an incomplete gift under Treas Reg §25.2511-2(b).

Aside from the need to comply with the Regulations, many practitioners go out of their way to avoid custom GRUT provisions on the theory that the provisions can create tax risks without any actual benefit. In particular, to avoid any claim by the IRS that the trust corpus should be included in the settlor's estate under IRC §2036 after the trust term has expired, the settlor should generally not have retained interests in the GRUT other than the permissible qualified unitrust interest. Specifically, the settlor should not be given any retained rights with respect to the trust corpus after the trust term expires.

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VI. GRANTOR RETAINED UNITRUST PROVISIONS

§16.16 A. Form: Declaration of Transfer to Trustee

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16.16-1 Declaration of transfer to trustee

I, _ _[*name of settlor*]_ _ (called the "settlor"), hereby transfer and deliver to _ _[*name of trustee*]_ _, as trustee, the property described in Schedule A, attached to this instrument.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.17 B. Form: Trust Name

§16.17 B. Form: Trust Name

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16.17-1 Trust name

ARTICLE ONE
Trust Name

The trust created by this instrument may be referred to as the _ _[*full name(s) of settlor(s), e.g., John J. Smith*]**_ _ Grantor Retained Unitrust.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.18 C. Form: Trust Estate

§16.18 C. Form: Trust Estate

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16.18-1 Trust estate

ARTICLE TWO
Trust Estate

All property subject to this instrument from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.

Comment: A prohibition on additional contributions to the GRUT is not required.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.19 D. Form: Irrevocability of Trust

§16.19 D. Form: Irrevocability of Trust

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16.19-1 Irrevocability of trust

ARTICLE THREE
Irrevocability of Trust

This trust is irrevocable and may not be altered or amended.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.20 E. Form: Trust Term

§16.20 E. Form: Trust Term

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16.20-1 Trust term

ARTICLE FOUR
Trust Term

This trust is effective immediately and terminates on the expiration of a period of _ _[*number*]_ _ years from the date of this trust. The period before termination is hereafter referred to as the trust term.

Comment: For a discussion of considerations involved in selecting the term, see §16.3.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.21 F. Form: Operation During Trust Term

§16.21 F. Form: Operation During Trust Term

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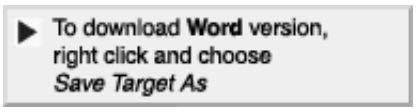
16.21-1 Operation during trust term

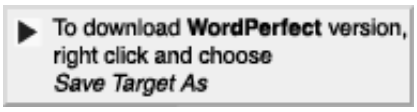
ARTICLE FIVE
Operation During Trust Term

During the trust term, the trustee shall distribute to the settlor, at the times set forth in this Article Five, an amount equal to the percentage specified below of the value of the trust assets determined annually on the first business day of each taxable year of the trust. If the settlor is not then living, the trustee shall distribute the required amount to the settlor's estate.

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§16.22 1. Form: Payment for Each Year of Trust





16.22-1 Payment for each year of trust

[*Use of one of the following alternatives*]

[*Alternative 1: Payment for each taxable year*]

A. The settlor's right to receive the unitrust amount shall begin on the date of this document. The trustee may not issue a note, other debt instrument, option, or similar financial arrangement in satisfaction of the unitrust amount. The unitrust amount shall be payable to the settlor _ _[*annually/semi-annually/quarterly/monthly*]**_ _ for each taxable year of the trust term. The unitrust amount may be paid after the close of the taxable year, as long as the payment is made no later than the date by which the trustee is required to file the federal income tax return of the trust for the year (without regard to extensions) or, if no return is required to be filed because the trust is a grantor trust, the date by which the trustee would be required to file a return if one were required.**

[*Alternative 2: Payment based on anniversary date*]

A. The settlor's right to receive the unitrust amount shall begin on the date of this document. The trustee may not issue a note, other debt instrument, option, or similar financial arrangement in satisfaction of the unitrust amount. The unitrust amount shall be payable to the settlor _ _[*annually/semi-annually/quarterly/monthly*]**_ _ for each year of the trust term from the date of this document. The unitrust amount may be paid after the anniversary date of this document as long as the payment is made no later than 105 days after the anniversary date.**

Comment: The use of one of these provisions is mandatory; and the payment requirement may not be satisfied by allowing the settlor to withdraw the unitrust amount. Treas Reg §§25.2702-3(c)(1)(i), 25.2702-3(c)(4).

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.23 2. Form: Unitrust Amount

§16.23 2. Form: Unitrust Amount

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16.23-1 Unitrust amount

[*Use of one of the following alternatives*]

[*Alternative 1: Fixed interest*]

B. The specified percentage of the trust value to be distributed to the settlor each year shall equal _ _[*specify percentage of initial trust value*]_ _**.**

[*Alternative 2: Varying unitrust interest*]

B. The specified percentage of the trust value to be distributed to the settlor each year shall equal

Year 1: _ _[*specify percentage*]_ _

Year 2 and following: _ _[*specify varying percentages for each year*]_ _

Comment: The unitrust payout percentage need not remain constant during the trust term. The only limitation is that the unitrust amount payable in any year may not exceed 120 percent of the amount payable in the previous year. Treas Reg §25.2702-3(c)(1)(ii). Because this is the only limitation on the unitrust amount, apparently the unitrust amount can be decreased from one year to the next and the percentage change in the unitrust amount from one year to the next need not be constant.

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§16.24 3. Form: Correcting Distributions

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16.24-1 Correcting distributions

C. If at any time the value of the trust's assets is incorrectly determined by the trustee then, within a reasonable time after the value is set for federal tax purposes, the trustee shall pay to the settlor (in the case of undervaluation), or the settlor shall repay to the trustee (in the case of overvaluation), an amount equal to the difference between the amount that the trustee should have paid to the settlor and the amount actually paid to the settlor.

Comment: The language dealing with correcting distributions if an erroneous unitrust amount has been distributed because the value of the trust property has been incorrectly determined is required. Treas Reg §§25.2702-3(c)(2), 1.664-3(a)(1)(iii). If the value of any property held by the trust is not objectively determinable (such as real estate, closely held stock, or partnership interests), it may be advisable to have an independent party value that property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.25 4. Form: Short Taxable Year

§16.25 4. Form: Short Taxable Year

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16.25-1 Short taxable year

D. If a taxable year of the trust that is for a period of less than 12 months, including the taxable year in which the trust terminates, the unitrust amount shall be the amount otherwise determined for the year, multiplied by a fraction, the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

Comment: This provision is mandatory. Treas Reg §§25.2702-3(c)(3), 1.664-3(a)(1)(v). The trust normally will have a short taxable year in the year the unitrust begins unless the starting date of the unitrust is the first day of a taxable year (*i.e.,* January 1 of a given year). Similarly, the trust normally will have a short taxable year in the year in which the trust term terminates unless the termination date is the last day of a taxable year (*i.e.,* December 31 of a given year).

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.26 5. Form: Trust Income

§16.26 5. Form: Trust Income

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16.26-1 Trust income

[E]. All income of the trust shall be distributed to the settlor no less frequently than annually.

[*If appropriate, add the following option*]

[*Option: Distribution of amount equal to taxes on trust income*]

If the settlor is taxed on trust income not distributed to the settlor, an amount from such income equal to the settlor's taxes on that income shall be distributed to the settlor no less frequently than annually.

Comment: This provision is authorized, but not required, by Treas Reg §25.2702-3(c)(1)(iii). It is not recommended. The provision results in payment to the settlor of trust income in excess of the unitrust amount. Although the distribution of income in excess of the unitrust amount to the settlor increases the value of the settlor's retained interest and thereby reduces the value of the remainder interest, its value is zero for gift tax purposes because an income interest is not a qualified interest under IRC §2702. This provision can also be modified to require distribution of capital gains taxes payable by the settlor attributable to GRUT assets. See §16.8.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.27 6. Form: Limitation on Trust Distributions

§16.27 6. Form: Limitation on Trust Distributions

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16.27-1 Limitation on trust distributions

[F]. The trustee shall make no distribution to any person other than the settlor during the trust term. provided, however, that this provision does not limit the trustee's ability to make distributions for trust expenses.

Comment: This provision is mandatory. Treas Reg §25.2702-3(d)(3).

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.28 7. Form: Commutation Prohibited

§16.28 7. Form: Commutation Prohibited

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16.28-1 Commutation prohibited

[G]. Commutation (prepayment) of the interest of the settlor is prohibited.

Comment: This provision is mandatory. Treas Reg §25.2702-3(d)(5).

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.29 8. Form: Distribution on Expiration of Trust Term

§16.29 8. Form: Distribution on Expiration of Trust Term

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16.29-1 Distribution on expiration of trust term

[H]. If the settlor survives the expiration of the trust term, the trustee shall pay the settlor all remaining amounts due under the obligation to pay the unitrust amount as set forth herein. If the settlor fails to survive the trust term, the trustee shall pay all remaining amounts due under the obligation to pay the unitrust amount as set forth herein together with the portion of the trust estate includable in the settlor's gross estate to the settlor's estate. Any amounts remaining after such payment shall be distributed in accordance with Article Six.

Comment: To determine the amount of the GRUT includable in a deceased settlor's estate, see Treas Reg §20.2036-1(c)(2). For further discussion, see §16.3. Unlike a GRIT or a QPRT, the settlor's reversion if he or she fails to survive the trust term is not a qualified interest and therefore does *not* reduce the value of the gift in the case of a GRUT.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.30 G. Form: Distributions on Termination

§16.30 G. Form: Distributions on Termination

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16.30-1 Distributions on termination

ARTICLE SIX
Distributions on Trust Termination

On expiration of the trust term, this trust shall terminate and be distributed as follows: _ _[*Specify distribution to family members and others.*]_ _

Comment: If the settlor survives the term, the distribution can be made outright or in further trust, but the settlor should not be the trustee of the trust or have any interest in it. See ETIP discussion in §4.29 regarding the inadvisability of traditional generation-skipping transfer tax planning with the GRUT remainder if the settlor survives the trust term. The drafter should also keep in mind that the perpetuities period begins when the GRUT is established and not at the expiration of the trust term.

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§16.31 H. Form: Trustees

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16.31-1 Trustees

ARTICLE SEVEN
Trustees

A. If at any time the _ _[*person/institution*]**_ _ named as trustee fails to qualify or ceases to act as trustee, the _ _**[*persons/institutions*]**_ _ listed below shall serve as successor trustees in the order named:**

First: _ _[*Name of successor trustee*]**_ _**

Second: _ _[*Name of second successor trustee*]**_ _**

_ _[*If the nominated successor also fails to qualify or ceases to act, _ _*[*name*]*_ _ shall have the power to name a successor trustee.*]**_ _**

B. The trustee shall be entitled to reasonable compensation from time to time for services rendered to the trust.

[*If appropriate, add the following option*]

[*Option: Nomination of special trustee*]

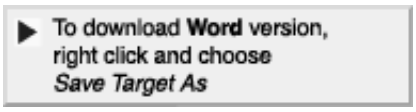
C. Notwithstanding the provisions of Paragraph A above, _ _[*name*]**_ _ of _ _**[*city*]**_ _, California, shall act as special trustee for the sole purpose of making the required annual valuation of trust assets. _ _**[*If the nominated successor also fails to qualify or ceases to act, _ _*[*name*]*_ _ shall have the power to name a successor trustee.*]**_ _**

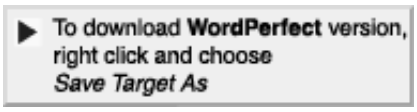
Comment: If a power to name a successor trustee is given to the settlor, the power should expire at the end of the term of the retained interest unless the drafter is certain that the trustee does not hold any powers after the term that would cause inclusion in the settlor's estate if held by the settlor. See §14.15.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.32 I. Form: Trustee Powers

§16.32 I. Form: Trustee Powers





16.32-1 Trustee powers

ARTICLE EIGHT
Trustee Powers

To carry out the purposes of the trust created by this instrument, and subject to any limitations stated elsewhere in this instrument, the trustee shall have the following powers in addition to those conferred by California Trust Law:

A. To retain, purchase, or otherwise acquire underproductive property.

B. To manage, control, grant options on, sell, convey, exchange, partition, divide, improve, and repair trust property.

C. To lease trust property.

D. To borrow money and to encumber trust property by mortgage, deed of trust, pledge, or otherwise.

E. To initiate or defend, at the expense of the trust, any litigation relating to the trust or any property of the trust estate.

F. To carry, at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.

G. To partition, allot, and distribute the trust estate on final distribution in undivided interests or in kind, or partly in money and partly in kind, at valuations determined by the trustee, and to sell any property the trustee considers necessary for division or distribution. The trustee may, in the trustee's discretion, make a nonprorata division between beneficiaries if the respective assets distributed to the beneficiaries have equivalent or proportionate fair market values. The income tax bases of assets distributed nonprorata need not be equivalent and may vary to a greater or lesser amount, as determined by the trustee in the trustee's discretion.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.33 J. Form: Applicable Law

§16.33 J. Form: Applicable Law

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16.33-1 Applicable law

ARTICLE NINE
Applicable Law

The laws of the State of California shall govern the validity, construction, interpretation, and administration of this trust.

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.34 K. Form: Statement of Intent

§16.34 K. Form: Statement of Intent

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16.34-1 Statement of intent

ARTICLE TEN
Statement of Intent

It is the settlor's intent that this trust shall provide the settlor with a qualified unitrust interest under Treasury Regulation §25.2702-3(c)-(d). All provisions of this instrument shall be interpreted according to this intention. Unless prohibited by the Code, Treasury Regulations, or any revenue rulings, revenue procedures, notices, or other administrative pronouncements by the Internal Revenue Service, the trustee shall have the power, without application to any court, to amend this document to comply with any additional requirements for qualification as a Grantor Retained Unitrust under Internal Revenue Code §2702.

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of trustee*]__
_ _[*Typed name*]_ _

__[*Signature of settlor*]__
_ _[*Typed name*]_ _

[*Acknowledgment; see §8.12*]

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Source: Estate Planning/Drafting California Irrevocable Trusts/16 Grantor Retained Unitrusts (GRUTs)/§16.35 L. Form: Description of Transferred Property

§16.35 L. Form: Description of Transferred Property

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16.35-1 Description of transferred property

SCHEDULE A
Property Transferred and Delivered to the Trustee

_ _[*Describe property*]_ _

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17

Qualified Personal Residence Trusts (QPRTs)

Bruce Givner
Owen Kaye
Bruce D. Whitley

I. OVERVIEW OF QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRTs)
- A. Purpose and Use of QPRTs §17.1
  - 1. Applicable Statute and QPRT Regulations §17.2
  - 2. Note on Using Acronyms With Clients §17.3
  - 3. Example of QPRT §17.4
  - 4. Are QPRTs Underused? §17.5
- B. Advantages of QPRTs §17.6
  - 1. Tax Advantages of QPRTs §17.7
    - a. Gift Tax Advantage of QPRT §17.8
    - b. Estate Tax Advantage of QPRT §17.9
    - c. Income Tax Advantage of QPRT §17.10
  - 2. Creditor Advantages of QPRT §17.11
    - a. Diminishing Value of Retained Interest §17.12
    - b. Fraudulent Transfer Limitations §17.13
    - c. Bankruptcy Protection §17.14
- C. Disadvantages of QPRTs §17.15
  - 1. Tax Disadvantages of QPRTs §17.16
  - 2. Financial Disadvantages of QPRTs §17.17
    - a. When Encumbered Property Used §17.18
    - b. Effect on Financial Statements §17.19
    - c. Reduced Ability to Borrow §17.20
    - d. Payment of Rent After Term Ends §17.21
- D. Candidates for QPRTs §17.22
- E. Expenses of QPRTs
  - 1. Initial Expenses §17.23
  - 2. Ongoing Expenses §17.24

II. TAX CONSIDERATIONS
- A. Requirements of QPRT Regulations §17.25
  - 1. Personal Residence Requirement §17.26
    - a. Appurtenant Structures §17.27
    - b. Fractional Interests §17.28
    - c. Community Property §17.29
  - 2. Required Governing Instrument Provisions §17.30
  - 3. Summary of Governing Instrument Regulations §17.31
  - 4. Required Conversion to GRAT §17.32
- B. Gift Tax Considerations for QPRT
  - 1. Transfer of Residence as "Completed Gift" §17.33
  - 2. No Qualification for Gift Tax Annual Exclusion §17.34
- C. Estate Tax Treatment of QPRT
  - 1. Treatment if Grantor Survives §17.35
    - a. Gift of Further Term Interest §17.36
    - b. Power to Extend QPRT Term §17.37
  - 2. Treatment if Grantor Fails to Survive §17.38
  - 3. Transfer Tax Apportionment §17.39
- D. Income Tax Issues Related to QPRT §17.40
  - 1. Need for Grantor Trust Status §17.41
  - 2. Loss of Preferential Tax Basis Treatment §17.42
  - 3. Grantor Trust Status Strategies §17.43
  - 4. Grantor Trust Status for GRAT §17.44

E. GST Tax Considerations §17.45
F. State Tax Considerations §17.46
1. Real Property Tax §17.47
2. Documentary Transfer Tax §17.48

III. STRUCTURING THE QPRT §17.49
A. Selecting QPRT Term §17.50
1. Pure Estate Tax Motivation §17.51
2. Fear of Paying Rent §17.52
3. Creditor Concerns §17.53
B. Calculating Value of QPRT Gift §17.54
C. How Many QPRTs? §17.55
D. How Many Residences? §17.56
E. Naming Trust as Remainder Beneficiary §17.57
F. Example of "Reverse" QPRT §17.58

IV. ALTERNATIVES TO QPRT §17.59
A. Outright Gift §17.60
B. Sale-Leaseback §17.61
C. Part-Gift, Part-Sale §17.62
D. Family Limited Partnership §17.63
E. Grantor Retained Annuity Trust §17.64
F. Joint Purchase §17.65
G. "Zeroed-Out" QPRT §17.66
H. Intentionally Defective QPRT §17.67
I. Summary of Alternatives to QPRT §17.68

V. DRAFTING QPRT §17.69
A. Form: Declaration of Transfer to Trustee §17.70
B. Form: Trust Name §17.71
C. Form: Trust Estate §17.72
D. Form: Limit on Additions to Trust Estate §17.73
E. Form: Irrevocability of Trust §17.74
F. Form: Trust Term §17.75
G. Form: Operation During Trust Term §17.76
1. Form: Limitations on Trust Property §17.77
2. Form: Separate Account for Cash Additions §17.78
3. Form: Exclusive Use of Residence §17.79
4. Form: Trust Income to Settlor §17.80
5. Form: Distribution of Excess Cash §17.81
6. Form: Limit on Trust Distributions §17.82
7. Form: Payment of Trust Expenses §17.83
8. Form: Sale of Residence §17.84
9. Form: Damage to or Destruction of Personal Residence §17.85
10. Form: Cessation of Use as Personal Residence §17.86
11. Form: Cessation of QPRT Status §17.87
12. Form: Prohibition on Transfer to Settlor §17.88
H. Form: Distributions on Termination §17.89
1. Form: Trust Operations Account §17.90
2. Form: Trust Income §17.91
3. Form: Remaining Trust Estate §17.92
I. Form: Conversion to Annuity Trust §17.93
1. Form: Payment of Annuity §17.94
2. Form: Beginning Date/Deferral of Payment §17.95
3. Form: Payment for Each Year of Trust §17.96
4. Form: Annuity Amount §17.97
5. Form: Short Taxable Year §17.98
6. Form: Value of Trust Estate §17.99
7. Form: Prohibition Against Additions §17.100
8. Form: No Distributions to Other Persons §17.101
9. Form: Commutation Prohibited §17.102
10. Form: Distribution on Expiration of Trust Term §17.103
J. Form: Office of Trustee §17.104
K. Form: Trustee Powers §17.105
L. Form: Governing Law §17.106

M. Form: Statement of Intent §17.107
N. Form: Description of Transferred Property §17.108
O. Form: Distribution on Termination if Settlor Survives §17.109
P. Form: QPRT Client Memorandum §17.110
Q. Form: Sample Letter Transmitting Draft QPRT to Client §17.111
R. Form: QPRT Diagrams for Husband and Wife §17.112

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I. OVERVIEW OF QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRTs)

§17.1 A. Purpose and Use of QPRTs

In most situations a qualified personal residence trust (QPRT) is a way for a parent to transfer a residence to children at a dramatically reduced transfer tax cost. In other situations it can be a way to lessen the attractiveness of the residence's equity to a currently unforeseeable creditor. In short, a QPRT can be a way to achieve both goals: transfer tax reduction and asset protection.

As discussed in this chapter, a QPRT is a particular form of grantor retained income trust (GRIT). It owes its existence to the enactment of IRC §2702, which eliminated the advantages of using GRITs in estate plans that benefit specified family members (*i.e.,* a grantor's spouse, ancestors and descendants of the grantor or spouse, the grantor's siblings, or the spouse of any of these relatives). See §17.2. On using these acronyms with clients, see §17.3. For a typical example of a QPRT, see §17.4. On the underuse of QPRTs, see §17.5. Advantages of QPRTs are discussed in §§17.6-17.14. Disadvantages of QPRTs are discussed in §§17.15-17.21. On QPRT planning and client counseling, see §17.22. On QPRT expenses, see §§17.23-17.24.

For a detailed discussion of tax considerations, see §§17.25-17.48. On structuring the QPRT, see §§17.49-17.58. On alternatives to a QPRT, see §§17.59-17.68. On drafting the QPRT (with complete forms), see §§17.69-17.112. For further discussion, see McCaffrey & Schneider, *Qualified Personal Residence Trusts—The Shelter for Your Shelter*, Estate Planning 2007, chap 7 (Cal CEB 2007).

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§17.2 1. Applicable Statute and QPRT Regulations

In general, the applicable statute (IRC §2702) is quite brief, and the regulations are quite long. As a result, a QPRT is almost entirely a creature of the detailed regulations. Treas Reg §25.2702-5.

Internal Revenue Code §2702 established a valuation rule that applies to the gift made when a grantor transfers property to a trust that benefits the grantor and the grantor's family members. Under this rule, the value of the gift is the value of all property transferred to the trust, minus only "qualified" interests retained by the grantor. The income and contingent reversion interests retained by the grantor in a typical GRIT are not "qualified" interests. See chap 14. Thus, if a client funds a trust with $1,000,000 for the benefit of a child and retains the right to all trust income for 10 years, the plainly punitive result under §2702 is that the client is considered to make a $1-million gift when the trust is created, even though the actual economic benefit to the child is considerably less.

Section 2702 contains an important exception, however. The special valuation rule does not apply to a transfer that "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." IRC §2702(a)(3)(A)(ii).

Were the statute read literally, this exception would be of questionable value due to the practical problems that might arise in administering a trust that could not hold cash and, arguably, could never sell the residence. Fortunately, the regulations promulgated under IRC §2702(a)(3)(A)(iii) allow these problems to be addressed if a personal residence trust satisfies the QPRT requirements. The regulations also provide for a personal residence trust (PRT) that is *not* qualified, but the nonqualified trust is an unlikely choice for the estate planner because it retains the limits of the statute itself. PRTs may have uses, however, due to the regulation prohibiting repurchase by the grantor. See §17.42. For further discussion, see Blattmachr, Slade & Zeydel, *Partial Interests—GRATs, GRUTs, QPRTs (Section 2702)*, Tax Management Portfolios 836-2d (2007).

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§17.3 2. Note on Using Acronyms With Clients

Before Chapter 13 (IRC §§2701-2704) was added to the Internal Revenue Code, these structures were known as "House GRITs." Then they became QPRTs. Now there is a nonqualified version of these structures known as a personal residence trust (PRT). When the residence that is part of a QPRT is sold, the trust converts to a GRAT (grantor retained annuity trust). See §17.32. One of the alternatives to a QPRT to consider for a residence is a family limited partnership (FLP). See §17.63. However, practitioners must be careful in using these acronyms with clients and their advisors for fear of confusion. Use of acronyms also helps perpetuate one of the chief criticisms that clients have of lawyers, which is their attitude of condescension.

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§17.4 3. Example of QPRT

Mom, age 65, has a residence worth $1,000,000, free and clear, and $5,000,000 of other assets. She has previously used none of her $1,000,000 lifetime transfer tax exclusion. The fact that she has so much in other assets is important for two reasons. First, it means that she has a realistic belief that she will have a taxable estate and she would like to reduce the amount of estate taxes that will be imposed on what passes to her adult Son. Second, it means that she is not likely going to need the equity in the residence to provide retirement income.

Mom has, according to Table 2000CM (the mortality table prescribed in Temp Treas Reg §20.2031-7T(d)(7)), an almost 18-year life expectancy. Also, her own parents are alive at ages 95 and 92. Thus, the table may understate her actual life expectancy. She reviews, with her lawyer, the gift that would be created by QPRTs of various terms, calculated using the 3.4-percent applicable federal rate (AFR) for May 2010, as discussed in chap 6:

Term of Retained Interest (Years)	*Value of Gift*	*Term of Retained Interest (Years)*	*Value of Gift*
0	$1,000,000	16	$339,730
1	951,730	17	306,390
2	904,670	18	274,360
3	858,690	19	243,800
4	813,680	20	214,810
5	769,600	21	187,510
6	726,450	22	162,020
7	684,190	23	138,460
8	642,740	24	116,890
9	602,040	25	97,390
10	562,040	26	79,970
11	522,760	27	64,650
12	515,720	28	51,380
13	446,660	29	40,080
14	409,980	30	30,650
15	374,300		

Mom initially likes the idea of a 15-year term, in light of the fact that she has—according to the standard mortality table—an 18-year life expectancy. She realizes that her own life expectancy might be a lot more, given the fact that her parents are still alive. However, were she to select, for example, a 20-year term, that would reduce the gift by only $159,490, or about $32,000 per additional year. Since the QPRT is an all-or-nothing technique, because the entire value of the QPRT will be included in her estate if she dies during the term, she decides that the extra risk is not worthwhile.

She settles on a 15-year term both because she is likely to survive that term and because she is not concerned about having to pay rent after the end of that term. She retains the right to live in the residence rent free for the 15-year term and, if she dies before the end of the term, the residence reverts to her estate.

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§17.5 4. Are QPRTs Underused?

Some practitioners have noted that "QPRTs… remain underutilized." Anderson & Chae, *Keeping the "Family" In the Family Home: Special Planning Challenges Posed By QPRT Trusts*, 7 Cal Trusts & Est Q 4 (Winter 2001). Empirical evidence suggests that little has changed since that article was published. On January 9, 2009, the question was posed to a roomful of 50 CPAs: "How many of you have *any* clients who have their home in a QPRT?" Four hands were raised. The next question was posed: "How many of you have, in your practice, more than one client with a home in a QPRT?" Only one hand was raised. But see Stein, *Importance of Trusts In Asset Protection*, 12 Cal Trusts & Est Q 17 (Winter 2007) ("[t]he qualified personal residence trust (QPRT) is an irrevocable trust very frequently used for both estate planning and asset protection"). See also Choate, The QPRT Manual: The Estate Planner's Guide to Qualified Personal Residence Trusts (2004) (available at http://www.ataxplan.com).

Some of the underuse, no doubt, stems from the parent's fear of having to pay rent at the end of the QPRT term. Perhaps the development of "reverse" or "return" QPRTs (see §17.36) will ease that fear and contribute to a greater usage of QPRTs. Some of the underuse stems from a lack of experience on the part of the professional community. It is hoped that the examples in this chapter will make it easier to spot situations in which QPRTs are appropriate, and make counsel feel more comfortable reviewing QPRTs with their clients as a normal part of the estate planning process. Some of the underuse is attributable to a misunderstanding of how QPRTs make the equity in the residence truly unattractive to a future creditor.

Finally, in terms of estate tax planning, perhaps QPRTs were not underused in the past because there were not that many taxable estates. The Tax Policy Center (TPC), a joint venture of the Urban Institute and the Brookings Institution, indicates that almost 33,000 estates filed returns in 2007, but fewer than half of those estates (14,700) had to pay any estate tax at all (http://www.taxpolicycenter.org/briefing-book/key-elements/estate/how-many.cfm). The estate tax liability totaled $21.2 billion. For 2009, TPC projects that 14,900 estate tax returns were filed, of which only 5500 owed estate tax, totaling about $13.8 billion. In 2011, however, assuming a $1 million exclusion (see chap 2), an estimated 108,200 estates of decedents dying that year will file estate tax returns and 44,200 of those estates will pay taxes totaling $34.4 billion. So, perhaps QPRTs should be implemented in more situations.

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§17.6 B. Advantages of QPRTs

QPRTs provide two types of advantages: (1) tax advantages (see §§17.7-17.10); and (2) creditor protection advantages (see §§17.11-17.14).

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§17.7 1. Tax Advantages of QPRTs

As discussed in chap 14, the basic design and objectives of the QPRT are those of what was known as a "common law GRIT" before Congress began to legislate restrictions in this area. The typical common law GRIT is an irrevocable trust in which the grantor retains the right to all trust income for a specified term. At the end of the term, the trust terminates and the corpus is distributed to the remainder beneficiaries (or the trust might continue to function for the benefit of other beneficiaries). However, the grantor must cease to have any interest or power that would (1) cause the grantor to be taxed on trust income (see chap 3) or (2) cause the trust property to be included in the grantor's estate (see chap 2) after the end of the term. Also, the trust instrument will typically provide that if the grantor dies during the term, the trust will end immediately and the trust estate will be distributed to the grantor's estate, to the grantor's revocable trust, or as appointed in the grantor's will.

The perceived benefit of this arrangement results from the method used to value the gift that is made on transfer to the trust. If IRC §2702 does not apply, the value of the gift is the value of the property transferred to the trust minus the following:

- The value of an income interest for the lesser of the trust term or the grantor's life; and
- The value of right of reversion of the entire trust corpus to the grantor in the event of his or her death during the term.

For purposes of this calculation, the two retained interests are valued under IRC §7520, using the Internal Revenue Service's actuarial tables and an assumed interest rate (rounded to the nearest 0.2 percent) equal to 120 percent of the federal midterm rate, compounded annually, in effect under IRC §1274(d)(1) for the month in which the valuation date falls. See chap 6.

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§17.8 a. Gift Tax Advantage of QPRT

If the grantor survives the term, the QPRT method of valuing the gift will typically result in a greater transfer of wealth to the remainder beneficiaries than would occur if the grantor simply made a transfer, without retained interests of property, that had the same value as the gift determined under these rules.

EXAMPLE 1: In May 2010, a 60-year-old widower transfers a house worth $800,000 to a GRIT with a 7-year term that is not subject to the IRC §2702 valuation rules because the trust meets the requirements of a QPRT. The value of the gift, using the IRC §7520 interest rate for that month of 3.4 percent, is 71.847 percent of $800,000, or $574,776. (The value of the retained income interest is 20.019 percent, or $160,152, and the value of the reversionary interest is 8.134 percent, or $65,072.) If the residence appreciates at 5 percent each year, the remainder beneficiaries will receive a house worth $1,125,680 at the end of the 7-year term. Assuming that the house is then sold by the beneficiaries and capital gains tax on the appreciation is paid, they will still have a fund of more than $1 million. Note that most of the gain in this example ($250,000) can be excluded from the grantor's taxable income if the house is sold before the end of the term. See §17.41.

EXAMPLE 2: Instead of creating a QPRT, the client makes an outright gift of $574,776 (the gift tax value for the QPRT). For the donee to have property worth $1 million at the end of 7 years, the donee would need an investment that would generate a rather unlikely after-tax rate of return of 9 percent per year. If the return rate is a more realistic 5 percent after tax, the donee would end up with a fund of $808,768. Thus, the QPRT has shifted approximately $200,000 of additional wealth out of the grantor's estate and into the donee's hands. Furthermore, the client will probably find that a transfer of the residence to a QPRT is less onerous than an immediate $574,776 gift.

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§17.9 b. Estate Tax Advantage of QPRT

The estate tax advantage of the QPRT is simple: If the grantor survives the term, the value of the assets will be excluded from the grantor's taxable estate. In the typical situation, the house has appreciated and it is not included in the parent's estate.

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§17.10 c. Income Tax Advantage of QPRT

The income tax advantage of a QPRT is that it is a "grantor trust." As such, the trust's existence is ignored and the grantor is entitled to deduct the property taxes and interest (if any) on the mortgage. In addition, if the residence is sold, the grantor is entitled to exclude the first $250,000 of capital gain under IRC §121.

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§17.11 2. Creditor Advantages of QPRT

A residence in a QPRT is not completely protected from a future creditor. However, once it has been in a QPRT for many years, the equity is much less attractive to a creditor because the value of the grantor's retained interest in the trust decreases. See §17.12. (This assumes that the transfer of the residence to the QPRT was not a fraudulent transfer by the grantor (see §17.13) and that the grantor manages to avoid bankruptcy (§17.14).)

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§17.12 a. Diminishing Value of Retained Interest

The grantor's retained interest in the QPRT is an asset that is available to a judgment creditor. However, as each year of the retained term passes, the value of that retained interest becomes less valuable.

EXAMPLE: Mom is now in Year 5 of her 15-year QPRT in §17.4. A creditor has a $1,000,000 judgment against Mom. Mom no longer has the $5,000,000 in other assets; they have been lost in legal fees and poor investments. What is the value of Mom's retained interest? The following table shows the value of her retained interest for each year of the 15-year term (*e.g.*, $437,960 in Year 5):

Years Remaining in 15-Year Term	*Value of Retained Interest*
15	$625,700
14	590,020
13	553,340
12	515,720
11	477,240
10	437,960
9	397,960
8	357,260
7	315,810
6	273,550
5	230,400
4	186,320
3	141,310
2	95,330
1	48,270

Even knowing that the retained interest has a value, how does the judgment creditor realize that value? After all, the judgment creditor is most interested in a lump sum of cash. Does the judgment creditor prevail on the judge to remove Mom from the house so that the judgment creditor can place a tenant in the home and collect rent from the tenant? That will not work, as discussed in §17.32, because once the residence is not Mom's residence, the QPRT trustee must sell the residence and convert the trust to a grantor retained annuity trust (GRAT). Even if the residence has appreciated in value, the annuity payments are based on the original value at the time of the transfer to the QPRT. The judgment creditor will then have to seize the annuity payments. However, suppose the trustee fails to make the annuity payments; does that force the judgment creditor into yet another lawsuit? These uncertainties and problems motivate most judgment creditors to settle with Mom on terms that are attractive to Mom (compared with what would have occurred had she still owned the residence).

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§17.13 b. Fraudulent Transfer Limitations

Two types of transfers may be fraudulent: (i) one made with actual intent to hinder, delay or defraud the creditor; and (ii) one made without receiving reasonably equivalent value for the transfer. CC §3439.04. See §1.8. What if Mom's transfer of the residence to the QPRT in May 2010 (see §17.4) is attacked by the judgment creditor as a fraudulent transfer? If this type of attack is successful, the hurdles described in §17.12 will disappear because the transfer to the QPRT will be unwound. At first glance, Mom's transfer seems vulnerable to the fraudulent transfer attack because she did not receive equivalent value (the home was worth $1,000,000 and the value of her retained interest was only $625,700). However, has the creditor's fraudulent transfer claim been raised in a timely fashion?

The statute of limitations on fraudulent transfers is "4 years/1 year/7 years" defined as follows: (i) the normal limitations period is 4 years from the date of transfer; (ii) however, if the creditor is unaware of the transfer (creditors are almost always unaware of the transfer), then the period may be extended to 1 year after the transfer was discovered or reasonably could have been discovered; (iii) in no event may the period be extended to more than 7 years from the date of the transfer. CC §3439.09. In this regard, QPRTs are special because the transfer to the QPRT requires recording the deed to the property in the name of the QPRT trustee. Recording a deed is deemed to put the world on notice, even if the creditor is actually unaware of the transfer. Therefore, the statute of limitations for a QPRT is generally a flat 4 years from the date of transfer. In this example, if the judgment is obtained in 2015, the transfer to the QPRT cannot be unwound as being fraudulent.

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§17.14 c. Bankruptcy Protection

A bankruptcy trustee has 10 years to attack a transfer to "a self-settled trust or similar device." 11 USC §548(e)(1)(A). The phrase "self-settled device" is not defined. The trustee must prove that the transfer was made "with actual intent to hinder, delay, or defraud" a creditor. In other words, the transfer by Mom in §17.4 may be subject to attack by a bankruptcy trustee long after (1) the drafting attorney discarded his files, and (2) most documents regarding the transaction have been lost or discarded. Therefore, the attorney must document Mom's solvency and reasons for the transfer when it occurs.

There is an inverse relationship between estate tax and creditor protection benefits as motives for planning. In estate tax planning, the absence of a nontax motive can result in a loss of desired tax benefits. See discussion in §2.48 of family limited partnership cases that have criticized entities as being formed merely for tax reasons. In contrast, however, the bankruptcy court decision in *Premier Capital Funding, Inc. v Earle (In re Earle)* (Bankr SD Ala 2002) 307 BR 276 is an excellent example of a situation in which tax motives prevented the loss of creditor protection by defeating an allegation that a transfer was fraudulent. Mr. and Mrs. Earle had lived in their home since the 1970s. They lost it in a tax sale in June 1994, but Mrs. Earle redeemed it in December 1997. In June 1998, Mrs. Earle transferred the home into a 20-year QPRT. At that time, the home was Mrs. Earle's primary asset. Less than 4 years later (November 2001), Mr. and Mrs. Earle filed for protection under Chapter 13 of the Bankruptcy Code. A creditor moved to (1) change the proceeding to Chapter 7 and (2) set aside the QPRT as done "with actual intent to hinder, delay, or defraud creditors" in violation of Alabama's fraudulent transfer statute.

The court carefully analyzed the various "badges of fraud" under the statute (similar to CC §3439.04(b)). The federal estate tax return (Form 706) for the estate of Mrs. Earle's mother-in-law, which had incurred significant estate taxes, was due in January 1998, a few months before the QPRT was formed. Mrs. Earle had consulted both an accountant and an attorney in connection with that estate. The accountant "planted" the idea of a QPRT in Mrs. Earle's head. The attorney testified about the significant concerns regarding the estate tax liability and the lack of liquidity with which to pay the estate taxes. That attorney suggested that Mrs. Earle consider a QPRT to reduce her own potential estate tax liability. The court noted that it was the suggestion of the professionals, not that of Mrs. Earle, to form the QPRT. This was extremely important because it showed that the QPRT was not created in a vacuum; Mrs. Earle and her accountant had seen her mother-in-law's estate incur estate tax liability that caused problems for the entire family. The QPRT was the idea of the professionals, presumably in an effort to keep Mrs. Earle from experiencing problems similar to those experienced by her mother-in-law's estate. The estate tax reason for forming the QPRT helped to overcome the allegation that the home was transferred to the trust primarily for the purpose of delaying, hindering, and defrauding the creditors of the bankrupt debtor. The court therefore held that the creditor had failed to prove that the property was transferred with actual intent to hinder, delay, or defraud creditors.

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§17.15 C. Disadvantages of QPRTs

Although QPRTs have both tax and creditor protection benefits, they also have estate planning (see §17.16) and financial (see §§17.17-17.20) drawbacks.

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§17.16 1. Tax Disadvantages of QPRTs

QPRTs pose significant estate planning problems:

- *Possible inclusion of the entire trust in the grantor's estate.* If the grantor fails to survive the term of the retained interest, the entire trust estate will be included in the grantor's estate due to the reversion and the retained income interest. IRC §2036. Inclusion of the trust in the grantor's estate results in a more egregious total transfer tax than would occur if the grantor had made an outright gift. The outright gift would have eliminated transfer tax on the increased value between the date of the gift and the date of death.
- *Possible loss of a new tax basis for the residence on the grantor's death.* IRC §1014 (IRC §1022 if the grantor dies in 2010). This problem can be serious when the grantor's residence has a low basis.
- *Possible loss of the ability to exclude $250,000 ($500,000 if married and filing a joint return) of capital gain on sale of a residence under IRC §121.*
- *Possible need for the grantor to move out of the residence at the end of the term*. As a result, the grantor will lose the deductions for the mortgage interest (if any) and property taxes on the property, and will have to pay nondeductible rent unless a new residence is acquired.

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§17.17 2. Financial Disadvantages of QPRTs

The financial disadvantages of a QPRT relating to encumbered property (see §17.18), financial statements (see §17.19), borrowing (see §17.20), and rent (see §17.21) must be carefully reviewed with the client before proceeding with a QPRT. In most situations, these disadvantages are not important to the client or can be overcome.

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§17.18 a. When Encumbered Property Used

It is easiest to transfer property to a QPRT if the property has no debt. Although the direct payment of mortgage interest is not an additional gift, payment of principal is an additional gift and subject to the gift tax under IRC §2702. Contributions to the trust to pay the mortgage do not qualify for the IRC §2503(c) gift tax annual exclusion because the remainder beneficiaries do not have a present interest in the trust. The grantor could not contribute cash to the trust to pay the mortgage because the contribution of cash to a QPRT is prohibited except in limited circumstances.

If the grantor cannot transfer unencumbered property to the QPRT, the grantor could transfer the residence to the QPRT but retain the obligation under the mortgage with the lender. If the grantor retains the obligation, the value of the gift of the residence will be its gross fair market value and not its value net of the mortgage. However, ongoing mortgage payments by the grantor should not have any further gift tax consequences. For this to work, the grantor and the trust should execute a private indemnification agreement to guarantee that the trust will be compensated if it loses the property, because the lender will surely insist on holding a security interest in the property. The IRS has not issued any rulings thus far regarding the viability of this option.

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§17.19 b. Effect on Financial Statements

Once the residence is owned by the QPRT, how does the grantor reflect the retained interest on his or her financial statement (*e.g.*, when applying for a loan)? Clearly the grantor no longer owns the residence. Does the grantor list the dollar value of the retained interest as an "interest in a trust" with more detailed description in a footnote? There is no obviously correct answer to this question. Certainly, once the residence is in the QPRT the grantor's financial statement will show less value and, as a result, the grantor will be less "bankable."

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§17.20 c. Reduced Ability to Borrow

Once the QPRT owns the residence, the grantor cannot borrow on the property. Therefore, before transferring the residence to the QPRT, the grantor may first take out a loan secured by the residence, reserving the loan proceeds for future business or personal use. After that loan is in place, the grantor may transfer the residence to the QPRT (at the then reduced net value). By contrast, the QPRT trustee can borrow on the residence as needed to improve the residence.

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§17.21 d. Payment of Rent After Term Ends

The primary financial disadvantage of a QPRT is the requirement that the grantor pay rent to the trust once the retained term ends. The development of "reverse" QPRTs has ameliorated this disadvantage somewhat. See §17.36. However, anyone considering a QPRT must decide that paying rent is an acceptable result. This truly requires looking into a crystal ball: Will the grantor still be living in this residence at the end of the term? Will the grantor be able to afford to pay rent to continue living in the residence? Will the grantor's financial situation be the same? Worse? Better? What will be the grantor's relationship with the remainder beneficiary?

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§17.22 D. Candidates for QPRTs

Every estate planning client is a candidate with whom the attorney should at least discuss the advantages and disadvantages of a QPRT. A young client with a residence with little equity may decide to start now with a QPRT. The gift to the remainder beneficiaries, who may be children yet to be born, will be small, but the valuable equity of the residence to be acquired in the future will be excluded from the taxable estate and protected from future creditors.

- A couple (husband and wife) worth $10,000,000, of which $1,000,000 is the equity in the residence, is an excellent candidate to consider a QPRT. Given their nonresidential assets, they are likely to be able to afford to pay rent when the QPRT terminates, and they are unlikely to need the equity in the residence to retire on and they are likely to have a taxable estate.
- A couple (husband and wife) worth $10,000,000, of which $8,000,000 is the equity in the residence, can at least consider a QPRT for a small portion of the equity in the residence. Perhaps in the future the nonresidential portion of their estate will increase. In the meantime, protecting a portion of their most important asset is worth considering.

In other words, a QPRT should be part of the normal discussion of estate planning that the attorney has with each client. Even if the client decides not to proceed with a QPRT today, planting the seed for the future is a step in the right direction.

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E. Expenses of QPRTs

§17.23 1. Initial Expenses

There are many expenses involved in setting up a QPRT. The first expense is, of course, that of counseling the client. It will take several hours to meet with the client; review the clients goals and objectives (*e.g.*, estate planning, estate tax planning, creditor protection for the client, creditor protection for the heirs, passing on values and virtues, maintaining the client's standard of living); describe the advantages and disadvantages of a QPRT; run preliminary calculations; and review existing estate planning documents. Once discussions have moved beyond the preliminary stage, the residence must be appraised and the appraisal reviewed; loan documents examined for a due-on-transfer clause; title documents reviewed; term or terms selected; and decisions made about the trustees and the contingent remainder beneficiaries, *i.e.*, the children or a trust for their benefit. Finally, the QPRTs and contingent remainder beneficiary trust must be drafted, along with the deeds (from parents to each other as separate property; from separate property to the QPRTs) and related real property documents, *e.g.,* PCORs that must be filed for property tax purposes. See §17.47. Once the documents have been signed, notarized, and—where needed—recorded, a federal gift tax return must be prepared and filed. Due to the interaction of the QPRT rules with the generation-skipping transfer (GST) tax, an amendment to the family trust is often needed to "equalize" benefits for the family of a child who dies before the end of the QPRT term. See §17.45. This is a complex process far beyond the scope of preparing a family trust and pourover wills. It is not unusual for this process to cost tens of thousands of dollars.

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§17.24 2. Ongoing Expenses

Once the QPRT is "up and running" there may be nothing further for the client to do. The grantors pay the property taxes, insurance, and any mortgage payments. The QPRT trustee may have nothing to do until the retained term ends. The fact that there is, in most situations, nothing to do can lead to problems.

For example, what happens if the residence is sold and the proceeds are not reinvested, within the required 2-year period, in a replacement residence? The attorney will want to be aware of this fact to help the trustee calculate the amount of the annuity on the converted GRAT. See §17.32.

Further, how does the attorney keep track of the termination date of the QPRT? For example, a QPRT established in 2010 could have a 30-year term, and the attorney in a small firm may be retired or dead long before 2040. Of course it is, in the first instance, the responsibility of the grantor and the trustee to keep track of the termination date. However, this consideration demonstrates the need for a sole practitioner to have a long-term, even perpetual, calendar system to pass on to the attorney who takes over the practice on the practitioner's retirement, death, or disability.

What if the client wishes to refinance the mortgage? Lenders generally do not like to make loans to irrevocable trusts. Such loans are available, but not from all lenders and generally at somewhat higher interest rates. (An extra one-eighth to one-quarter percent interest is a price worth paying for the estate tax or creditor protection benefits of a QPRT.) The loan broker may advise the client to "take the residence out" of the QPRT, "just temporarily," to facilitate the new mortgage. Once the new mortgage is in place, the client is supposed to put title back in the name of the QPRT trustee. This is a bad idea, for the re-transfer often does not occur in practice.

In addition, the removal of the residence raises an academic question: If the QPRT trustee can transfer title out to facilitate a new mortgage, is the QPRT truly an irrevocable trust for estate tax purposes? For creditor protection purposes? Some practitioners use "agency" agreements in this situation. Under this type of agreement, the grantor agrees to take title to the QPRT property merely to facilitate the new loan and then agrees to re-transfer title to the trustee. However, the attorney should instead advise the client upfront that refinancing a residence in a QPRT is a difficult task.

These examples are reasons why the attorney should consider including a client with a QPRT in the attorney's ongoing estate plan maintenance program. Checking in with the client once a year will ensure that these types of events do not get overlooked and, potentially, subvert the QPRT's goals.

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II. TAX CONSIDERATIONS

§17.25 A. Requirements of QPRT Regulations

The requirements and permissible terms for a QPRT are strictly regulated by Treas Reg §25.2702-5(c). As a result, the typical QPRT governing instrument contains relatively few custom terms except for the provisions for distribution of the remainder after the period of the grantor's retained interest ends. Although a QPRT must be irrevocable, the trust instrument may give the trustee the power to reform the trust to comply with the requirements for a QPRT. The reformation must be begun within 90 days after the due date (including extensions) for the filing of the gift tax return reporting the transfer of the residence and must be completed within a reasonable time after commencement. Treas Reg §25.2702-5(a)(2).

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§17.26 1. Personal Residence Requirement

Generally, the regulations allow a grantor to establish a QPRT for the "principal residence" or for "one other residence" (or for both as long as separate QPRTs are used). Thus, the grantor can establish QPRTs for both a principal residence and a vacation home but cannot have QPRTs for two vacation homes. A married couple can have QPRTs for a principal residence and two vacation homes by arranging ownership so that each spouse is the sole owner of one of the vacation homes, with each spouse then establishing a separate QPRT for his or her vacation home.

The regulations provide that a residence is a "principal residence" if it meets the requirements of former IRC §1034 pertaining to rollover of gain. To qualify as the "one other residence," a "dwelling" must be used by the taxpayer for personal use each year for the greater of 14 days or 10 percent of the number of days during which the dwelling is rented. Treas Reg §25.2702-5(c)(2)(i)(B), incorporating portions of IRC §280A(d). Although former IRC §1034 was repealed in 1997, this does not appear to affect the meaning of the regulation.

Nonbinding private letter rulings suggest that the IRS will be liberal in its interpretation of a "principal residence" and the "one other residence." See, *e.g.,* IRS Letter Ruling 9544018, in which the IRS ruled that stock in a corporation holding real property that entitled the stockholder to exclusive use of the property constituted a "principal residence" or "one other dwelling." (There is no similar favorable ruling for owning a residence through a limited liability company.) See also IRS Letter Ruling 9609015, in which the IRS determined that a residence and an attached rental unit constituted a "principal residence."

Generally, a building will not qualify as a residence if it is used for nonresidential purposes beyond the use of a portion of the premises as a home office. Treas Reg §25.2702-5(c)(2)(iii). A personal residence does not include personal property. Treas Reg §25.2702-5(c)(2)(ii).

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§17.27 a. Appurtenant Structures

A personal residence (principal or otherwise) may include appurtenant structures used by the "term holder" (the grantor) for residential purposes and adjacent land not in excess of what is reasonably appropriate for residential purposes (taking into account the residence's size and location). Treas Reg §25.2702-5(c)(2)(iii). The IRS has been relatively lenient in determining the amount of land that is considered to be "appropriate." The IRS has been similarly lenient in allowing appurtenant structures.

- In IRS Letter Ruling 9739024, the IRS approved a QPRT with a lot of 40.71 acres that included a pool with pool house, tennis courts, and a second house with a separate garage, noting that lots in the area could not be less than 40 acres.
- In IRS Letter Ruling 200241039, the IRS approved a QPRT containing a vacation residence, a guest house, a barn, a boathouse, two sheds, and a large pier and dock.
- In IRS Letter Ruling 200626043, the IRS allowed a QPRT containing a vacation home having five bedrooms, five baths, and multiple additional structures, including a detached three-car garage, an artist studio, and an unheated "bunk house" with two bedrooms, one bathroom, and no kitchen.
- In IRS Letter Ruling 200822011, the IRS allowed a QPRT containing a single-family dwelling used exclusively for residential purposes, a general purpose barn, and three sheds on a lot larger than required by zoning restrictions, noting that many residences in the area were situated on even larger lots.

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§17.28 b. Fractional Interests

The regulations permit funding a QPRT with an undivided fractional-share interest in a personal residence. See Treas Reg §25.2702-5(c)(2)(i)(C), (c)(2)(iv). Spouses may share a single QPRT if the governing instrument prohibits any person other than one of the spouses from holding a term interest in the trust concurrently with the other spouse. See Treas Reg §25.2702-5(c)(2)(i)(C), (c)(2)(iv). However, this is generally not recommended. See §17.29.

Although the grantor's QPRTs can be funded only with interests in two residences, there is no limit on the number of QPRTs that can be created. This rule allows multiple QPRTs for a single residence, which permits QPRTs to be created in different years or for different terms if a grantor does not want to go "all or nothing" regarding the date the grantor must survive. Multiple QPRTs can also be used to reduce the assets that need to be allotted a generation-skipping transfer (GST) tax exemption to avoid GST tax if QPRTs are established for children and their issue and a child dies during the term of the retained interest.

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§17.29 c. Community Property

In theory, spouses may share a single QPRT. However, in practice, most practitioners establish separate QPRTs for each spouse, and they do that with separate trust instruments. In the case of a community property residence, this involves partition of the community property interest into equal shares to be held as tenants in common. It is common to have husband and wife start by holding the residence, which is community property, as trustees of their "family" (revocable "living" or "inter vivos") trust. The next step is for them to deed a 50-percent interest in the residence from themselves as trustees of the "family" trust to each of them as separate property. Then they deed their 50-percent interests to the trustees of their respective QPRTs. This approach lowers the gift tax values of the gifts to the trusts because each gift involves a fractional share of the residence and fractional shares have a discounted appraisal value. (A half interest in a residence may be worth only 40 percent of the full fair market value of the entire residence, reflecting a 20-percent valuation discount for the combined interests. In *Estate of Eileen Kerr Stevens*, TC Memo 2000-53, the court allowed a 25-percent discount for 50-percent undivided interests in real property. In *Andrew K. Ludwick*, TC Memo 2010-104, the court allowed 17-percent discounts for transfers to two QPRTs of undivided tenants-in-common interests in a vacation home in Hawaii.) Of course, a reduced value should be claimed on a gift tax return only in accordance with a report of a competent appraiser.

The primary drawback of partitioning a community property residence into equal shares of separate property is that there will not be a step-up in basis for both halves of the residence if one spouse dies during the term. IRC §1014 (IRC §1022 if one spouse dies in 2010). Another pitfall to avoid when creating a QPRT for a married couple is gift-splitting under IRC §2513. See §17.38.

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§17.30 2. Required Governing Instrument Provisions

Treasury Regulation §25.2702-5(c)(1) defines a "qualified personal residence trust" as

> a trust meeting all the requirements of this paragraph (c). These requirements must be met by provisions in the governing instrument, and these governing instrument provisions must by their terms continue in effect during the existence of any term interest in the trust.

The required governing instrument provisions paraphrased in §17.31 create a trust subject to the following rules:

- The QPRT can hold one residence and a limited fund for expenses. The fund for expenses is kept separate, and excess funds are returned to the grantor periodically and on termination of the trust.
- The residence must continue to be the grantor's principal residence or other residence during the term, subject to provisions allowing its sale if replaced within 2 years. (Similar rules apply in the event of a destruction.) More specifically, the residence must be used or held for use as a personal residence.
- Under Treas Reg §25.2702-5(c)(7), a residence is held for use as a personal residence of the grantor "so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence." (The "held for use" provision is relevant when a grantor is moved to a convalescent hospital.)
- If the QPRT ceases to meet the requirements for a QPRT, the trust estate is returned to the grantor or the trust converts to a qualified annuity trust. See §17.32. This rule can be applied on a fractional-share basis if, for example, a residence is sold and replaced with a residence of lower value.
- To prevent circumvention of the provision for distribution on disqualification, the regulations prohibit distributions to anyone other than the grantor during the trust term and do not allow commutation (a premature termination in which the grantor receives the present value of the remaining income interest and the remainder beneficiaries receive the rest of the trust assets).

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§17.31 3. Summary of Governing Instrument Regulations

The following is a cursory paraphrase of the regulations establishing the scheme described in §17.30:

- *Income of the trust.* Treasury Regulation §25.2702-5(c)(3) requires payment of all income to the term holder not less frequently than annually.
- *Distribution from the trust to other persons*. Treasury Regulation §25.2702-5(c)(4) prohibits distributions of corpus to any beneficiary other than the term holder before expiration of the retained interest.
- *Assets of the trust.* Treasury Regulation §25.2702-5(c)(5) prohibits the trust from holding any asset other than one residence, with the following exceptions:
- Cash held in a separate account to meet trust expenses, including mortgage payments and expenses for improvement, to be paid within 6 months. Excess sums must be distributed back to the grantor at least quarter-annually, and all remaining cash must be distributed back to the grantor at the end of the trust term.
- Insurance on the residence.
- Proceeds of sale, insurance, and so forth, resulting from transfer or destruction of the residence.
- *Commutation.* Treasury Regulation §25.2702-5(c)(6) requires that the governing instrument must prohibit commutation.
- *Cessation of use as a personal residence.* Treasury Regulation §25.2702-5(c)(7) provides that the trust ceases to be a QPRT if it ceases to be used as the term holder's residence. If the residence is sold or destroyed, the trust may remain a QPRT if the residence is replaced within 2 years.
- *Disposition of trust assets on cessation as a personal residence trust.* Treasury Regulation §25.2702-5(c)(8) provides that if the trust ceases to be a QPRT as to certain assets (other than at the end of the term), the assets must be
- distributed outright to the term holder within 30 days (a generally unsatisfactory alternative from an estate planning perspective) or
- "converted 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" as defined in Treas Reg §25.2702-3.
- If the entire trust is disqualified, the annuity amount is the amount that would have produced an original retained interest value (at the trust's inception) equal in value to the interests that were actually retained, using the interest rate applicable at the trust's inception.
- If only some of the assets cease to qualify, this amount is multiplied by an appropriate fraction. The starting date of the annuity is the date of the property's sale or destruction or the date on which it ceased to be used as a residence. When annuity payments are delayed, as might occur when it is initially uncertain whether sales proceeds will be reinvested, the late payments accrue interest.

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§17.32 4. Required Conversion to GRAT

A QPRT must be converted into a grantor retained annuity trust (GRAT) if it ceases to qualify as a QPRT during the term. (The alternative of returning all assets to the grantor is unacceptable from an estate planning perspective because it destroys any benefits of the QPRT that have already been achieved.) The grantor's interest in the GRAT must satisfy the Treas Reg §25.2702-3 requirements for a qualified annuity interest. The minimum amount of the GRAT annuity payment is the amount that results in the annuity's having the same value as the surrendered QPRT "income" interest as calculated under IRS valuation tables. The effect of these requirements is to impose still more governing instrument requirements for the QPRT.

Conversion to a GRAT will create a gift tax problem because the conversion to a GRAT that pays the minimum annuity required by the regulations is based on the value of the residence when the trust was established. If the residence has increased in value between the time the QPRT was established and the time of conversion, the conversion may result in an economic benefit to the remainder beneficiaries that the IRS will classify as a gift. See IRS Letter Ruling 9448035. But see IRS Letter Ruling 200220014, in which the IRS ruled that conversion of a QPRT into a GRAT did not result in a gift despite the residence's increased value, although the ruling did not discuss the fact that, due to appreciation, the current value of the income interest in the QPRT exceeded the value of the GRAT annuity interest. Accordingly, it may be best to provide that the annuity amount will be calculated using the greater of the fair market value of the residence when the QPRT is established or at conversion. It is unclear that making a gift on conversion produces a bad result, however, even though this would be a gift of a future interest that does not qualify for the IRC §2503(b) annual gift tax exclusion.

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B. Gift Tax Considerations for QPRT

§17.33 1. Transfer of Residence as "Completed Gift"

A QPRT will not accomplish its objectives unless the transfer of the residence to the QPRT results in an immediate "completed gift." Treas Reg §25.2511-2(b). The grantor should not retain any power to change remainder beneficiaries. Further, if the remainder beneficiary is a second trust (as often recommended), the grantor also must not have the power to change the remainder beneficiaries of the second trust.

- If the transfer to the QPRT is a completed gift, a gift tax return is required for the year of the transfer. Because the IRS may try to revalue the gift for estate tax purposes after the decedent's death, an accurate and well-documented appraisal is required and must be preserved even if no gift tax is due.
- If additions to the trust are made after its initial creation, in the form of improvements to the residence or principal reductions on a mortgage, additional gift tax returns are required for later years. Such gifts are valued in the same manner as the original trust contributions; however, the deductions for the retained interests must be calculated based on the number of years remaining in the retained interest term.

The grantor should pay all operating expenses personally. This makes it unnecessary to deal with the issue of timing additional gifts. It is also unnecessary to deal with the complex regulations concerning distributions of excess cash. Treas Reg §25.2702-5(c)(5)(ii)(A)(2). Alternatively, the grantor may establish an account on which the QPRT trustee can also sign. If and when the QPRT trustee writes a check on that account to pay QPRT expenses, a gift occurs. Because the account is owned by the grantor, it is included in the grantor's estate. Little harm results, however, because additional gifts do not qualify for the annual exclusion in the first place. See §17.34.

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§17.34 2. No Qualification for Gift Tax Annual Exclusion

Transfers to QPRTs are gifts of future interest that do not qualify for the $13,000 (plus further cost-of-living adjustments after 2010) per-donee IRC §2503(b) gift tax annual exclusion. This result cannot be avoided by giving beneficiaries *Crummey* withdrawal powers (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) because Treas Reg §25.2702-5(c)(4) expressly prohibits distributions to anyone other than the term holder during the term.

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C. Estate Tax Treatment of QPRT

§17.35 1. Treatment if Grantor Survives

If the grantor survives the term, the residence or other remaining trust estate will not be included in the grantor's taxable estate unless the grantor retained other rights in the trust estate that did not expire at the end of the term. In particular, continued possession of the residence after the term presents essentially the same issues that arise whenever the owner of a residence transfers the residence to children and continues in possession.

If possession is retained under an agreement in effect at the time of the transfer, the property will be included in the estate under IRC §2036(a). The retention of possession is itself evidence of such an agreement, express or implied. Although estates often prevail when the issue of the existence of an agreement is submitted to a jury, it is undesirable to create a situation in which litigation (or a compromise during audit) becomes likely.

It is apparently permissible for the grantor to retain the right to lease the residence for fair market value rental after the end of the QPRT term. This is expressly authorized by language in the preamble to the final IRC §2702 amended regulations. TD 8743, 1998-1 Cum Bull 543. See also IRS Letter Ruling 9626041 (retained right to lease back residence at the end of a personal residence trust term does not result in retained enjoyment if grantors are required to pay fair market rent). But see *Estate of Timothy J. Tehan*, TC Memo 2005-128 (decedent's agreement to pay all assessments, taxes, insurance premiums, and maintenance and repair expenses in exchange for exclusive possession of residence gifted to children did not require payment of fair market rent).

Other techniques that allow for continued possession by the owner after the end of the trust term include the gift of a further term interest to the grantor (see §17.36) and the creation of a power to extend the trust term by the grantor (see §17.37).

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§17.36 a. Gift of Further Term Interest

Another technique has recently been developed to allow the grantor to retain the use of the residence after the end of the term: the "reverse" or "return" QPRT. In this technique, the remainder beneficiaries transfer the residence to a new QPRT that gives the grantor a further term interest in the residence. As a result, the beneficiaries make a taxable gift to the grantor of the present value of the grantor's right to use the residence; the grantor need not pay rent, and the grantor's estate will not be reduced by fair market value rental payments. This result may be extremely attractive if the original grantor has concerns about paying rent and neither the original grantor nor the beneficiaries have any transfer tax concerns at the time of the transfer. This may require modification of the original instrument if the residence is held after the end of the term in a continuing trust that has spendthrift provisions that prevent the beneficiaries from making gifts of interests in the residence. This cannot be agreed to in advance because the retained interest would cause the residence to be included in the grantor's estate under IRC §2036(a). See IRS Letter Rulings 200848003, 200848008. For an example of a "reverse" or "return" QPRT, see §17.58.

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§17.37 b. Power to Extend QPRT Term

A more exotic technique that has been used to allow the grantor to retain the use of the residence after the end of the term is for the grantor to give an independent third person, in the original instrument, the power to extend the term of the trust when the purpose of the trust has been defeated, *e.g.,* by an increase in the estate tax applicable exclusion amount or by a decline in the property's value or in the value of the grantor's other assets. If the trust term is extended until the grantor's death, the property will be included in the grantor's estate and the remainder beneficiaries may be able to obtain a step-up in basis for income tax purposes to the date-of-death value of the residence (as compared with the grantor's carryover basis) without adverse estate or gift tax consequences.

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§17.38 2. Treatment if Grantor Fails to Survive

If the grantor fails to survive the term, the residence is included in the grantor's estate for estate tax purposes. Double taxation of the same transfer is avoided because the original gift will not be treated as an adjusted taxable gift under IRC §2001(b). Unfortunately, if the gift was split with the spouse under IRC §2513, there is usually no comparable adjustment with respect to the spouse's adjusted taxable gifts. (Internal Revenue Code §2001(e) provides an adjustment that applies only when inclusion results from the application of IRC §2035. If the grantor transfers the term interest within 3 years before death, however, the residence will be included in the grantor's estate under IRC §2035 and the IRC §2001(e) adjustment will apply.) Accordingly, gift splitting is usually undesirable in this situation. Under IRC §2513(a)(2), the spouse may be required to split the gift to the QPRT if the spouse splits other gifts in the same year. Gift splitting can be avoided by naming the spouse as a potential remainder beneficiary of the QPRT, because gift splitting is not available for a gift that may benefit the spouse. IRC §2513(a)(1); Treas Reg §25.2513-1(a), (b)(4). See §2.43.

Clients are less likely to establish QPRTs if the original gift is not shielded by the unified credit. If the gift is not shielded, gift tax is paid, and the grantor fails to survive, the result approximates an undesirable prepayment of estate tax (except that the tax formula takes into account the previous gift tax obligation based on transfer tax rates in effect at death rather than those in effect at the time of the gift). This result is somewhat ameliorated by the fact that the funds used to pay the gift tax are removed from the estate if the grantor survives creation of the QPRT by 3 years. IRC §2035(b).

QPRTs are normally drafted to provide that the trust estate reverts to the probate estate or the grantor's revocable trust if the grantor does not survive the term. The reversion reduces the value of the gift and makes it easier to address tax apportionment and similar problems. If the grantor survives the term, the distribution can be made outright or in further trust; however, the grantor should not be the trustee of the trust or have any interest in it. The drafter should keep in mind that the perpetuities period begins when the QPRT is established.

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§17.39 3. Transfer Tax Apportionment

Use of a QPRT can create some drafting problems regarding a tax apportionment clause in the grantor's will or primary revocable trust. If there is no clause and the grantor survives the term, no estate tax is apportioned to the residence.

As with any large gift that uses a significant portion of the unified credit, it may be difficult to achieve other grantor objectives (*e.g.,* equality among children) because the estate tax burden is born entirely by the remaining estate. If, however, the grantor fails to survive and the residence is included in the estate, (1) the residence will bear a share of the tax, and (2) the total amount of death tax will be significantly higher than hoped if the residence has appreciated. A clause that apportions the entire estate tax attributable to the appreciated residence to the residue of the grantor's estate may deplete the residue far beyond the grantor's wishes.

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§17.40 D. Income Tax Issues Related to QPRT

The income tax issues related to a QPRT involve "grantor trust" status. This is an area that causes great confusion to all clients, virtually all accountants and lawyers, and even many lawyers who engage in "estate planning." The specialist understands that the two bodies of tax law (income and transfer tax) are not "in pari materia" as courts have stated, for example, with respect to estate and gift taxes. However, to anyone else, it seems incomprehensible that the client can "own" an irrevocable trust for income tax purposes but not "own" that same trust for transfer tax (estate, gift, and generation-skipping transfer tax) purposes. Beyond the conceptual difficulty, the real problem lies in selecting powers that confer income tax ownership without estate tax ownership.

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§17.41 1. Need for Grantor Trust Status

The transfer of a residence to an irrevocable trust raises questions about the effect of the transfer on the tax treatment of future transactions affecting the trust and the residence. Although a literal reading of some of the statutes does not fully clarify the issues, the IRS has consistently ignored grantor trusts for tax purposes. Indeed, Rev Rul 85-13, 1985-1 Cum Bull 184, 185, states (emphasis added):

> It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, *and yet retain its vitality as a separate entity* capable of entering into a sales transaction with the grantor.... *At the time* A *became the owner of the trust,* A *became the owner of the trust property*.

Given the IRS's position, there is little doubt that, as long as the QPRT is a grantor trust under IRC §671 for both principal and income, there should be no loss of benefits during the term of the retained income interest under:

- The IRC §121 exclusion of $250,000 ($500,000 if married and filing a joint return) of gain on sale of a residence. (Note, however, that the opportunity to take advantage of §121 will be lost if the home is not sold before the end of the trust's retained income term.) The IRS ruled favorably on this point in connection with an earlier version of the statute in Rev Rul 85-45, 1985-1 Cum Bull 183.
  - This requires that the grantors must actually use the property as their principal residence for all but the last 3 years to qualify for the exclusion as to 100 percent of the gain for the entire ownership period.
  - The right to use the property is not sufficient to qualify for the exclusion, and discontinuous use of the property may result in loss of the exclusion for gain allocated to periods of nonqualified use.
- The IRC §163(h)(3) deduction for qualified residence interest. See IRS Letter Ruling 9402011.
- The IRC §164(a)(1) deduction for state and local real property taxes. See IRS Letter Ruling 9402011.

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§17.42 2. Loss of Preferential Tax Basis Treatment

Under IRC §1014, a taxpayer is normally entitled to a new income tax basis for the determination of gain or loss when the taxpayer dies. This may result in a substantial tax benefit if the taxpayer has owned a residence for a long period or has used the gain rollover provisions of former IRC §1034 (or IRC §1031 in the case of rental property later used by the taxpayer as a personal residence) when making earlier sales and purchases of residences. Potential strategies for preserving the benefit of §1014 by having the grantor repurchase the residence from the QPRT (or a grantor trust receiving the residence at the end of the QPRT term) have been blocked by Treas Reg §25.2702-5(b)(1), (c)(9). These regulations require that the governing instrument of a QPRT or nonqualified personal residence trust (PRT) prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or any entity controlled by the grantor or the grantor's spouse, at any time during the term of the retained interest, and any time after the original duration of the term interest ends during which the trust remains a grantor trust. As a result, the grantor cannot repurchase the residence in a tax-free transaction with a grantor trust, with the consequence that a repurchase by the grantor results in the seller recognizing gain. See form of prohibition in §17.88.

PRACTICE TIP: Some practitioners believe the regulation is invalid with respect to PRTs because it seeks to place conditions on an unconditional statutory exception. If the grantor may want to repurchase the residence at the end of the term, the practitioner should consider the use of a PRT instead of a QPRT.

One method for avoiding recognition of gain regarding a principal residence is for the QPRT to provide that the residence passes to another grantor trust on termination of the QPRT. This approach causes the gain on any eventual sale of the residence to be recognized by the grantors, who can avoid tax on all or a portion of the gain by making use of the IRC §121 $250,000 ($500,000 for a married couple filing a joint return) exclusion of gain on sale of a principal residence. The trust must be made to qualify as a grantor trust by inclusion of powers other than powers that would cause inclusion in the grantor's gross estate. See §17.43. The trust instrument also must continue to prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or any entity controlled by the grantor or the grantor's spouse, at any time during which the trust remains a grantor trust.

Another method for avoiding recognition of gain regarding a principal residence is for the QPRT to sell the residence to a third party just before the end of the QPRT term, while the QPRT is still a grantor trust. This approach does not permit the grantors to remain in the residence. However, the gain will be recognized by the grantors, who can avoid tax on all or a portion of the gain by making use of the IRC §121 $250,000 ($500,000 for a married couple filing a joint return) exclusion of gain on sale of a principal residence.

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§17.43 3. Grantor Trust Status Strategies

As long as a QPRT remains a QPRT, it will be a grantor trust with respect to income because the grantor is entitled to all income. Generally, the simplest way to make the trust into a grantor trust regarding principal is to satisfy IRC §673(a), which provides:

> The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

Because GRITs are most likely to be used by older grantors and longer retained interests produce the greatest tax benefits, the typical QPRT will have a reversionary interest greater than 5 percent. See §17.50. In IRS Letter Ruling 200822011, the IRS ruled that a personal residence trust would be treated as a grantor trust for this reason. Unfortunately, relying exclusively on IRC §673(a) results in a loss of grantor trust status at the end of the term of the retained interest, when the grantor ceases to have a reversion and also ceases to have a right to trust income.

It is often desirable to have grantor trust status continue after the end of the term. This is true for two reasons: First, to continue the income tax benefits mentioned in §17.41. Second, to avoid taxation of the rent payments the grantor makes to the trust to avoid inclusion of the property in the grantor's estate if the grantor retains the right to occupy the residence, as discussed in §2.50. Continuing grantor trust status can be accomplished in several ways. For example, the grantor may give a nonadverse party the power to add remainder beneficiaries to the trust, limiting the new beneficiaries to a desired group. IRC §674(b)(5). See also IRC §677(a)(3).

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§17.44 4. Grantor Trust Status for GRAT

If a QPRT ceases to be qualified as such during the term of the retained interest (usually because the residence is sold or repurchased), the trust must be converted into a grantor retained annuity trust (GRAT). See §17.32. Because this conversion can only happen earlier than the end of the trust term, the GRAT should also be a grantor trust under IRC §671.

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§17.45 E. GST Tax Considerations

A QPRT is not a particularly useful device for making gifts that may be subject to GST tax. The principal problem is that under IRC §2642(f) the value of the "gift" for purposes of GST tax will be the value of the trust corpus at the end of the term rather than the value used for gift tax purposes (*i.e.,* the value of the transferred property at the beginning of the term, reduced by the value of the retained interest). Thus, it is better to make transfers to skip persons in a manner that does not involve a retained interest.

GST tax issues typically arise when the QPRT provides that the remainder beneficiaries are the grantor's children (or a trust for their benefit), with issue of deceased children taking the share of a deceased child. If a child dies during the term and the interests of each child are not treated as separate trusts for GST tax purposes under IRC §2654(b)(2), protecting the trust from GST tax may require most of the grantor's GST exemption, even though only a fraction of the trust estate passes to grandchildren. See §4.20.

Accordingly, some practitioners design QPRTs in a way that prevents generation-skipping transfers. This strategy can be accomplished by leaving the remainder to only those children who survive the term, with an amendment being made to the grantor's will or revocable trust to ensure that the issue of deceased children will receive a correspondingly larger share of the grantor's other assets. This type of clause is often called an "equalization" clause. This strategy works out well economically because a grantor with enough wealth to establish a QPRT usually has enough wealth to "equalize" benefits for the heirs of a deceased child who are excluded from a share of the residence. The drafting issue is whether the equalization is based on the value of the residence on the grantor's date of death or on the QPRT's termination date. As always in estate planning, if there is uncertainty about whether the grantor's other assets will be sufficient, then an insurance trust may provide the answer.

Another strategy is to establish a separate QPRT for each child so that the death of a child will only necessitate applying GST exemption to the QPRT for that particular child.

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Source: Estate Planning/Drafting California Irrevocable Trusts/17 Qualified Personal Residence Trusts (QPRTs)/§17.46 F. State Tax Considerations

§17.46 F. State Tax Considerations

QPRTs are creatures of federal tax law. Unfortunately, it is all too easy to create a problem where they intersect with California law. Moreover, California law is increasingly difficult and unforgiving, a trend destined to continue as the state wrestles with long-term budget problems. On property taxes, see §17.47. On documentary transfer taxes, see §17.48.

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§17.47 1. Real Property Tax

Although a QPRT's real property tax consequences are uncertain in some cases, they appear to include the following:

- The initial transfer to the trust is a transfer for the grantor's benefit that is not a change of ownership under Rev & T C §62(d). Therefore, the transfer should not cause a reassessment of the transferred property.
- Trust termination may trigger a reassessment unless the Rev & T C §63.1 parent-child transfer exclusion applies. This exclusion must be claimed within 3 years after the transfer to the children or before the children transfer the residence to a third person other than a parent or child, whichever occurs first. Rev & T C §63.1(e)(1)(B).
- The children must be the trust's sole remainder beneficiaries. The presence of a grandchild with a living parent or another nonexempt transferee as a permissible appointee of the property may result in a reassessment of the grantor's entire interest in the residence.
- The State Board of Equalization apparently believes that the transfer to the children occurs at the end of the grantor's retained interest rather than on creation of the trust.
- In any event, a claim of exclusion may be filed within 6 months after receipt of a notice of supplemental or escape assessment issued because of the transfer. Rev & T C §63.1(e)(1)(C). See §14.11.
- California Constitution art XIIIA and Rev & T C §69.5 contain provisions allowing homeowners over age 55 to transfer base-year value from one residence to another. This benefit should be available while the residence is owned by the QPRT. See Letter to Assessors 2006/010, Q&A B2 (Feb. 6, 2006). See also California Estate Planning, chap 15 (Cal CEB 2002).
- Transferring the residence to a QPRT may result in loss of the $7000 homeowner's exemption under Cal Const art XIII, §3(k) and Rev & T C §218 if the entire interest in the residence is transferred to the QPRT. The exemption can probably be applied to a retained fractional interest or claimed by a spouse in regard to an interest owned by the spouse. The value of the exemption is $70 per year, reduced by the income tax benefit of claiming income tax deductions for payments of real property taxes.

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§17.48 2. Documentary Transfer Tax

The transfer of the residence to the QPRT qualifies for the exemption under Rev & T C §11911 (*i.e.*, the transfer is a "bonafide gift and the grantor received nothing in return," as stated in the County of Los Angeles, Registrar-Recorder/County Clerk, Notice of Exempt Transactions Under the Documentary Transfer Tax). The transfer to the children's trust (contingent remainder beneficiary) at the end of the QPRT term should be exempt for the same reason.

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§17.49 III. STRUCTURING THE QPRT

A QPRT is a flexible planning technique. That flexibility leads to problems in helping the client make decisions. For example, what is the desired number of years for the retained term? As with all estate planning, the first priority is to determine the client's goals. Although the client has come to the office for estate planning, reducing taxes is almost always not the client's most important goal. The client's most important goal is more likely to be something like "maintaining my standard of living from now until the day I die" (or "maintaining dictatorial control over all my assets until the day I die"). The process of helping the client to articulate all of the client's goals and objectives may take several hours, if not several meetings. Once the client's goals and objectives have been articulated, the attorney must help the client put them into a prioritized list.

Is it more important for the client to save estate tax? If so, this consideration suggests a shorter retained term. Is it more important for the client to put off the date at which rent must be paid? If so, that consideration suggests a longer retained term. See §17.50. One way of handling the issue of selecting the desired number of years for the retained term is to use more than one QPRT, as discussed in §17.55.

Other issues arise in structuring the QPRT. How many residences will be the subject of a transfer to a QPRT? See §17.56. Should the contingent remainder beneficiary be a person or a trust for that person's benefit? See §17.57. Are there ways to ease the burden on the grantor of paying rent after the end of the retained term? See §17.58.

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§17.50 A. Selecting QPRT Term

A QPRT can be established for any term desired. However, selecting a term is something of a gamble. Increasing the term reduces the value of the gift because the gift is the value of the residence minus the retained income interest and the retained reversion interest. A long-term income interest is obviously more valuable than a short-term interest. A longer term, however, increases the chance that the grantor will fail to survive the term, thereby increasing the possibility that the residence will revert to the grantor's estate. The reduction in the value of the gift is less for older grantors because the reversion is larger. These obvious facts are reflected in the IRS's valuation formulas. On calculating the value of the gift, see §17.54.

Balanced against the basic desirability of a long term is the fact that the entire benefit of the QPRT will be lost if the grantor fails to survive the term. See §17.51. Further, the advantage diminishes as the length of the term increases because each year added to the term of the retained interest reduces the gift by fewer dollars than the addition of the previous year. Fear of paying rent is an additional consideration in favor of a longer term. See §17.52. Creditor concerns are an additional consideration in favor of a shorter term. See §17.53. From an economic point of view, better results can be obtained at some point by passing the residence to a grantor trust for the benefit of the remaindermen and allowing the grantor to lease the property from the trust. At some point, the fair market rental will be greater than the reduced gift tax value that will result from increasing the term by a year. Thus, the leaseback will move more property out of the estate than an extended QPRT term, without the risk of death during the extended term. The following table illustrates this fact:

Value of Gift per $100,000 of Fair Market Value of Residence Made by 60-Year-Old Grantor on Creation of QPRT, Calculated Using IRC §7520 **Interest Rate of 3.4 Percent**

Term of Retained Interest (Years)	*Value of Gift*	*Reduction in Gift Due to Additional Year of Term*
0	$100,000	N/A
1	95,703	$4,297
2	91,499	4,204
3	87,384	4,115
4	83,357	4,027
5	79,418	3,939
6	75,584	3,834
7	71,847	3,737
8	68,195	3,652
9	64,621	3,574
10	61,119	3,502

The following table indicates the likelihood of the grantor's failing to survive a chosen term. These figures are derived from statistics that do not take into account gender, health status, health and diet habits, and accessibility to high-quality health care. The survival prospects of any particular individual may be substantially different.

Probability of Surviving Specified Number of Years After Given Age

Additional	*Percentage After*	*Percentage After*	*Percentage After*

Years	*Age 55*	*Age 65*	*Age 75*
1	99	98	96
2	99	97	92
3	98	95	88
4	97	93	83
5	96	91	79
6	95	89	74
7	94	86	69
8	93	84	64
9	92	81	59
10	90	79	53

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§17.51 1. Pure Estate Tax Motivation

To the extent that the client is primarily concerned with passing value to the next generation, and doing so without risk, the attorney must evaluate the client's age and health. If the client is 65, and the mortality table suggests a life expectancy of 18 years, then a 20-year term is ill-advised. The fact that the client's parents lived into their 90s is no guaranty that the client will also live that long. The client's parents may have grown up in a time of less stress and less pollution, and in a less dangerous city. Also, perhaps the client was adopted and was never informed of that fact.

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§17.52 2. Fear of Paying Rent

If the client is somewhat interested in estate tax planning, but is very concerned about paying rent, the attorney must first be certain that the client is comfortable with the technique. Will the client have enough resources to pay rent when the term ends? Or will the client later complain that the attorney failed to warn the client strongly enough about this disadvantage? Or is the client counting too much on the possibility that the remainder beneficiaries will enter into a "reverse" or "return" QPRT? See §17.58. In this situation, a 65-year-old with an 18-year life expectancy might well select a 20-year term, on the assumption that he or she will "beat the odds." Besides, if the grantor does not beat the odds, the grantor may be comfortable with the estate tax inclusion. The attorney should be certain to carefully document this and other risks in writing to the client.

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§17.53 3. Creditor Concerns

If the client is extremely concerned with protecting the equity from future creditors, that suggests a shorter term. Of course, the attorney should first make sure the client is solvent, so that the attorney is not a party to a fraudulent transfer. See §17.13. Ensuring and documenting solvency also protects the client. First, a lack of contemporaneous solvency will make the transfer to the QPRT vulnerable to attack. Second, a fraudulent transfer may result in a bankruptcy court denying the homestead exemption. See §17.14.

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§17.54 B. Calculating Value of QPRT Gift

The gift that is made when a QPRT is created can be calculated by using the IRS Tables in IRS Pub 1457 or by using commercial estate planning computer software that incorporates the IRS tables. See, for example, Estate Planning Tools, published by Brentmark Software (http://www.brentmark.com). There is also a "quick and dirty" calculation which can be made with a typical hand calculator. The formula for this calculation is:

$$\text{Gift} = \text{FMV} \times 1/(1 + i)^N \times \text{Survival Probability}$$

In this formula, FMV is the full fair market value of the residence, *i* is the interest rate per interval, N is the number of intervals, and Survival Probability is the probability that the grantor will survive until the end of the term. The interval is usually 1 year. The calculation $1/(1 + i)^N$ provides the present value of the right to receive $1 at the end of the term, sometimes described as the amount that must be invested today to produce a fund of $1 at the end of the term. This is multiplied by the Survival Probability because the remainderman of a standard QPRT receives nothing unless the grantor survives the term.

The interest rate is the IRC §7520 rate for the month of the transfer. This is published monthly in the Internal Revenue Bulletin and reprinted by major tax services. Under IRC §7520, the applicable interest rate is the rate (rounded to the nearest 0.2 percent) equal to 120 percent of the federal midterm rate, compounded annually, in effect under IRC §1274(d) for the month in which the valuation date falls.

The probability of survival is calculated using Table 2000CM, found at the end of Temp Treas Reg §20.2031-7T(d)(7), which shows the number of people still alive at each year of age out of a pool of 100,000 people. All 100,000 are alive at age zero, and 11 people are still alive at age 109. The chance that a person age X will survive until age Y is calculated by dividing the number of people alive at age Y by the number of people alive at age X. Thus, the chance that a newborn will survive to age 109 is 11/100,000.

For example, the gift made when a 60-year-old person transfers an $800,000 residence to a QPRT with a 7-year term in a month when the IRC §7520 interest rate is 2.4 percent is:

$$\$800{,}000 \times 1/(1 + 0.024)^7 \times 79{,}530/87{,}595$$

The present value of remainder interest without regard to the need to survive is 1/1.1806, or 84.703 percent. The probability of survival is 90.793 percent. The value of the gift is therefore $615,240 (($800,000 ×.84703) ×.90793).

The practical necessity of using either a computer program or the "quick and dirty" method is illustrated by the IRS's sample calculations described in IRS Pub 1457, which arrive at the same $615,240 figure for an equivalent GRIT by making the incomprehensible calculations shown in §14.13. Keep in mind that excessive precision is hardly warranted in view of the fact that the $800,000 fair market value for the house can hardly be viewed as an exact figure.

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§17.55 C. How Many QPRTs?

The question of how many QPRTs should be created is related to the selection of the QPRT term. Sometimes the client cannot make a decision: Should the term be 10 years? Should it be 15 years? QPRTs are very flexible devices. The client can reasonably decide, for example, to transfer one-third of the residence to a 10-year QPRT, one-third to a 15-year QPRT, and the remaining one-third to a 20-year QPRT. The gift tax result will not be as favorable as if the entire residence were transferred to a 20-year QPRT, but the client can be certain that if he or she survives at least 10 years, some of the residence will be excluded from the client's taxable estate.

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§17.56 D. How Many Residences?

The regulations allow each parent to transfer an interest in the principal residence and one other residence to a QPRT. See §17.26. That means that, with a married couple, up to three residences can be transferred to QPRTs when each spouse claims a separate vacation residence as his or her own.

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§17.57 E. Naming Trust as Remainder Beneficiary

A good rule of thumb in estate tax planning is to not make transfers directly to children; instead, make them to irrevocable trusts for the children's benefit. After all, the attorney represents the parents, not the children. Children are inherently unreliable; at some point they are convinced that they know more than their parents. The best way to protect the parent is to keep the children one step removed from the assets. Furthermore, holding assets in trust for the children protects the children from their own potential future mistakes, *e.g.*, the parent's despised future ex-son-in-law or daughter-in-law.

With QPRTs, that rule of thumb has two additional positive aspects: (1) property tax and (2) generation-skipping transfer (GST) tax. When the QPRT term ends, the residence should pass to an irrevocable trust for the benefit of the grantor's children. If a child has died and is survived by children (the grantor's grandchildren), that branch of the family should be excluded from the remainder beneficiary trust. That seemingly harsh result can be ameliorated by making a change in the grantor's primary estate planning documents. (A client entering into a QPRT transaction is unlikely to be relying on a will as the client's primary estate planning document.) The parent's family trust should be amended to include a "make-up" provision (sometimes called an "equalization" provision) for that branch of the family. This technique has the following advantages:

- There will be no reassessment of the residence for property tax purposes (because there will be no grandchildren involved in the trust which is the owner of the residence after the end of the QPRT term); and
- The parent can make an allocation of GST exemption to the remainder beneficiary trust when it acquires the residence at the end of the term, when the estate tax inclusion period (ETIP) ends (see IRC §2642(f)(3); Treas Reg §26.2632-1(c)(2)).

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§17.58 F. Example of "Reverse" QPRT

Mom is now 80 and has a remaining life expectancy of 10 years. The QPRT has ended and the residence is owned by Son. The residence is still worth $1,000,000, but Mom has lost her other assets, so the fair rental value of $4000 per month frightens her. Son establishes a new QPRT under which Mom will have the right to live in the residence for 5 years rent free. At the end of the 5-year term, the new QPRT ends and Mom will, if she wishes to remain in the residence, have to pay the fair rent. Son's gift is $145,717. This gift is eligible for the gift tax annual exclusion, so Son must file a gift tax return for $145,717, minus $13,000 (in 2010) for one gift tax annual exclusion, resulting in a taxable gift of $132,717. When the 5-year term ends, Mom will be 85 and, they hope, less concerned about using her remaining funds to pay rent.

This type of "reverse" or "return" QPRT was first approved in IRS Letter Ruling 200814011. There are now at least ten such rulings. See §17.36. Although the IRS expressed no opinion on whether the children's transfer of the residence to the QPRT would cause the residence to be included in the parent's estate under IRC §2036, careful planning should avoid that result.

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§17.59 IV. ALTERNATIVES TO QPRT

The decision about whether to use a QPRT typically involves the following questions:

- Is the client willing to lose ownership of a home? Is the client willing to have the children lose the step-up in basis that would otherwise occur on the client's death? Ownership and basis may be minor concerns in some situations, *e.g.,* when a vacation home has a high basis after the spouse's death and the surviving spouse is confident that the children will not allow her to vacation in their Lake Tahoe "cottage" after the QPRT term expires.
- Is the client concerned about the inability to lease back the property after end of the QPRT term?
- What is the opportunity cost—not just on paper, but in terms of probable behavior? Will a QPRT discourage the client from making annual exclusion gifts? Will the QPRT exhaust unified credit that might be better applied to transferring interests in a family business or a family limited partnership? Or will no opportunity be sacrificed by creating a QPRT because the client would otherwise do nothing?
- Is the client likely to survive the term?
- Is the client likely to meet the occupancy requirement for at least most of the term?
- Is the property value reasonably certain to appreciate?

The array of possible answers to these questions illustrates why QPRTs are not for everyone. Although practitioners should avoid overselling QPRTs, they are an appropriate part of certain clients' estate plans and should be reviewed with all clients.

Based on possible answers to these questions, there are a number of alternatives to a QPRT for both estate tax and creditor protection purposes. Alternatives to a QPRT are discussed in §§17.60-17.67. For a summary of alternatives, see §17.68.

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§17.60 A. Outright Gift

In unusual situations the parent may prefer an outright gift of the residence to the children or to a trust for their benefit. The parent must be prepared to (1) start paying rent immediately if he or she intends to continue living in the residence, and (2) use a portion of the parent's gift tax applicable exclusion amount equal to the residence's net value.

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§17.61 B. Sale-Leaseback

A sale-leaseback makes sense in a number of situations. For example, if Mom has no more gift tax applicable exclusion amount left, a sale to Son accompanied by a lease-back at fair rental value may be an attractive way to exclude future appreciation from Mom's estate. That is especially the case during a period when the long-term applicable federal rate (AFR) is low, yet long-term hyper-inflation is expected due to massive government budget deficits. However, Mom and Son must be careful that each element of the transaction is done at appraised value and that the transaction is structured as it would be were it between independent third parties, including proper security, downpayment, and other terms. Otherwise, the residence will be included in Mom's estate under IRC §2036.

In *Estate of Maxwell v Commssioner* (2d Cir 1993) 3 F3d 591, the court stated: "[T]he rent paid by the decedent to [her son and his wife] came remarkably close to matching the mortgage interest which they paid to her." The court added: "Not only did the rent functionally cancel out the interest payments made by [her son and his wife], but [they] were at no time called upon to pay any of the principal on the $250,000 mortgage debt." 3 F3d at 592. On that basis, the Second Circuit affirmed the Tax Court decision that the decedent made a transfer with an implied understanding that she would continue to reside in her home until her death and therefore the transfer was not a bona fide sale for an adequate and full consideration in money or money's worth.

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§17.62 C. Part-Gift, Part-Sale

Perhaps the most common transaction is neither an outright gift nor a sale-leaseback but a combination of the two. There is both a practical reason for this and a reason grounded in the Internal Revenue Code itself.

The practical reason is that Mom wants to remove future appreciation of the residence from her taxable estate. She is willing to allocate some of her lifetime transfer tax exclusion to this transaction. However, she is unwilling to part with all of the equity. So she agrees to transfer her $1,000,000 residence to Son as follows: $200,000 as a gift, with the balance paid in the form of a 30-year, fully amortized note at 4.38 percent, the IRC §7520 rate for long-term payments made monthly in May 2010. Although Mom must pay fair rent while she continues to reside in the residence, she knows that if she moves out in the future, she will continue to receive monthly payments of $3996.64 for the remainder of the 30-year period.

The tax reason why these transactions are so common is found in IRC §2001(f)(2) ("final determination"). That section provides that, if the value of a gift is shown on a federal gift tax return (Form 709), and the IRS does not contest the value before the expiration of the statute of limitations, the reported value shall be treated as finally determined for federal gift tax purposes, provided the gift was adequately disclosed. See §2.46A. Assume that Mom sells her residence to Son for what she believes is fair market value ($1,000,000) in 2010. Mom dies in 2020. The IRS, in auditing her estate tax return (Form 706), determines that the value of the residence in 2010 was $1,500,000, not $1,000,000. That $500,000 of extra value was a gift; since it was not reported, the gift tax statute of limitations never expired. For that reason, in every sale to a family member it is advisable to file a federal gift tax return, accompanied by a professional, third party appraisal, showing at least some gift to commence the running of the statute of limitations.

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§17.63 D. Family Limited Partnership

Imagine that Mom planned to sell her home in the future and use the proceeds to buy investment real estate, or that she planned to turn it into rental property. It might make sense for Mom to contribute the home now to a family limited partnership and enter into a fair market lease with the partnership. Of course, failure to pay fair rent will probably result in inclusion of the property in Mom's estate under IRC §2036. See *Estate of Thompson v Commissioner* (3d Cir 2004) 382 F3d 367, discussed in §2.48. Generally, a family limited partnership is not an attractive alternative to a QPRT. The IRS and the courts do not look favorably on the use of a family limited partnership to hold personal use property. Obtaining an independent third party's determination of the fair rental value, having a written lease that would be appropriate between independent third parties, and actually paying the rent should, at least in theory, persuade the IRS and the courts not to apply unfavorable tax treatment to such a partnership. However, the presence of a personal use asset is likely to cause problems that could otherwise be avoided, and the cost of a hostile audit, appeal, and litigation will be unwelcome to the client.

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§17.64 E. Grantor Retained Annuity Trust

There is a practical limit of the extent to which a QPRT will reduce the value of a gift. When the residence is extremely valuable, there will be an immediate taxable gift even if Mom has her entire lifetime transfer tax exclusion available (calculated using an interest rate of 3.4 percent, based on example in §17.4):

Net Equity of Residence	*Value of Gift for 15-Year Term for 65-Year-Old Grantor*
$1,000,000	$374,300
$2,000,000	$748,600
$3,000,000	$1,122,900
$4,000,000	$1,497,200
$5,000,000	$1,871,500
$6,000,000	$2,245,800

The table above also could apply when Mom has valuable principal and vacation residences and wishes to use QPRTs for both. The prospect of paying, with $6,000,000 of equity, a gift tax of $1,010,610 ($2,245,800 ×.45) may be unappealing. There are several approaches to consider.

First, Mom may transfer only a portion of each residence to a QPRT. That will be helpful for both estate tax and creditor protection purposes. For estate tax purposes, a transfer of a 50-percent interest in the residence will—if she survives the term—remove 50 percent of the value from her estate and allow for a tenancy-in-common discount on the 50-percent interest still in her estate, as discussed in §17.29. Again, the tenancy-in-common discount should be determined by a competent appraiser. For creditor protection purposes, the retained interest is less attractive than a 100-percent fee interest.

Second, Mom may begin with a gift of a 1-percent undivided interest to Son. Then she would enter into a fair market lease with Son for the 1-percent. Then she would hire a business appraiser to value the remaining 99-percent tenancy-in-common interest. Depending on the appraiser and the market conditions, that discount may reduce the value of the gift by 10 to 30 percent.

Third, Mom may transfer the residence to a grantor retained annuity trust (GRAT), as illustrated in the example below. Of course, any transaction must be done strictly in accordance with independent third party appraisals.

EXAMPLE: The following figures illustrate how a GRAT might work. These figures are hypothetical, including the amount of rent paid to the trust. Note that the payment of excessive rent would be an additional taxable gift.

Year 1: Mom transfers the residence, with $6,000,000 of net equity, to a trust for the benefit of Son, which is a grantor trust as to Mom and thus ignored for income tax purposes. The payments under the GRAT require an annuity of 5 percent ($300,000) in the first year, with the payments increasing at 20 percent per year for the 9-year term. The GRAT results in a gift from Mom to Son of $1,055,370. Mom enters into a lease for $500,000 per year with the GRAT. The GRAT has a $200,000 surplus in Year 1.

Year 2: The annuity payment is $357,000. The GRAT receives $500,0000 of rent, so it has a surplus of $343,000 ($200,000 + $143,000).

Year 3: The annuity payment is $424,830. The GRAT receives $500,000 of rent, so it has a surplus of $418,170 ($343,000 + $75,170).

Year 4: The annuity payment is $505,547.40. The GRAT receives $500,000 of rent, so its surplus is reduced to $412,622.60 ($418,170 − $5,547.40).

Year 5: The annuity payment is $601,601.40. The GRAT receives $500,000 of rent, so its surplus is reduced to $311,021.20 ($412,622.60 − $101,601.40).

Year 6: The annuity payment is $715,905.60. The GRAT receives $500,000 of rent, so its surplus is reduced to $95,115.60 ($311,021.20 − $215,905.60).

Year 7: The residence is appraised. It has gone up in value by 7 percent per year and is now worth $9,000,000. Mom buys the residence from the GRAT. Mom makes a down payment of 33.3 percent ($3,000,000). There is no recognized gain on the sale since the GRAT is a grantor trust. The GRAT uses $851,927.40 to make the Year 7 annuity payment to Mom.

Year 8: The annuity payment required to Mom is $1,013,793.60.

Year 9: The annuity payment is $1,206,414.60. The GRAT terminates and its asset (the note from Mom for $6,000,000) is distributed to the remainder beneficiary (Son, or a trust for his benefit).

The net result is that a note equal to the beginning value of the residence is deducted from Mom's estate, and Mom used her entire lifetime transfer tax exclusion but paid only $25,000 in gift tax in Year 1. Moreover, she only had to survive 9 years to accomplish this result, much shorter than a typical QPRT term.

This is an extremely complex transaction. As a rule of thumb, the attorney should allow at least twice as much time and effort for this type of transaction as for a QPRT.

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§17.65 F. Joint Purchase

The grantor can contribute an amount equal to the fair market value of a life estate in a personal residence as part of a joint purchase of new property. That eliminates the risk of estate inclusion that results when a QPRT is created with property the grantor already owns because, with a joint purchase, there is no taxable gift and no transfer of property with a retained interest. For example, the value of a life estate in a $1,000,000 residence for the joint lives of a couple who are both age 60 is $713,620, assuming an IRC §7520 interest rate of 5 percent. Thus, there is no net gift on the contribution of this amount by the couple to the purchase of the residence. On valuation of property interests, see chap 6. However, this no-tax result requires that the remaindermen of the property contribute funds to the purchase equal to the value of the remainder interest ($286,380 in this example) from a source other than a gift from the grantor. The transaction has the benefit of shifting any appreciation during the grantor's lifetime to the remaindermen.

Because there is no taxable gift, the GST tax issue does not arise. The transaction has the same implied benefit as a QPRT that the payment of maintenance expenses by the holder of the life estate is not treated as a gift to the remaindermen. In this case, the grantor should not retain a reversion because the property will not otherwise be included in the grantor's estate, as it would be in the case of property transferred to a QPRT.

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§17.66 G. "Zeroed-Out" QPRT

A few planners with clients who cannot get the benefit of a standard QPRT because they have already exhausted their IRC §2010 unified credit or IRC §2505 gift tax applicable exclusion amount might want to consider a "zeroed-out" QPRT. In a zeroed-out QPRT, the grantor retains the right to income and the right to receive an interest equal in value to the initial fair market value of the residence at the end of the term. Unlike a standard QPRT and like a zeroed-out GRAT (see §15.5), a zeroed-out QPRT is designed to have no gift tax cost and produces a benefit only if the property transferred to the QPRT appreciates during the term. That benefit also must be weighed against the loss of a step-up in basis on the grantor's death after the end of the term under IRC §1014. The value of the right to receive an interest equal in value to the initial fair market value of the residence at the end of the term, in addition to the value of the right to live in the residence and to receive all income from the trust during the term, is equal to the value of the property. Accordingly, there is no taxable gift on the transfer of property to the QPRT. If the property appreciates during the term, the amount of the appreciation will pass tax free to the QPRT remainder beneficiaries. Under Treas Reg §25.2702-5(c)(9), the interest in the residence must be retained by the trustee after the term rather than distributed to the grantor. Also, the property transferred to the QPRT should be less than a 100-percent interest in the residence because the grantor's retained interest will be less than a 100-percent interest in the appreciated property and so will be discounted to reflect its lack of marketability. For further discussion, see McCaffrey & Schneider, *GRAT and QPRT Planning*, Estate Planning 2002 §5.49 (Cal CEB 2002).

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§17.67 H. Intentionally Defective QPRT

The GRAT conversion requirement discussed in §17.32 suggests a planning strategy that may be called an "intentionally defective QPRT" in which a residence that is expected to be sold within a short time is transferred to a QPRT that will then convert to a GRAT when the property is sold. The advantage of a QPRT over a GRAT funded with the property is that the value of the grantor's reversion in the QPRT may be deducted (in addition to the value of the retained income interest) in valuing the gift to the remainder beneficiaries of the trust. See §17.2. In contrast, only the value of the grantor's retained annuity interest may be deducted in valuing the gift to the remainder beneficiaries of a GRAT. See chap 15. A further advantage of a QPRT is that the property need not be sold within the first year of the trust to make the required annuity payment if the grantor no longer desires a sale of the property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/17 Qualified Personal Residence Trusts (QPRTs)/§17.68 I. Summary of Alternatives to QPRT

§17.68 I. Summary of Alternatives to QPRT

Factors	Alternatives to QPRT				QPRT
	Do nothing	*Outright gift to children (or a trust for their benefit)*	*Sell to children (or trust for their benefit) for fair market value*	*Contribute to a family limited partnership*	
Set-up costs	N/A	Prepare the deed, PCOR, Prop. 58, 709 (and trust for the children) and lease	Prepare the deed, PCOR, Prop. 58, note, deed of trust, escrow and lease (and trust for the children)	Prepare FLP, corporate GP, heirs' trusts, deed, PCOR, 709	QPRT, calculations, deed, PCOR, Prop. 58, children's trust, appraisal, 709
Annual upkeep	N/A	Pay rent	Pay rent	1065, 1120S, 1041s, minimum franchise taxes	Not usually
Pay Gift Tax?	No	If gift exceeds exclusion	No	Depends on interest of children's trusts	If gift exceeds exclusion
Save Estate Tax?	No	On increase over gift value	On increase over purchase price	Yes due to valuation discounts	On increase over purchase if parent outlives the term
Homestead?	Yes	No	No	No	Yes
Can creditor get the house?	Yes	No (unless a fraudulent transfer)	No (unless a fraudulent transfer), but creditor can seize the note	No (unless a fraudulent transfer), but can get a charging order on parents' LP interests	No (unless fraudulent transfer or, in bankruptcy, 10 year self-settled trust rule applies)
Does the parent pay rent?	No	Yes when children no longer living at home	Yes when children no longer living at home	Yes	Not until retained term ends
Can the parent deduct the mortgage?	Yes	Yes if a grantor trust	Yes if a grantor trust	Parents' interest flows through on the K-1	Yes, until the retained term ends and thereafter if a grantor trust
Can the parent use the equity?	Yes	No	No	Indirectly through the FLP	No

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§17.69 V. DRAFTING QPRT

The statute and regulations rigorously regulate the contents of a QPRT; many provisions are mandatory. Treas Reg §25.2702-5(c)(1). The typical QPRT trust instrument contains few custom provisions other than those pertaining to names, dates, the trust term, the real property description, and the disposition at the end of the trust term. The IRS has provided a sample QPRT designed to meet the requirements of the statute and regulations. However, the sample QPRT does not give the grantors a reversionary interest as provided by most QPRTs. (The reversionary interest, as discussed in §7.7, reduces the value of the gift.) The sample QPRT also does not include a commonly used provision disposing of the residence to a grantor trust at the end of the term. Rev Proc 2003-42, 2003-1 Cum Bull 993.

If the disposition at the end of the term involves a trust, the terms of the continued trust may be incorporated into the QPRT instrument. However, most practitioners prefer to use a separate trust instrument. A separate trust instrument emphasizes the fact that the "continued" trust is actually a different trust in terms of disposition scheme and tax consequences. That is less confusing to the clients and their accountants. Regardless of whether a continuing trust or a second trust is used, the distributive provisions may not include any provisions that might cause the original transfer to the QPRT to be an incomplete gift under Treas Reg §25.2511-2(b).

Aside from the need to comply with regulations, many practitioners go out of their way to avoid custom QPRT provisions on the theory that they can create tax risks without any actual benefit. In particular, the drafter should avoid provisions regarding possible repurchase of the residence to prevent the IRS from contending that (1) the transfer was a sham or (2) a retained interest will cause the trust corpus to be included in the grantor's estate under IRC §2036. Similarly, the grantor should not expressly retain any right to lease the residence after the trust term. If a lease is contemplated, the grantor should instead have the QPRT pass to a second trust at the end of the term, naming a trustee of the second trust who will be receptive to the lease.

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§17.70 A. Form: Declaration of Transfer to Trustee

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I, _ _[*name of settlor*]_ _ (called the "settlor"), hereby transfer and deliver to _ _[*name of trustee*]_ _, as trustee, the property described in Schedule A, attached to this instrument.

Comment: Technically, the settlor (or grantor) can be the trustee. However, the more conservative approach is not to name the grantor or the grantor's spouse. Most clients, with some discussion, will agree on a trusted third party, even an adult child.

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Source: Estate Planning/Drafting California Irrevocable Trusts/17 Qualified Personal Residence Trusts (QPRTs)/§17.71 B. Form: Trust Name

§17.71 B. Form: Trust Name

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ARTICLE ONE
Trust Name

The trust created by this instrument may be referred to as the _ _[*full name of settlor, e.g., JOHN J. SMITH*]**_ _ Qualified Personal Residence Trust.**

Comment: The words "qualified personal" in this form may be omitted.

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§17.72 C. Form: Trust Estate

▶ To download **Word** version, right click and choose *Save Target As*

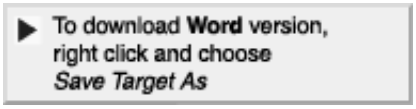
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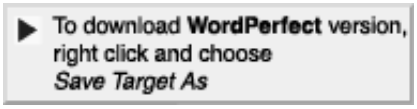
ARTICLE TWO
Trust Estate

A. *Administration of Trust Estate*. All property subject to this instrument from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.

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§17.73 D. Form: Limit on Additions to Trust Estate





B. *Additions to Trust*. No additions may be made to the trust estate except as expressly authorized in this trust.

Comment: Limits on the permitted assets of the trust are required by Treas Reg §25.2702-5(c)(5).

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§17.74 E. Form: Irrevocability of Trust

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ARTICLE THREE
Irrevocability of Trust

This trust is irrevocable and may not be altered or amended. Despite the preceding sentence, the trustee shall have the power, acting alone, to amend the trust to the extent provided in Treasury Regulation §25.2702-5(a)(2) (or any later regulation or statute) in any manner required for the sole purpose of ensuring that the trust qualifies as a qualified personal residence trust for purposes of Internal Revenue Code §2702(a)(3)(A) and Treasury Regulation §25.2702-5(c) (including, as to the grantor retained annuity trust (GRAT) administered under Article Seven, the qualification of the annuity interest under Internal Revenue Code §2702(b)(1) and Treasury Regulation §25.2702-3).

Comment: The second sentence is based on the sample QPRT in Rev Proc 2003-42, 2003-1 Cum Bull 993.

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§17.75 F. Form: Trust Term

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ARTICLE FOUR
Trust Term

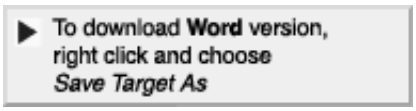
This trust is effective immediately and terminates on the death of the settlor or end of a period of _ _[*number*]_ _ years from the date of this trust, whichever occurs first. The period before termination is referred to as the "trust term."

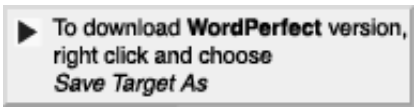
Comment: For discussion of considerations involved in selecting the term, see §17.50. Although the trust specifies that it is effective immediately, the deed should be recorded contemporaneously with the signing of the trust instrument to avoid any confusion about whether the term ends the specified number of years after the date the trust was signed or after the date the deed was recorded.

In addition, the attorney should insert a reminder in the firm's calendar system about the QPRT termination date. See §17.24.

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§17.76 G. Form: Operation During Trust Term





ARTICLE FIVE
Operation During Trust Term

During the trust term, all assets of the trust shall be administered as follows in accordance with this Article Five, except that assets of the separate account described in Article Seven shall be administered in accordance with Article Seven.

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§17.77 1. Form: Limitations on Trust Property

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A. *Limitations on Trust Property*. This trust is not permitted to hold any assets other than the following:

(1) One residence, or a portion thereof, used or held for use as a personal residence of the settlor. For purposes of this subparagraph, a personal residence is a single property that is a principal residence within the meaning of Internal Revenue Code §1034, one other residence within the meaning of Internal Revenue Code §280A(d)(1) but without regard to Internal Revenue Code §280A(d)(2), or an undivided interest in either.

(2) Cash in an amount not to exceed the amount required to pay trust expenses incurred or reasonably expected to be paid during the six-month period after the addition of the cash to the trust:

(a) For improvements to be paid within six months from the date on which the addition of cash is made to the trust;

(b) For the trust's purchase of an original residence within three months after the date of execution of this trust, but only if the trustee has previously entered into a contract to buy that residence; and

(c) For the trust's purchase of a residence to replace another residence within three months after the addition of the cash to the trust, but only if the trustee has previously entered into a contract to buy that residence.

(3) Improvements to the residence if the residence, as improved, meets the requirements of a personal residence of the settlor.

(4) Proceeds from the residence's sale.

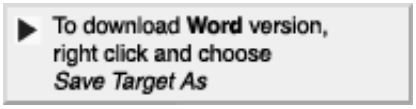
(5) Insurance policies on the residence and the policies' proceeds. For purposes of this Article Five, amounts received due to any involuntary conversion of the residence (within the meaning of Internal Revenue Code §1033) shall be treated as insurance proceeds.

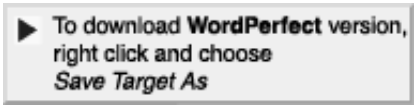
Comment: This clause is required by Treas Reg §25.2702-5(c)(1), (c)(2)(i), (c)(5)(i)-(ii). Presumably, the regulations eventually will be amended to reflect the repeal of former IRC §1034.

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Source: Estate Planning/Drafting California Irrevocable Trusts/17 Qualified Personal Residence Trusts (QPRTs)/§17.78 2. Form: Separate Account for Cash Additions

§17.78 2. Form: Separate Account for Cash Additions





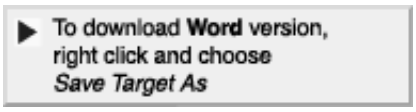
B. *Separate Account for Cash Additions*. Any cash initially transferred to the trust estate and any additions of cash to the trust shall be held and administered as a separate account known as the "trust operations account." The trustee may accept any additional contribution of cash and later additions of cash. However, no such contribution or addition may be accepted that causes the balance of the account to exceed the limits set forth in Article Five, subparagraph A(2).

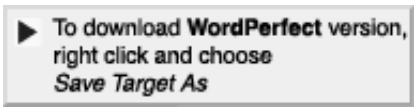
Comment: Treasury Regulation §25.2702-5(c)(5)(ii)(A)(1) requires the separate account for cash additions. By implication, cash transferred at the beginning of the trust is an "addition" for purposes of the requirement.

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Source: Estate Planning/Drafting California Irrevocable Trusts/17 Qualified Personal Residence Trusts (QPRTs)/§17.79 3. Form: Exclusive Use of Residence

§17.79 3. Form: Exclusive Use of Residence





C. *Exclusive Use of Residence*. During the term of this trust, the settlor shall be entitled to exclusive use and possession of the residence (including any replacement residence). This right is subject to the trustee's right to sell the residence and subject to the provisions in this trust for creation of an annuity interest under Article Seven if the trust ceases to be a qualified personal residence trust (QPRT). If the settlor does not use the residence as a residence at any time, the trustee may hold the residence for use as a personal residence of the settlor, prohibiting occupancy by any other person other than the spouse or a dependent of the settlor, as long as this action will continue to qualify the trust as a QPRT.

Comment: This clause gives the settlor the right of possession necessary to satisfy the "personal residence" requirement. See §17.10. When both spouses transfer interests to a single trust, this clause should be modified to comply with the requirement that the trust specify that no person other than a spouse may hold a term interest in the trust concurrently with the other spouse. See Treas Reg §25.2702-5(c)(2)(iv).

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§17.80 4. Form: Trust Income to Settlor

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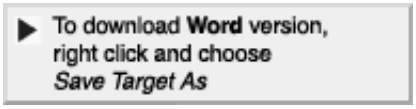
D. *Distribution of Income*. All income of the trust shall be distributed to the settlor no less frequently than annually.

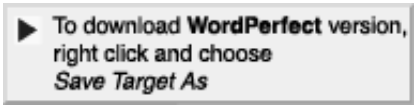
Comment: This clause is required by Treas Reg §25.2702-5(c)(3).

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Source: Estate Planning/Drafting California Irrevocable Trusts/17 Qualified Personal Residence Trusts (QPRTs)/§17.81 5. Form: Distribution of Excess Cash

§17.81 5. Form: Distribution of Excess Cash





E. *Distribution of Excess Cash*. No less frequently than quarterly, the trustee shall determine whether the balance of the trust operations account exceeds the amount permitted by Article Five, subparagraph A(2). If the limit is exceeded, the excess amount shall be immediately distributed to the settlor. On expiration of the trust term, any amounts held in the trust operations account that are not used to pay trust expenses due and payable on the date of termination (including expenses directly related to termination) shall be distributed outright to the settlor within 30 days. If the settlor is deceased, distribution shall be made to the settlor's _ _[*estate/revocable trust*]_ _.

Comment: This clause is required by Treas Reg §25.2702-5(c)(5)(ii)(A)(2), which does not take into account the possibility of the settlor's death.

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§17.82 6. Form: Limit on Trust Distributions

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F. *No Distributions to Other Beneficiaries*. No portion of the trust estate may be distributed to any person other than the settlor before expiration of the trust term.

Comment: This clause is required by Treas Reg §25.2702-5(c)(4).

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§17.83 7. Form: Payment of Trust Expenses

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G. *Payment of Trust Expenses*. Subject to the limits of Article Five, subparagraph A(2), the settlor agrees to make any additions to the trust operations account that may be necessary from time to time to fund the trust expenses.

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§17.84 8. Form: Sale of Residence

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H. *Sale of Residence*. The trustee may sell the residence at any time and may acquire a replacement residence. In exercising its discretion, the trustee shall consider the mandatory obligations of the trustee under this instrument, the settlor's needs, and the QPRT's purposes. In the event of sale, the trustee shall hold the proceeds in a separate account under Treasury Regulation §25.2702-5(c)(5)(ii)(C). The trust shall cease to be a QPRT as to the proceeds of sale no later than the earlier of:

(1) The date that is two years after the date of sale;

(2) Termination of the term holder's interest in the trust; or

(3) The date on which a new residence is acquired by the trust.

Comment: Much of this clause is mandatory. See Treas Reg §25.2702-5(c)(7)(ii). If the trustee is not authorized to hold the sale proceeds in a separate account, a provision for immediate cessation of QPRT status must be substituted. Immediate cessation is not desirable. See §17.10. This is one reason clients with QPRTs should be part of the attorney's ongoing estate plan maintenance program. See §17.24.

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§17.85 9. Form: Damage to or Destruction of Personal Residence

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I. *Destruction of Personal Residence*. If damage or destruction renders the residence unusable as a residence, the trust ceases to be a QPRT on the date that is two years after the date of damage or destruction (or the date of termination of the term holder's interest in the trust, if earlier) unless, before that date, replacement or repairs to the residence are completed or the trust acquires a new residence. If the trustee receives insurance proceeds due to damage to or destruction of the residence, the trustee shall hold the proceeds in a separate account under Treasury Regulation §25.2702-5(c)(5)(ii)(D). The trust ceases to be a QPRT as to the insurance proceeds no later than the earlier of:

(1) The date that is two years after the date of the destruction or damage;

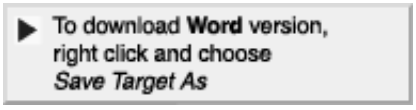
(2) Termination of the term holder's interest in the trust; or

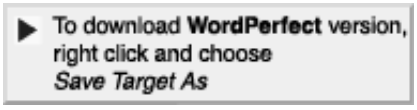
(3) The date on which the proceeds are spent to repair or replace the residence.

Comment: Most of this clause is mandatory under Treas Reg §25.2702-5(c)(7)(iii).

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§17.86 10. Form: Cessation of Use as Personal Residence





J. *Cessation of Use as Personal Residence*. Subject to the rules in Article Five, paragraph I, that apply when a cessation of use of a residence by the settlor is caused by the residence's sale or destruction, the trust ceases to be a QPRT if it ceases to be used or held for use as a personal residence. A residence is held for use by the settlor as long as it is not occupied by any other person (other than the settlor's spouse or dependent) and is available at all times for use by the settlor as a personal residence.

Comment: This clause is required by Treas Reg §25.2702-5(c)(7)(i).

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§17.87 11. Form: Cessation of QPRT Status

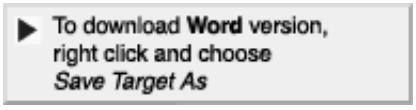
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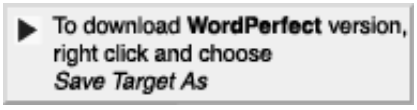
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K. *Cessation of QPRT Status*. Within 30 days after the date on which the trust ceases to be a QPRT as to any trust assets, those assets shall be converted to and held for the balance of the trust term in a separate share under Article Seven.

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§17.88 12. Form: Prohibition on Transfer to Settlor





L. *Transfer of Residence to Settlor Prohibited*. Except as expressly permitted by Treasury Regulation §25.2702-5(b)(1), (c)(9), the trustee may not sell or transfer the residence, directly or indirectly, to the settlor, the settlor's spouse, or an entity controlled by the settlor or the settlor's spouse during the term of this trust or at any time after the term as long as this trust remains a grantor trust as to the settlor within the meaning of Internal Revenue Code §§671-677. The purpose of the previous sentence is to satisfy the requirements of the referenced regulation, and the sentence shall be construed accordingly.

Comment: The provision is required by Treas Reg §25.2702-5(b)(1), (c)(9). See §17.42.

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§17.89 H. Form: Distributions on Termination

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ARTICLE SIX
Distributions on Trust Termination

On expiration of the trust term, this trust shall terminate and be distributed as follows:

Comment: If distribution is to be made to a trust that is a grantor trust with respect to the settlor within the meaning of IRC §§671-677, the trust receiving the distribution must contain the prohibition on transfer in §17.88. The restriction must remain in effect until the trust is no longer a grantor trust. Treas Reg §25.2702-5(b)(1), (c)(9).

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Source: Estate Planning/Drafting California Irrevocable Trusts/17 Qualified Personal Residence Trusts (QPRTs)/§17.90 1. Form: Trust Operations Account

§17.90 1. Form: Trust Operations Account

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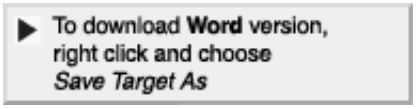
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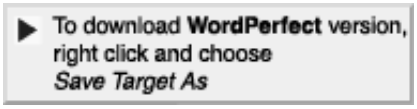
A. *Trust Operations Account*. The trust operations account shall be distributed as provided in Article Five, paragraph E.

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Source: Estate Planning/Drafting California Irrevocable Trusts/17 Qualified Personal Residence Trusts (QPRTs)/§17.91 2. Form: Trust Income

§17.91 2. Form: Trust Income

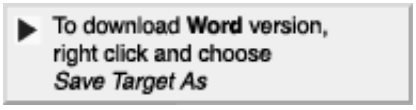


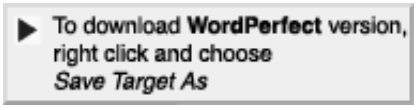


B. *Accrued Income*. Trust income accrued during the trust term shall be distributed to the settlor, if living, and otherwise to the settlor's _ _[*estate/revocable trust*]_ _.

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§17.92 3. Form: Remaining Trust Estate





C. *Distribution of Remainder*. If the trust terminates due to the settlor's death, the remaining trust estate shall be distributed outright or in further trust to persons and entities, including the estate and/or creditors of the settlor, that the settlor appoints by an instrument filed with the trustee. If the settlor fails to exercise this power of appointment, distribution shall be made to the settlor's _ _[*estate/revocable trust*]_ _. If the trust terminates due to expiration of the time interval stated in Article Four with the settlor surviving that time interval, the remaining trust estate shall be distributed as set forth in Schedule B to this trust.

Comment: For a form of Schedule B, see §17.109. For the reasons discussed in §17.38, it is normally desirable to provide that the trust estate reverts to the probate estate or the settlor's revocable trust if the settlor does not survive the term. As noted in §17.43, if the value of the reversion interest does not exceed 5 percent of the value of the residence, additional measures should be taken to ensure that the QPRT is considered to be a grantor trust.

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Source: Estate Planning/Drafting California Irrevocable Trusts/17 Qualified Personal Residence Trusts (QPRTs)/§17.93 I. Form: Conversion to Annuity Trust

§17.93 I. Form: Conversion to Annuity Trust

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ARTICLE SEVEN
Conversion to Annuity

If trust assets are to be held and administered as a separate share because the trust has ceased to be a QPRT as to those assets, the assets of the separate share shall be administered and distributed in accordance with this Article Seven. This article shall be construed according to the purpose of these provisions, which is to accomplish a conversion to a qualified annuity interest under Treasury Regulation §25.2702-5(c)(8).

Comment: For further discussion, see §17.32. The requirement that assets be converted within 30 days may be found in §17.86.

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§17.94 1. Form: Payment of Annuity

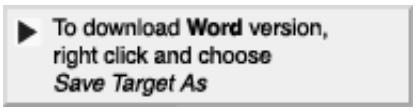
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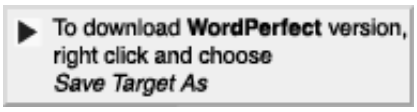
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A. *Payment of Annuity*. The trustee shall distribute to the settlor from the separate account an annuity at the times and in the amounts set forth in this Article Seven.

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§17.95 2. Form: Beginning Date/Deferral of Payment



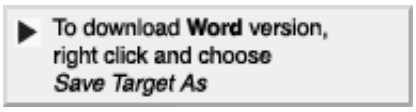


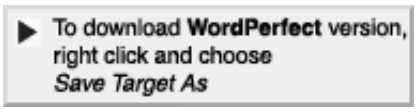
B. *Deferral of Payment*. The settlor's right to receive the annuity amount shall begin on the date of the sale of the residence, the date of damage to or destruction of the residence, or the date on which the residence ceases to be used or held as a personal residence (cessation date). The trustee may, however, defer payment of any annuity amount otherwise payable after the cessation date until the date that is 30 days after the assets are converted to a qualified annuity interest (conversion date). Any deferred payment must bear interest from the cessation date at a rate no less than the Internal Revenue Code §7520 rate in effect on the cessation date. At the trustee's sole discretion, the trustee may reduce the aggregate deferred annuity payments by the amount of income actually distributed from the trust to the settlor during the deferral period.

Comment: This provision is required by Treas Reg §25.2702-5(c)(8)(ii)(B).

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§17.96 3. Form: Payment for Each Year of Trust





[*Use one of the following alternatives*]

[*Alternative 1: Payment for each taxable year*]

C. *Time of Payment*. The annuity amount shall be payable to the settlor annually for each taxable year of the trust term. The trustee may not issue a note, other debt instrument, option, or similar financial arrangement to satisfy the annuity amount. The annuity amount may be paid after the close of the taxable year as long as the payment is made no later than the date by which the trustee is required to file the federal income tax return of the trust for the year (without regard to extensions).

[*Alternative 2: Payment based on anniversary date*]

C. *Time of Payment*. The annuity amount shall be payable to the settlor annually for each year of the trust term from the date of this document. The trustee may not issue a note, other debt instrument, option, or similar financial arrangement to satisfy the annuity amount. The annuity amount may be paid after the anniversary date of this document as long as the payment is made no later than 105 days after the anniversary date.

Comment: The use of one of these alternatives is mandatory. Treas Reg §§25.2702-3(b)(1)(i), 25.2702-3(b)(4), 25.2702-5(c)(8)(ii)(A).

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§17.97 4. Form: Annuity Amount

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D. *Annuity Amount*. The annuity amount shall not be less than an amount determined as follows:

(1) This rule applies if, on the conversion date, the trust estate does not include a residence used or held for use as a personal residence of the settlor. The annuity amount shall be the amount determined by dividing the lesser of (a) the value of all interests retained by the settlor as of the date(s) of the original transfer(s) of the residence to the trust or (b) the value of all the trust assets as of the conversion date by an annuity factor determined for the original trust term using the interest rate used in valuing the settlor's interest in the trust at the time of the original transfer.

(2) This rule applies if, on the conversion date, the trust estate includes a residence used or held for use as a personal residence of the settlor. The annuity amount shall be the amount determined under subparagraph D(1), multiplied by a fraction, the numerator of which is the excess of the fair market value of the trust assets on the conversion date over the amount (including acquisition costs) reinvested in the new residence or spent for repairs of the existing residence, and the denominator of which is the trust estate's fair market value on the conversion date.

[*If appropriate, add the following option*]

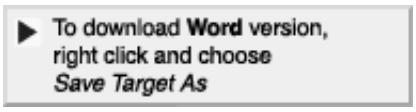
[*Option: Minimum annuity amount*]

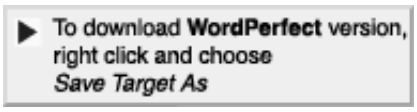
(3) The annuity amount shall be the minimum annuity amount so determined unless the trustee determines that the use of this annuity amount will result in an additional gift by the grantor to the trust due to the conversion, in which case the minimum annuity amount shall be increased to the minimum amount that results in there being no gift.

Comment: Except for the optional addition, this clause is mandatory. Treas Reg §25.2702-5(c)(8)(ii)(C)(2)-(3). The optional addition is recommended. See §17.32.

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§17.98 5. Form: Short Taxable Year



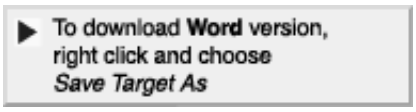


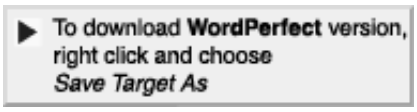
E. *Proration of Annuity Amount*. If a taxable year of the trust is less than 12 months, including the taxable year in which the trust terminates, the annuity amount shall be the amount otherwise determined for the year, multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

Comment: This provision is mandatory. Treas Reg §§25.2702-3(b)(3), 25.2702-5(c)(8)(ii)(A). The trust normally will not have a short taxable year in the year in which the annuity begins. However, this clause presumably applies to make the proration implied by the fact that the starting date of the annuity only coincidentally begins on the first day of a taxable year.

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§17.99 6. Form: Value of Trust Estate





F. *Determination of Annuity Amount*. The value of the trust estate for purposes of determining the annuity amount shall be the fair market value of the assets as determined for federal tax purposes. If the trustee incorrectly determines this value, within a reasonable time after the value is set for federal tax purposes, the trustee shall pay to the settlor (for undervaluation) or the settlor shall repay to the trustee (for overvaluation), an amount equal to the difference between the amount that the trustee should have paid to the settlor and the amount actually paid to the settlor.

Comment: This provision is mandatory. Treas Reg §§1.664-2(a)(1)(iii), 25.2702-3(b)(2), 25.2702-5(c)(8)(ii)(A).

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§17.100 7. Form: Prohibition Against Additions

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G. *Additional Contributions Prohibited*. Additional contributions to a separate account administered under this Article Seven shall be prohibited. If additional assets become subject to administration under this article after other assets are already being administered under it, the additional assets shall be administered separately.

Comment: This provision is mandatory. Treas Reg §§25.2702-3(b)(4), 25.2702-5(c)(8)(ii)(A).

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§17.101 8. Form: No Distributions to Other Persons

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H. *No Payments to Other Beneficiaries*. The trustee shall make no distribution to any person other than the settlor during the trust term as long as this clause shall not limit the trustee's ability to pay trust expenses.

Comment: This provision is mandatory. Treas Reg §§25.2702-3(d)(3), 25.2702-5(c)(8)(ii)(A).

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§17.102 9. Form: Commutation Prohibited

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I. *Commutation Prohibited*. Commutation (prepayment) of the settlor's interest is prohibited.

Comment: This provision is mandatory. Treas Reg §§25.2702-3(d)(5), 25.2702-5(c)(8)(ii)(A).

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§17.103 10. Form: Distribution on Expiration of Trust Term

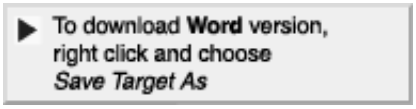
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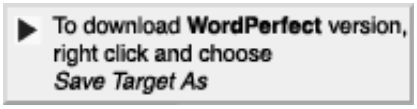
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J. *Distribution on Termination*. At the end of the trust term, the trustee shall pay the settlor, if living, and otherwise _ _[*the estate of the settlor/the trustee of that revocable trust known as* _ _[*specify name of trust*]_ _]_ _ **all remaining amounts due under the obligation to pay the annuity as set forth in this trust. Any amounts remaining after this payment shall be distributed in accordance with Article Six.**

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§17.104 J. Form: Office of Trustee





ARTICLE EIGHT
Office of Trustee

A. *Nomination of Successor Trustees*. If at any time the _ _[*person/institution*]_ _ named as trustee fails to qualify or ceases to act as trustee, the _ _[*persons/institutions*]_ _ listed below shall serve as successor trustees in the order named:

First: _ _[*Name of successor trustee*]_ _

Second: _ _[*Name of second successor trustee*]_ _

_ _[*If the nominated successor also fails to qualify or ceases to act, _ _[name]_ _ shall have the power to name a successor trustee.*]_ _

B. *Compensation of Trustees*. The trustee shall be entitled to reasonable compensation from time to time for services rendered to the trust.

Comment: If a power to name a successor trustee is given to the settlor, the power should expire at the end of the term of the retained interest unless the drafter is certain that the trustee does not hold any powers after the term that would cause inclusion in the settlor's estate if held by the settlor. See §2.62.

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§17.105 K. Form: Trustee Powers

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ARTICLE NINE
Trustee Powers

To carry out the purposes of the trust created by this instrument and subject to any limits stated elsewhere in this instrument, the trustee shall have the following powers in addition to those conferred by California Trust Law:

A. To retain, buy, or otherwise acquire unproductive property.

B. To manage, control, grant options on, sell, convey, exchange, partition, divide, improve, and repair trust property.

C. To lease trust property.

D. To borrow money and to encumber trust property by mortgage, deed of trust, pledge, or otherwise.

E. To initiate or defend, at the trust's expense, any litigation relating to the trust or any trust property.

F. To carry, at the trust's expense, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability as to third persons.

G. To partition, allot, and distribute the trust estate on final distribution of the trust estate, in undivided interests or in kind or partly in money and partly in kind, at reasonable values determined by the trustee, and to sell any property the trustee considers necessary for division or distribution. The trustee may, in the trustee's discretion, make a nonprorata division between beneficiaries if the respective assets distributed to the beneficiaries have equivalent or proportionate fair market values. The income tax bases of assets distributed nonprorata need not be equivalent and may vary to a greater or lesser amount, as determined by the trustee in the trustee's discretion. The provisions of this paragraph G apply only on distribution of the remainder of the trust under Article Six, paragraph C.

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§17.106 L. Form: Governing Law

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ARTICLE TEN
Governing Law

California law shall govern the validity, construction, interpretation, and administration of this trust.

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§17.107 M. Form: Statement of Intent

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ARTICLE ELEVEN
Statement of Intent

Settlor intends that this trust shall qualify as a qualified personal residence trust under Treasury Regulation §25.2702-5(c) and that the provisions of Article Seven shall satisfy the requirements for conversion of the retained interest into a qualified annuity interest. All provisions of this instrument shall be interpreted according to this intention.

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _

[*Acknowledgment; see §8.12*]

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§17.108 N. Form: Description of Transferred Property

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SCHEDULE A
Property Transferred and Delivered to Trustee

1. That certain real property, which is a residence of the settlor and commonly known as _ _[*street address*]**_ _, which is situated in the City of _ _**[*city*]**_ _, County of _ _**[*county*]**_ _, State of California, and more particularly described as follows: _ _**[*Insert legal description*]**_ _.**

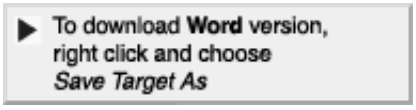
2. That certain policy of insurance on the residence described as follows: _ _[*Describe policy*]**_ _.**

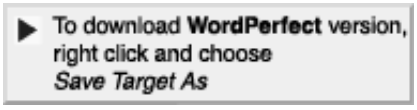
3. Cash in the amount of _ _[*dollar amount*]**_ _.**

Comment: Typically, the initial transfer to the trust is necessarily limited to the items listed in Appendix A. Listing of the policy is desirable to clarify that any insurance proceeds are a trust asset. The sum of cash transferred to the trust cannot exceed the limit in paragraph A(2) of Article Five (see §17.77).

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§17.109 O. Form: Distribution on Termination if Settlor Survives





SCHEDULE B
Distribution on Termination if Settlor Survives

If the settlor survives the period of years stated in Article Four, the remaining trust estate shall be distributed _ _[*e.g., in equal shares to the settlor's children,* _ _[*names*]_ _*. If any child is not then living, that child's share shall be distributed to any person(s) that the child appoints by a provision in the child's last will or codicil. If this power is not exercised, however, that child's share shall be distributed to its estate*]_ _**.**

Comment: The typical beneficiaries of a QPRT are the settlor's children. If the settlor chooses the sample language shown above, he or she will not be able to make disposition changes in his will. See §17.92. For discussion of GST tax issues raised when a grandchild is named as beneficiary, see §17.45.

A second trust can be the beneficiary of a QPRT if the grantor does not have any powers or interests with respect to the second trust that would cause the trust to be included in the estate of either the grantor or the grantor's spouse. Private letter rulings suggest that a retained right to rent the residence for fair market value after the QPRT term will not result in the residence being included in the settlor's estate under IRC §2036. See, *e.g.*, IRS Letter Ruling 9714025. The preamble to TD 8743, 1998-1 Cum Bull 543, 544, permits the settlor to rent the residence as long as the lessor is not a grantor trust with respect to the grantor of the QPRT. If the lessor is such a grantor trust, "the IRS under some circumstances may contend that the grantor has retained the economic benefit of the property," which could result in inclusion of the residence in the grantor's estate under IRC §2036. The grantor must actually pay rent to avoid inclusion. See, *e.g., Estate of Eleanor T. R. Trotter,* TC Memo 2001-250. For a sample client memorandum explaining these features of a QPRT, see §17.110.

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§17.110 P. Form: QPRT Client Memorandum

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QUALIFIED PERSONAL RESIDENCE TRUST

***Purpose of QPRT*. A qualified personal residence trust (QPRT) is an irrevocable trust created by the grantor, the primary asset of which is the grantor's principal residence or another residence such as a vacation home that is held as the personal residence of the grantor for a specified term of years. At the end of the term, the residence will be distributed to the grantor's children or to another continuing trust. The purpose of a QPRT is that the residence will pass to the children or continuing trust at the end of the term (including any appreciation in the value of the residence during the term of the trust) free of any gift or income taxes, at the cost of an immediate taxable gift based on the residence's discounted current value. The QPRT must be funded with a personal residence, or with cash used to buy a personal residence. Also, a reasonable amount of cash may be transferred to the trust to provide for expenses.**

***Estate and Gift Tax Benefit*. The transfer of the residence to a QPRT is a completed gift for gift tax purposes. The amount of the gift is computed by subtracting the present value of the grantor's retained interest from the value of the residence placed in trust. *Example*: At the May 2010 assumed interest rate of 3.4 percent, if a couple both age 65 (nearest birthdays) transfers a personal residence valued at $2,000,000 into two separate QPRTs (with an undivided 50 percent to each trust), claims a 25-percent valuation reduction for the fractional interests, and retains a "reversion" (the right to a return of trust property if he or she dies before the end of the trust term), then the QPRTs, in the aggregate, would constitute a taxable gift as set forth below and would transfer to the children the amounts shown:**

Residence Valued at $2 million Placed in Two QPRTs by Couple Ages 65, 65			
		Tax-Free Transfer to Children at End of Trust Term	
Trust Term	Taxable Gift	No Appreciation	4% Appreciation
5 yrs.	$1,138,814	$2,000,000	$2,433,306
10 yrs.	816,210	2,000,000	2,960,489
15 yrs.	537,884	2,000,000	3,601,887

Assuming that the grantor survives the term of the QPRT, the only portion of the value of the residence placed in the QPRT that will be subject to transfer tax is the taxable gift portion at the time of the transfer. The taxable gift portion can be sheltered from gift tax to the extent of the grantor's available applicable exclusion amount (a cumulative lifetime exemption equal to $1,000,000 for each grantor). At the end of the trust term, the entire value of the property in the QPRT, including any appreciation during the trust term, will pass to the remainder beneficiaries free of transfer tax.

***Income Tax*. The QPRT is a "grantor trust," meaning that any trust income is taxed to the grantor directly (because the principal trust asset is a residence, little or no income is expected). Also, with grantor trust status, the trust's deductions (*e.g.,* for real estate taxes) and tax benefits of owner-occupied real property (*e.g.*, IRC §121 capital gains exclusion) remain available to the grantor.**

***Termination*. At the end of the trust term, the residence will be distributed to the grantor's children, either outright or in continuing trust. Because the trust is treated as a completed gift for gift tax purposes on creation, and the grantor will have paid tax on any trust income earned before termination, the distribution at termination of the trust will be free of any gift tax or income tax, and the children will have a basis in the**

residence equal to the grantor's "carryover basis" in the property.

***Use After Termination*. If the grantor wishes to remain in the residence after the end of the trust term, the grantor could lease the property from the children for fair market value. Also, the children, or the trust for their benefit, can grant the grantor a right to live in the residence rent free for a limited term of years under a relatively new technique referred to as a "reverse" or "return" QPRT.**

***Other Requirements*. If the personal residence is sold during the term, the trustee may use the sale proceeds to buy a replacement personal residence within 2 years. Or, the trust will convert to a grantor retained annuity trust (GRAT) for the remainder of the term with an annuity payment based on the property's fair market value when the trust was created, unless the trustee determines that a larger annuity amount is needed to avoid a taxable gift based on the property's fair market value at the time of conversion, which will preserve most of the transfer tax benefit.**

***Death Before End of Term*. If the grantor dies before the end of the trust term, the property's full value will be included in the grantor's estate for estate and gift tax purposes. Therefore, the grantor should select a term with the risk of inclusion in mind. However, no "double taxation" will result if the grantor dies during the trust term because the transaction will effectively be treated for estate and gift tax purposes as if it had not occurred.**

Comment: This form is based on a sample client memorandum that originally appeared in the February 2005 issue of The Marin Lawyer. It is used with the permission of the author, Theodore A. Hellman of Hanson Bridgett, San Francisco. For a sample GRAT memorandum, see §15.38. For a sample letter transmitting a draft QPRT to a client, see §17.111.

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§17.111 Q. Form: Sample Letter Transmitting Draft QPRT to Client

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_ _[*Letterhead*]_ _

_ _[*Date*]_ _

File No:

Jane Doe
2___ _____ Road
Los Angeles, CA 90025

Re: Residence Trust

Dear Jane [a 41-year-old single person with no children],

This is to follow up your recent discussions with Bruce. Enclosed is a draft of the JANE DOE QUALIFIED PERSONAL RESIDENCE TRUST. This letter refers to the trust as a GRIT (grantor retained income trust) or QPRT.

1. HANDOUT

Enclosed is a copy of our handout generally describing QPRTs. Please refer to it for answers to questions you may have about QPRTs that are not addressed in this letter.

2. PURPOSE: ESTATE PLANNING

The residence trust is drafted to be a "Qualified Personal Residence Trust" as defined in Treasury Regulation §25.2702-5. The QPRT is part of your overall plan to attempt to reduce your ultimate estate tax liability.

3. PARTIAL TRANSFER

As you discussed with Bruce, we are transferring your residence 99 percent to the QPRT and 1 percent to the new irrevocable heirs' trust we are drafting and which you will receive under separate cover (the Jane Doe Heirs' Trust).

4. TRANSFER RESIDENCE TO QPRT

4.1. Deeds.

Also enclosed are two Grant Deeds and accompanying Preliminary Change of Ownership Report (PCOR) to transfer a 99-percent undivided interest in the residence to the QPRT and a 1-percent undivided interest in the residence to the Heirs' Trust. If you then survive your QPRT's term (tentatively 43 years), the 99-percent interest in the residence should not be included in your taxable estate (your heirs should inherit it free of estate tax). As to the 1-percent interest, this is a completed gift, effective when transferred, so it will not be included in your taxable estate.

4.2. No Property Tax Reassessment (Prop. 13 Impact).

The 99-percent transfer should not result in reassessment for property tax purposes, as it is a transfer to a

trust of which you are present beneficiary. On the PCOR we check box H.1: "to a trust for the benefit of the grantor." The County Assessors have become very aggressive in their rejection of property transfers when a reassessment exemption is claimed. It has been our experience that the Assessor proposes reassessment in well over half of the situations where it is not appropriate. If the Assessor asserts that the property should be reassessed, and you want us to handle that claim on your behalf, please mail or FAX us any communications they send you.

The 1-percent transfer will result in a reassessment for property tax purposes since it is not a transfer between parents and children. Therefore, a 1-percent interest in the residence *will be reassessed* now. However, since it appears the residence has gone down in value since you purchased it, that should not increase your property taxes.

When the QPRT terminates, the transfer of the residence to the new irrevocable heirs' trust we are preparing and will send you under separate cover, the Jane Doe Heirs' Trust ("remainder beneficiary" for the balance of this letter), *will not be exempt* since it is not a transfer between parents and children. Therefore, the residence *will be reassessed* at that point (in 43 years).

4.3. Documentary Transfer Tax.

Neither transfer (1 percent or 99 percent) should require the payment of a documentary transfer tax since they are bona fide gifts. This is noted on the face of the deeds by filling in "zero ($0)" in the blank line and referencing the appropriate section of the California Revenue and Taxation Code.

If the QPRT terminates after its term, the transfer of the residence to the remainder beneficiary *will not be exempt* since it is not a gift to children. If the QPRT terminates due to your death before the term is up, the reversion to your estate should not cause reassessment.

5. GRANTOR'S RETAINED RIGHTS

Under the QPRT's terms you, as Grantor, retain:

(i) the right to live in the residence rent-free for the set term of the QPRT (again, tentatively 43 years); and

(ii) the right to have the residence revert to your living trust if you die during the QPRT's term.

5.1. Term of Trust and Impact on Size of Gift.

You provided us with an appraisal that indicates your residence is currently worth $4,350,000 (and it is not subject to debt). Based on your wish for a 43-year term, the gift amount is indicated in the box below. We have also provided the gift amount for other terms in case you wish to reconsider for a term that is shorter than your actuarial life expectancy.

The following examples are based on a residence equity value of $5,000,000. The gift amount assumes that the QPRT term has been successfully completed. The gift tax numbers are merely approximations, assuming a 45-percent tax rate and no remaining unified credit. However, _ _[*name of accountant*]_ _, C.P.A., should put together more appropriate gift tax figures.

QPRT Term	*Gift Amount (gift tax)*
39 years	$623,659 ($280,647)
41 years	$510,472 ($229,712)
43 years	$406,203 ($182,791)

You must carefully consider that if you do not survive your QPRT's term, the entire date-of-death value of the residence will be included in your taxable estate (*i.e.,* as if the QPRT had never been created). Therefore,

you may wish to use a shorter term. (Shorter terms are also advantageous in discouraging unforeseeable future creditors.) Please let us know if you would prefer to use a term other than 43 years.

5.2. Reversion.

The second retained right—the "reversion"—is needed because a QPRT only works if you survive its term. If you die before the term ends, again, the residence is included in your taxable estate. If the residence is included in your taxable estate, your estate will need the assets to pay any tax that might be due. Of course, this reversion is also important for a reason other than providing liquidity: It reduces the size of the gift to the remainder beneficiary.

6. GIFT OF REMAINDER

6.1. Gift.

Upon the residence's transfer to the QPRT, you will be deemed to have made a gift to the remainder beneficiary (the trust for your heirs) of the amount to be determined by _ _[*name of accountant*]_ _, C.P.A.

6.2. Distribute.

The QPRT provides that, when its term ends, the residence (or whatever else is then in the QPRT) will be transferred to the remainder beneficiary. As a result, again, upon the transfer of your interest in the residence to the QPRT, you will be deemed to have made a gift to the remainder beneficiary of the amount to be determined by _ _[*name of accountant*]_ _, C.P.A.

6.3. Remaining Lifetime Exclusion (Unified Credit).

Only gifts of a "present interest" are eligible for the $13,000 annual gift tax exclusion. Since your gift to the remainder beneficiary is a gift of a "future interest," you *cannot* use your annual gift exclusion to help reduce that gift. However, assuming you have a sufficient portion of your lifetime transfer tax exclusion ($1,000,000) left (_ _[*name of accountant*]_ _, C.P.A. should confirm this), the gift should not cause a gift tax.

6.4. Accountant to Prepare Calculations.

_ _[*Name of accountant*]_ _, C.P.A. must prepare the precise calculations of the gift amount when she prepares your gift tax return (due April 15, 2011).

7. OPERATION OF THE QPRT

7.1. Limit on Cash to Pay Expenses.

A QPRT may only hold certain types of property other than the interest in the residence. Specifically, a QPRT may only hold enough cash to pay anticipated trust expenses. Every 3 months, the trustee must distribute to the QPRT's grantor the cash on hand in excess of the amount needed to pay anticipated trust expenses for the next 6 months. Since the QPRT is a "grantor trust" for federal income tax purposes, you will continue to deduct items such as mortgage interest and property taxes whether you or the QPRT pays for those items. Your payment of property insurance, maintenance, and property taxes are not additional taxable gifts per IRS Letter Ruling 9249014. You should still keep careful records of all such expenses. If your estate tax return is audited, the IRS may require proof of amounts spent for these items. You may continue to pay directly the residence's expenses (*e.g.,* property insurance, maintenance, and property taxes), and contribute only a nominal amount of cash to the QPRT, if any.

7.2. Grantor as Income Beneficiary.

During the QPRT's term, the trustee must distribute all trust income to you as the grantor. The trustee is prohibited from making distributions to anyone other than the QPRT's grantor.

7.3. Sale or Insurance Proceeds.

The only other assets the QPRT may hold are (i) the proceeds of any sale of the residence, (ii) insurance policies on the residence, and (iii) the proceeds of those insurance policies if anything happens to the residence.

7.3.1. Reinvestment of Sales or Insurance Proceeds.

If the residence is sold during the QPRT's term, you have 2 years to reinvest the proceeds from the sale in another residence. Since the QPRT is a grantor trust, the QPRT should be able to use your $250,000 income tax exclusion under Internal Revenue Code §121. Likewise, if the residence is damaged or destroyed during the QPRT's term, you have 2 years to fully spend any insurance proceeds to repair or replace the damaged residence.

7.3.2. Conversion to Annuity Trust.

To the extent the trustee fails to reinvest the proceeds in another residence (or repair the residence) within the 2-year period, the QPRT will cease to be a qualified personal residence trust as to the unreinvested proceeds. The trustee must then pay you an annuity for the remainder of the QPRT's term, using the unreinvested funds, under Treasury Regulation §25.2702-5(c)(8)(i)(B). (Since there are no precise rules for calculating the annuity, the professional fees to determine it will be approximately $600-$1200.) *You cannot have the sale proceeds outright*.

8. TERMINATION OF THE QPRT

The QPRT ends at the first to occur of (i) the end of the term period, or (ii) your death.

8.1. Termination Upon Death, if Before End of Term.

Upon your death (if death occurs before the end of the QPRT term), the trustee must distribute directly to your estate any cash in the QPRT in excess of the amount needed to pay trust expenses. The trustee must also pay to your estate any amounts then owing to you under any annuity created under the QPRT. After making those distributions, the trustee will distribute all remaining QPRT property to your living trust. The living trust's beneficiary will have a tax basis in the property received from the QPRT equal to the property's fair market value at your deaths.

8.2. Termination by Expiration of QPRT's Term.

If you survive the QPRT's term, the trustee must distribute the residence to the remainder beneficiary.

8.3. Move Out.

If you cease to live in the residence during the QPRT's term for any reason, the QPRT might no longer be a qualified personal residence trust. However, the Regulations provide that if you vacate the residence and the trustee does not rent it or otherwise permit *anyone* (other than you) to occupy it for the remainder of the term, it will continue to be a qualified personal residence trust.

9. REMAINDER BENEFICIARY: HEIRS' TRUST

When the trustee distributes the remaining property in the QPRT to the remainder beneficiary, you will have lost control over the residence (or other QPRT property). Control will then rest with the trustee of the heirs' trust.

9.1. Rent House.

If you continue to live in the residence after the end of the QPRT's term, the IRS may contend that, instead of making a gift of the remainder value of the residence, you, in substance, retained the right to use the residence. This would cause the gift to be disregarded and the entire value of the residence would be included in your taxable estate, defeating the QPRT's purpose. You should be able to avoid this consequence by paying market rent to the new owner (the remainder beneficiary).

9.2. New "Reverse" QPRTs.

In the past few years a new technique has emerged, the so-called Reverse QPRT. When the QPRT term ends, the heirs' trust owns the residence and provides you the right to live in the residence for an additional term, *e.g.,* 5 years. That is a gift from the heirs to you. We cannot establish that gift in advance. However, it is an interesting way to defer the time at which rent might be due.

9.3. Donee's Basis

The remainder beneficiary will have a "carryover" basis in the property under Internal Revenue Code §1015(a). Generally, that basis is what you paid for it. However, the failure to receive a step-up in basis to date-of-death fair market value is usually a reasonable cost to pay to reduce the ultimate estate tax.

10. FIDUCIARIES

10.1. Grantor as Trustee

Nothing formally prevents you from being the trustee of your QPRT. However, our approach, when seeking a terrific tax result, is to proceed in a conservative fashion. Since this device removes a valuable asset from the federal estate and gift tax system, there appears to be no benefit in naming the grantor as the trustee of the trust and inviting IRS scrutiny.

10.2 Your Choice of Trustee

Your brother _ _[*name of trustee*]_ _ is named as the QPRT's trustee. If _ _[*name of trustee*]_ _ becomes unable to serve, then your father, _ _[*name of successor trustee*]_ _, is named as successor trustee. The named trustees may designate additional successor trustees, who would serve if all named trustees are unavailable.

11. TAX RETURNS

11.1. Gift Tax Returns: 709

You must file a gift tax return (IRS Form 709) to reflect the residence's transfer to the QPRT. When filing the gift tax return, be sure to include a copy of the QPRT and the residence appraisal. _ _[*Name of accountant*]_ _, C.P.A. should handle that for you.

11.12. Income Tax Returns: Form 1041

The QPRT may not have to file income tax returns each year. See Treasury Regulation §1.671-4(b)(2) (see also §301.6109-1(a)(2)). All items of income and deduction generated by the QPRT will be reported on your individual tax return.

12. FRAUDULENT CONVEYANCES

Although you have not expressed any interest in this topic, we left the following discussion in for your review.

12.1. Risk.

One of the risks of any transfer is that a judge, with the benefit of 20-20 hindsight, might determine that the transfer was a "fraudulent conveyance." The result of such a finding, at a minimum, is that the transfer can be reversed to make the otherwise transferred assets available to creditors. The law also includes criminal penalties for egregious situations, but those are rarely invoked.

12.2. Solvency Analysis.

There is no automatic way to be certain of avoiding such an attack. However, the proper first step (if you are interested in this) is to have _ _[*name of accountant*]_ _, C.P.A. prepare a "solvency analysis." That includes a fair estimate of your assets and reasonably foreseeable liabilities. A transfer of only the excess of assets over reasonably foreseeable liabilities should be a strong defense against a "fraudulent conveyance" attack.

12.3. Law.

California law defines a "fraudulent conveyance" as follows (California Civil Code §3439.04, entitled "Acts Constituting Fraudulent Transfers—Intentional Acts" [emphasis added]):

"(a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose *before or after* the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation, as follows:

(1) With actual intent to hinder, delay, or defraud any creditor of the debtor.

(2) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor either:

(A) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(B) Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due."

Important terms are defined as follows (Civil Code §3439.01):

(b) "Claim" means a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.

(c) "Creditor" means a person who has a claim….

In other words, in valuing your liabilities you and _ _[*name of accountant*]_ _, C.P.A. must take into account reasonably foreseeable claims, not just those that are already clear.

13. REVIEW AND CHANGES/EXECUTION

Please review the enclosed documents carefully to determine if they accurately carry out your intent. Any changes can be easily made.

Because the QPRT is irrevocable, however, no changes can be made once it is executed. Therefore, you should request any changes at this time. Please be sure to check that the spelling of people's names is correct and that the names appear in the preferred manner (*i.e.,* where appropriate, with or without middle initial or name, correct middle initial, if one is used, and married vs. maiden name).

14. DISTRIBUTING DOCUMENTS

Please (i) keep the original signed QPRT in a safe place, and (ii) send a copy of the signed QPRT to each of _ _[*name of trustee*]_ _, _ _[*name of accountant*]_ _, C.P.A., and us for our respective files.

Please return the signed original Deeds and PCORs to us and we will forward them to the _ _[*Name*]_ _ County Recorder's Office for recordation.

15. CONCLUSION

This letter is intended to aid you in your review of the enclosed documents. I encourage you to read this letter carefully, and often if necessary, to make sure that it reflects your wishes. Again, please call me to discuss any of your questions or concerns.

Best regards,

__[*Signature*]__
OWEN KAYE, of

Givner & Kaye,
A Professional Corporation

ODK:hs

Enclosures

cc: _ _[*name of accountant*]**_ _, C.P.A. (w/encls.)**

Comment: In this letter, Jane Doe is a 41-year old single person with no children. The QPRT term is tentatively 43 years (the life expectancy of the transferor), although the letter recommends that the client consider a shorter term. See discussion in §17.50. For a sample QPRT client memorandum, see §17.110.

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§17.112 R. Form: QPRT Diagrams for Husband and Wife

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Print

John and Jane Client: Qualified Personal Residence Trust (QPRT)

Diagram #1: As Is (Before the QPRT)

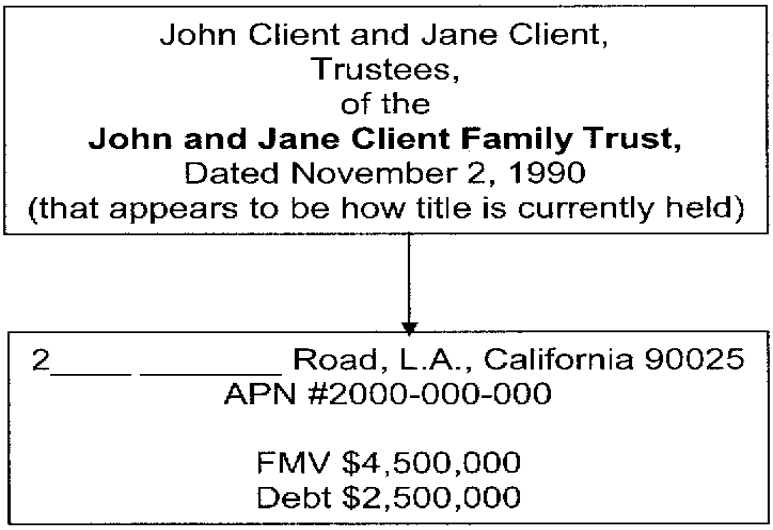
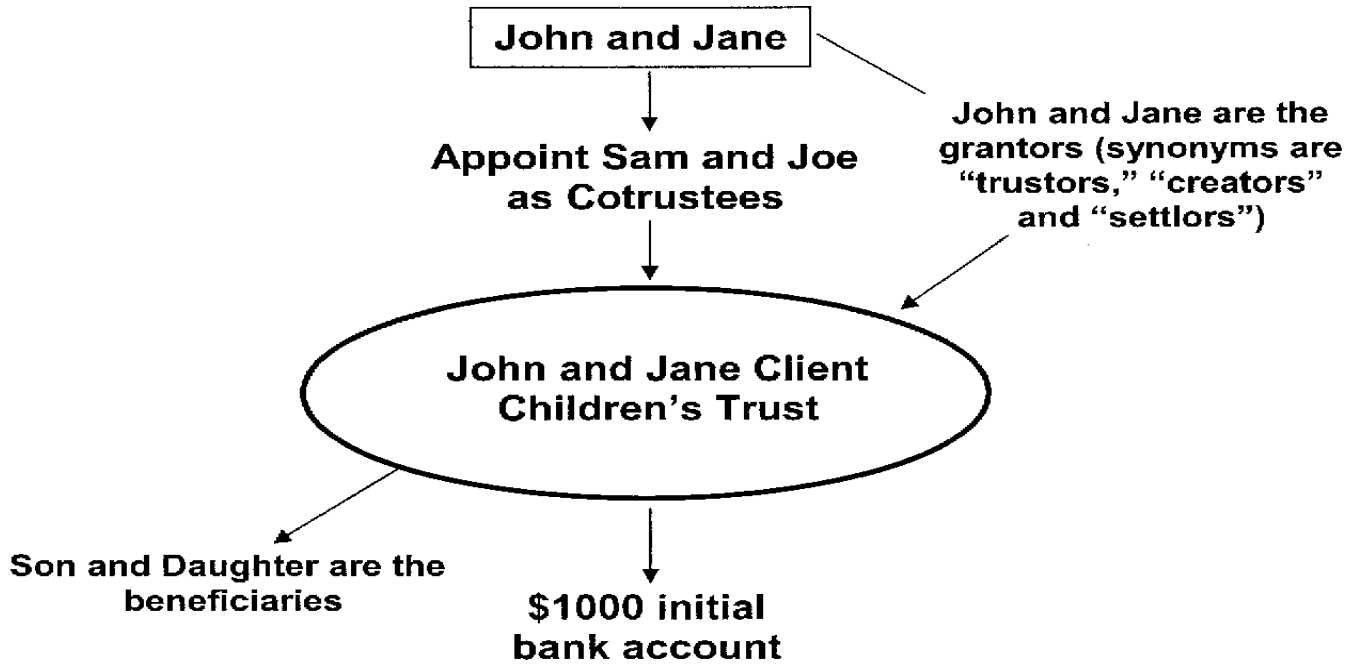


Diagram #2: Create the Children's Trust



Print

Qualified Personal Residence Trust (QPRT)

Diagram #3: Create the Residence Trusts

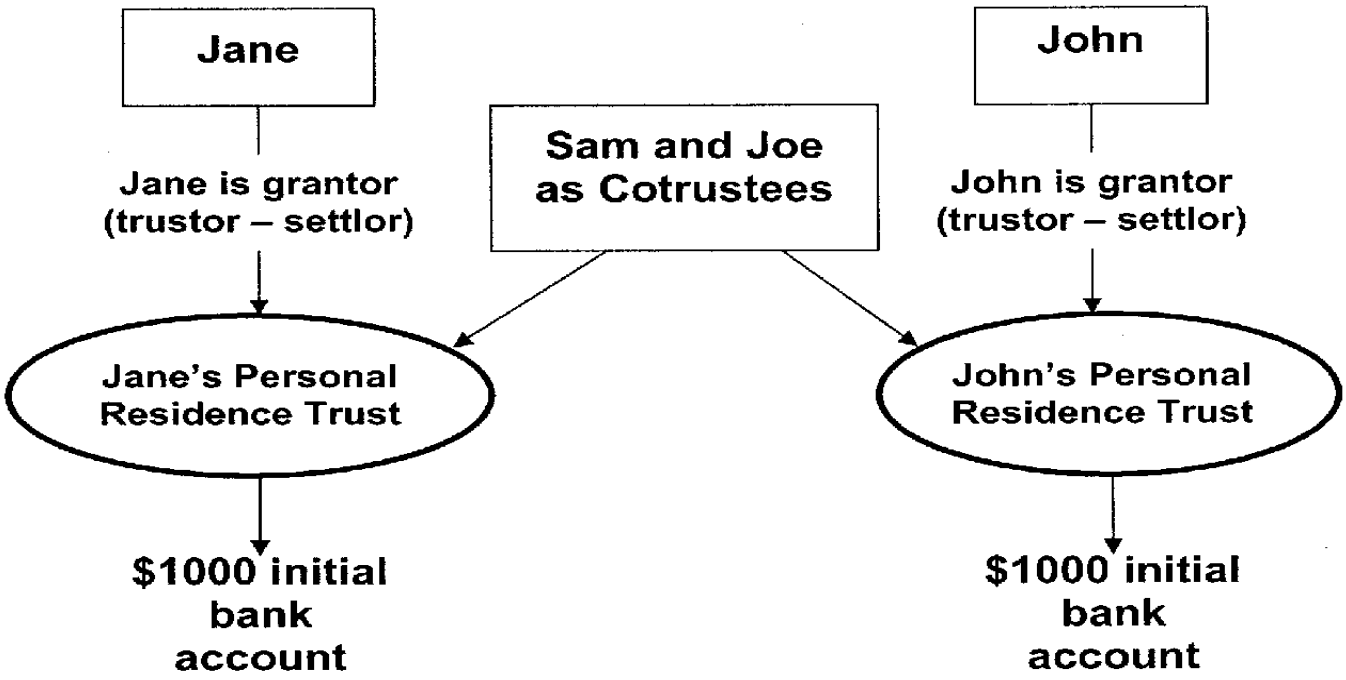
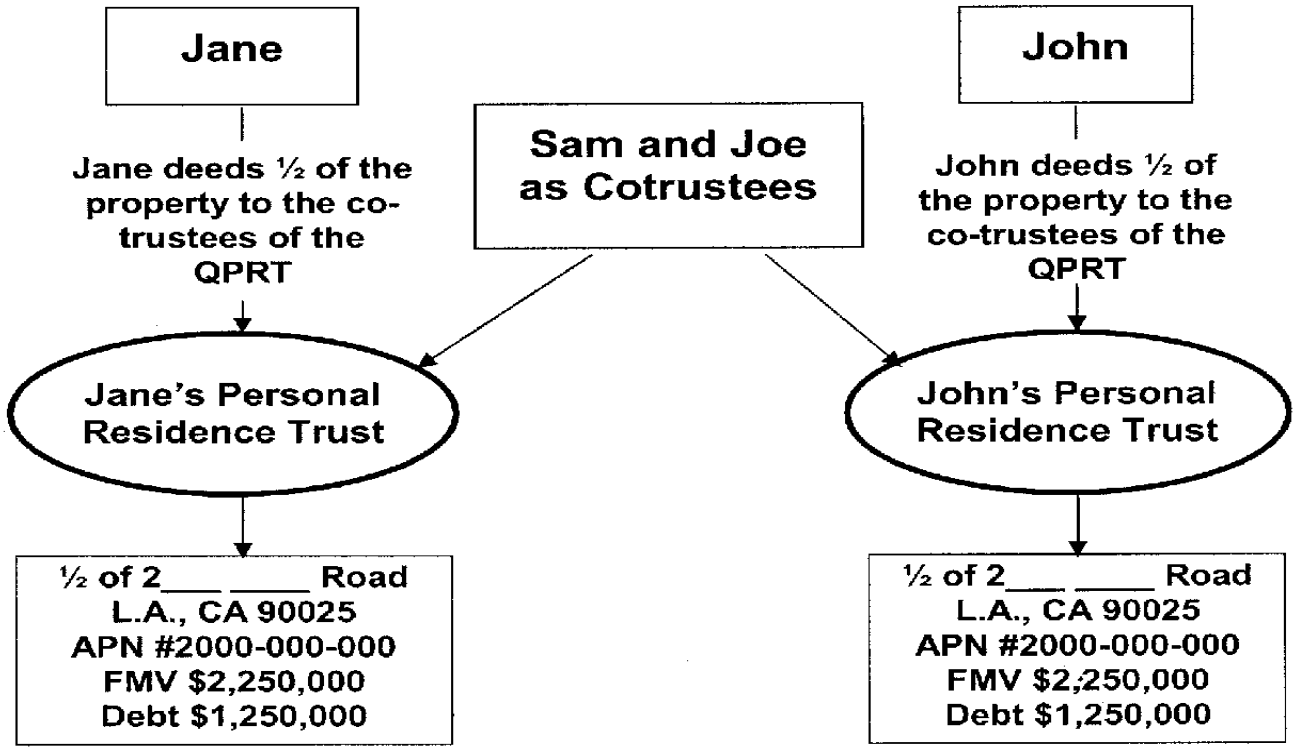


Diagram #4: Fund the QPRT



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Qualified Personal Residence Trust (QPRT)

Diagram #5: Prepare the Calculations

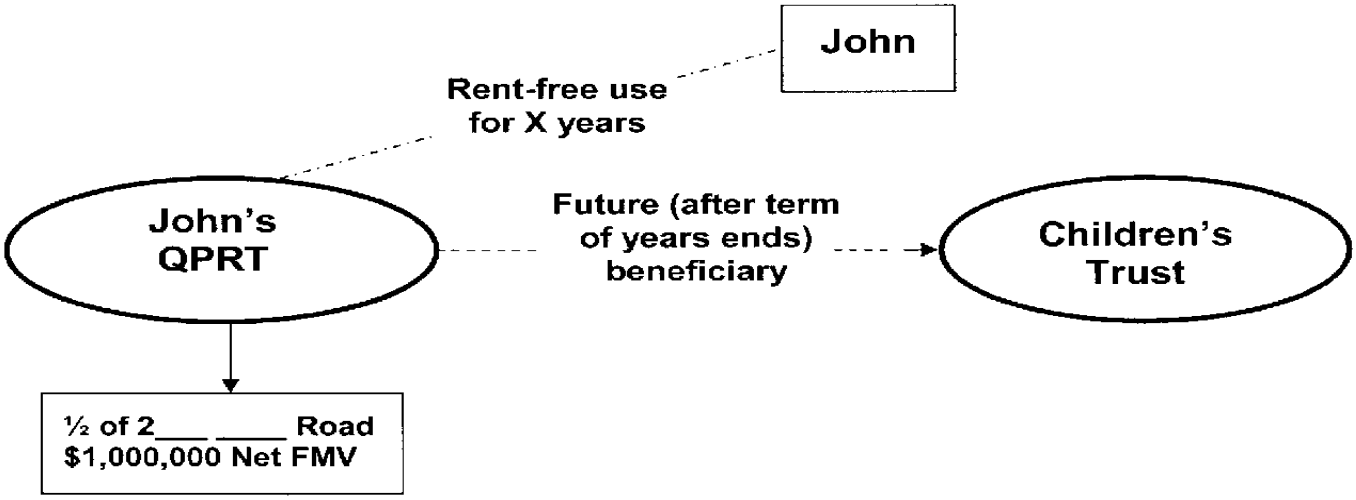
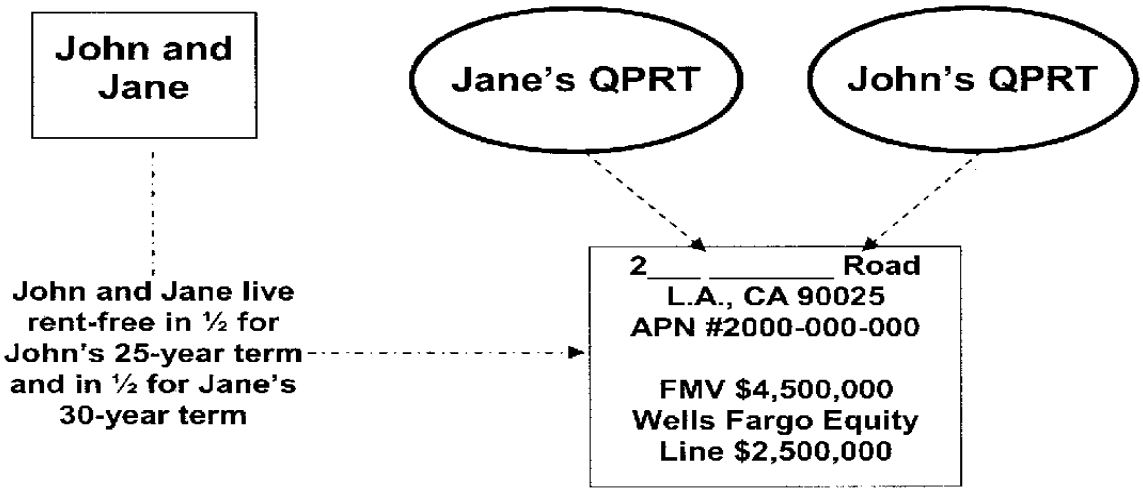


Diagram #6: After Creating the QPRT, During the Retained Term to Live There Rent Free



Print

Qualified Personal Residence Trust (QPRT)

Diagram #7: Alternative 1: QRPT Ends *Before* John's Death
House Goes to His Revocable Trust

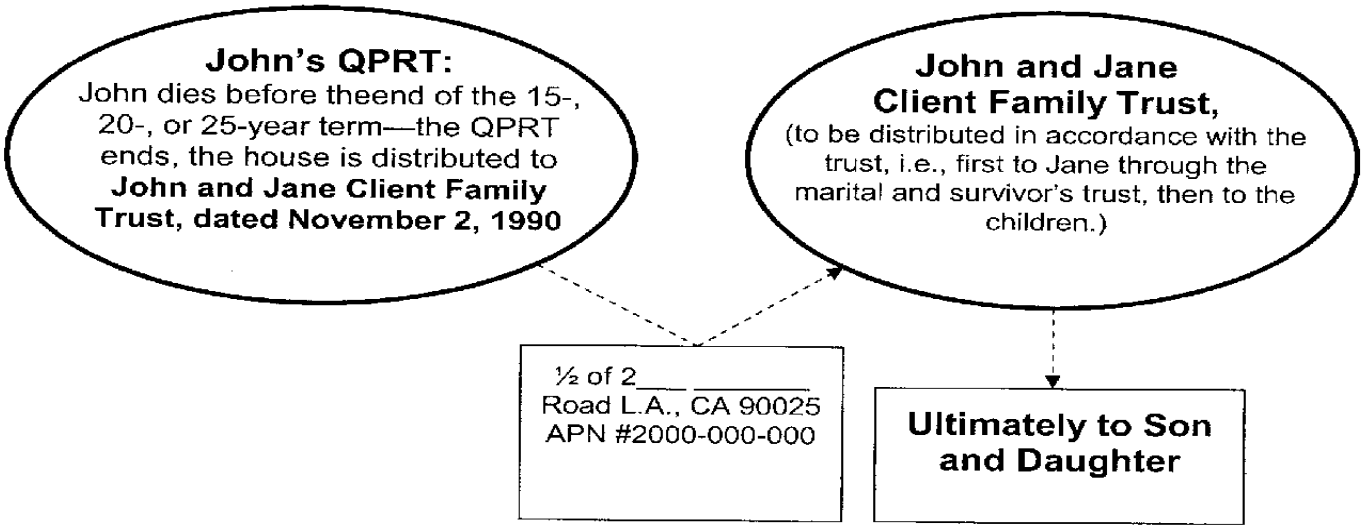
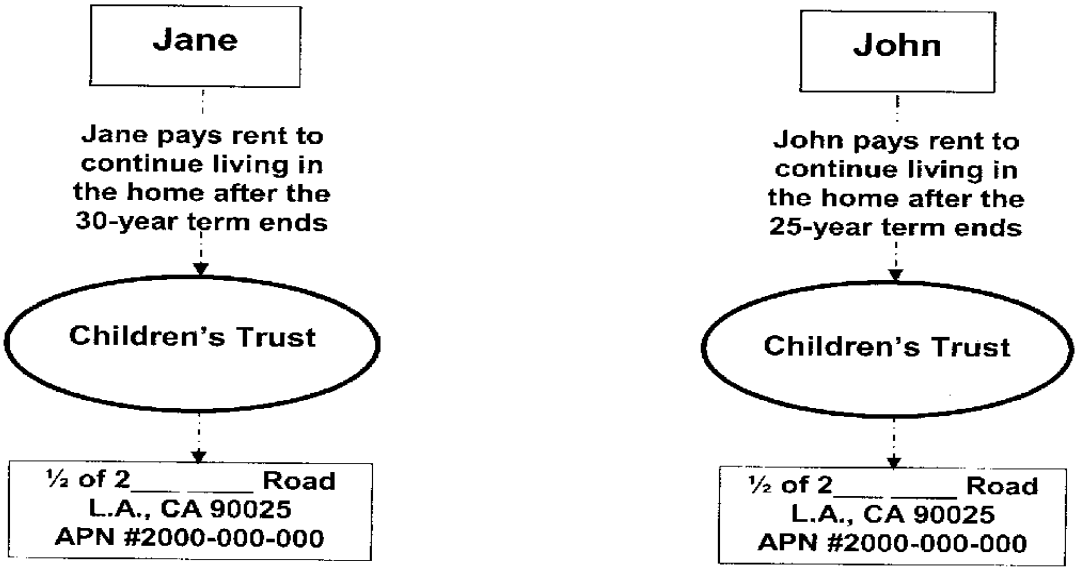


Diagram #8: Alternative 2: QRPT Ends *After* Term
House Goes to Children's Trust
No Gift Tax—House Excluded From John's and Jane's Estates



Comment: The fair market value and debt indicated in Diagram #1 are purely guesses made for purposes of this

series of diagrams.

The Children's Trust in Diagram #2 is needed as the contingent remainder beneficiary of the qualified personal residence trusts (QPRTs). It must be in existence before the QPRTs are signed.

Due to a generation-skipping transfer tax problem, if a child dies, that child's share is forfeited to the other children; in other words, that child's children do not receive the deceased child's share. The revocable trust must be drafted or amended to provide a "make-up" to a deceased child's branch of the family. There is also a Proposition 13 reason not to include grandchildren as beneficiaries. See §17.47.

The QPRT diagram for Jane would look the same as the one for John as illustrated in Diagram #5.

John is age 57. A 57-year-old has a 27.9-year life expectancy. The value of the gift to the children is determined as follows (using the IRC §7520 rate of 3.2 percent for June 2010):

Term	**15**	**20**	**25**
Gift	$492,760	$352,180	$224,980

Jane is age 52. A 52-year-old has a 32.3-year life expectancy. The value of the gift to the children is determined as follows (using the IRC §7520 rate of 3.2 percent for June 2010):

Term	**20**	**25**	**30**
Gift	$408,280	$291,790	$186,400

John and Jane pay, and deduct, the mortgage, property tax, etc., during the QPRT term as illustrated in Diagram #6; if they sell, they get the IRC §121 $250,000-per-person gain exclusion because the QPRT is ignored for income tax purposes.

If John dies before the end of the QPRT term, his share of the house goes to the family trust as illustrated in Diagram #7 (and vice versa if Jane dies first).

Because the home is not included in John's and Jane's estates, the children do not receive a "step up" in basis for purposes of a future sale as illustrated in Diagram #8. However, that may not create a problem: One of the children may wish to live in the home or the children may decide to convert the home to a rental and later transfer it in an IRC §1000 tax-deferred exchange. In other words, the capital gains tax may be deferred for many years.

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18

Charitable Remainder Trusts

Lynda S. Moerschbaecher

I. GOALS OF CHARITABLE REMAINDER TRUSTS §18.1

II. BASIC CHARACTERISTICS OF CHARITABLE REMAINDER TRUSTS §18.2
- A. Deduction Must Be Allowable §18.3
- B. Must Be Annuity Trust or Unitrust §18.4
- C. Provisions to Restrict or Control Trustee Prohibited §18.5
- D. Must Function Exclusively as Charitable Remainder Trust From Time of Its Creation §18.6
- E. Payment and Term Limitations for CRATs and CRUTs §18.6A
- F. Spousal Waiver of Any Right to Trust Property on Donor's Death §18.6B

III. OVERVIEW: TYPES OF QUALIFIED CHARITABLE REMAINDER TRUSTS
- A. Charitable Remainder Annuity Trust §18.7
- B. Charitable Remainder Unitrust
  - 1. Standard Type Unitrust §18.8
  - 2. Income-Only Unitrust §18.9
  - 3. Flip Unitrust §18.9A
  - 4. Accelerated Charitable Trust §18.9B
- C. Summary of Differences Between Annuity Trust and Unitrusts §18.10

IV. PLANNING CONSIDERATIONS §18.11
- A. Choice of Form of Trust
  - 1. Issues Relating to Estate Tax Repeal §18.11A
  - 2. Donor Considerations §18.12
  - 3. Nature of Funding Asset
    - a. Effect on Choice of Type of Charitable Remainder Trust §18.13
    - b. Specific Assets §18.14
  - 4. Needs of Beneficiary §18.15
- B. Beneficiaries and Their Payments
  - 1. To Whom Payments Will Be Made; Length of Payment Period §18.16
  - 2. Valuation for Computing Payment Amount §18.17
  - 3. Division of Trust Into Separate Trusts for Individual Recipients §18.17A
- C. Who May Serve as Trustee §18.18
- D. Selection of Remainder Beneficiary §18.19
- E. Tax Treatment of Transaction Creating Charitable Remainder Trust
  - 1. Settlor's Income Tax Deduction §18.20
  - 2. Settlor's Gift Tax Deduction §18.21
  - 3. Estate Tax Treatment in Settlor's Estate
    - a. Trust Must Be Includable in Decedent's Gross Estate for Deduction §18.22
    - b. Determination of Estate Tax Charitable Deduction §18.23
- F. Computing Amount of Deduction §18.24
  - 1. Annuity Trust §18.25
  - 2. Unitrust §18.26
    - a. Maximizing the Deduction §18.27
    - b. Using Special Factor for Payout Frequency §18.28
    - c. Method of Calculation §18.29
  - 3. Commercial Software §18.30
- G. Income Taxation of Recipients
  - 1. Governing Law §18.31
  - 2. Income-Only Unitrusts §18.32
- H. Taxation of Charitable Remainder Trusts and Trustees §18.33
  - 1. Definition of Unrelated Business Taxable Income (UBTI) §18.34
  - 2. Tax Treatment of Unrelated Business Taxable Income (UBTI) §18.35
  - 3. Excise Taxes on Prohibited Transactions §18.36

4. Tax Treatment on Termination of Trust §18.36A

V. DRAFTING CHARITABLE REMAINDER TRUSTS
A. Drafting Sources §18.37
1. Basic Approach of Regulations and Rulings §18.38
2. Sample Forms §18.39
B. Need for Initial and Continued Qualification §18.40
C. Form: Trust Is Irrevocable §18.41
D. Savings Clause
1. Effect on Qualification of Trust §18.42
2. Form: Savings Clause §18.43
E. Overview: Mandatory Clauses for Instrument §18.44
F. Specific Mandatory Clauses
1. Payment to Recipient: Annuity Trusts and Unitrusts §18.45
a. Annuity Trust
(1) Payments §18.46
(2) Valuation §18.47
(3) Form: Payment of Sum Certain (One Life) §18.48
(4) Joint and Survivor Recipients
(a) Form: Introduction §18.49
(b) Form: Payment During Joint Lifetimes §18.50
(c) Form: Payment After First Death §18.51
(5) Form: Time of Payment; From Income, Then Principal §18.52
b. Unitrust
(1) Payment of Fixed Percentage §18.53
(2) Joint Recipients §18.54
(3) Form: Payment of Fixed Percentage (One Life) §18.55
(4) Form: Joint and Survivor Recipients §18.56
(5) Form: Time of Payment; From Income, Then Principal §18.57
c. Income-Only Unitrust
(1) Requirements §18.58
(2) Form: Income-Only Unitrust §18.59
2. Valuation of Unitrust if Other Than First Day of Trust's Taxable Year
a. Requirements §18.60
b. Form: Unitrust Mandatory Clause (Valuation Date Does Not Occur on First Day of Each Taxable Year) §18.61
3. Proration of Annuity or Unitrust Amount
a. Requirements §18.62
b. Form: Proration of Annuity or Unitrust Amount §18.63
4. Distribution to Charitable Remainder Beneficiaries
a. Requirements
(1) On Termination of Noncharitable Interest §18.64
(2) Alternative Charitable Organizations §18.65
b. Tax Considerations §18.66
c. Form: Charitable Remainder Beneficiaries and Alternative Remainder Beneficiaries §18.67
d. Form: Power to Amend Charitable Remainder Beneficiary Designation §18.68
e. Form: Restricted Purpose §18.69
5. Adjustment for Incorrect Valuation of Trust Assets
a. Requirements §18.70
b. Form: Adjustment for Incorrect Valuation §18.71
6. Additions After Initial Contribution §18.72
a. Annuity Trust
(1) Requirements §18.73
(2) Form: Additional Contributions Prohibited §18.74
(3) Form: Assets From Testamentary Trust Are One Contribution; No Additional Contributions Permitted §18.75
b. Unitrust
(1) Requirements §18.76
(2) Form: Formula for Determining Unitrust Amount If Additional Contributions Permitted §18.77
(3) Form: Additional Contributions at Death §18.78
7. Prohibited Transactions: Private Foundation Restrictions
a. Rules §18.79
b. Exceptions §18.80
c. Form: Annuity Trust or Unitrust Mandatory Clause (Private Foundation Prohibitions) §18.81
8. No Investment Restrictions on Trustee

a. Requirements §18.82
b. Form: Investment of Trust Assets §18.83
9. No Payment of Gift, Estate, or Generation-Skipping Transfer Taxes From Trust
a. Disqualification of Trust §18.84
b. Form: No Taxes Payable From Trust §18.85
10. Form: No Other Noncharitable Payments §18.86
11. Form: Taxable Year §18.87
12. Form: Governing Law §18.88
13. Charitable Remainder Trusts Created at Death
a. Revocable Trusts
(1) Requirements §18.89
(2) Form: Charitable Remainder Trust Created in Revocable Trust §18.90
b. Testamentary Charitable Remainder Trusts
(1) Requirements §18.91
(2) Form: Deferred Payments §18.92
G. Optional Clauses §18.93
1. Sprinkling Powers Among Members of a Class
a. Requirements §18.94
b. Form: Allocation Among Class of Noncharitable Beneficiaries in Discretion of Trustee §18.95
2. Testamentary Power to Revoke Recipient's Interest
a. Requirements §18.96
b. Form: Annuity Trust or Unitrust (Testamentary Power to Revoke) §18.97
3. Partial Distributions in Kind to Charitable Organizations
a. Requirements §18.98
b. Form: Annuity Trust (Partial Distributions to Charitable Organization) §18.99
c. Form: Unitrust (Partial Distributions to Charitable Organization) §18.99A
H. No-Contest Clause §18.100

VI. REFORMATION OF CHARITABLE REMAINDER TRUSTS §18.101
A. Three Categories of Charitable Remainder Trusts §18.102
B. Deadlines for Reforming Trust
1. Category One Trusts §18.103
2. Category Two Trusts §18.104
C. Requirements of Reformation Rules §18.105

VII. ALTERNATIVES TO CHARITABLE REMAINDER TRUST
A. Pooled Income Fund §18.106
1. Comparison With Charitable Remainder Trusts §18.107
2. Drafting Requirements for Qualification §18.108
a. Contribution of Remainder Interest to Charity §18.109
b. Creation of Life Income Interest §18.110
c. Commingling of Property §18.111
d. Prohibition Against Exempt Securities §18.112
e. Maintenance by Charitable Organization §18.113
f. Prohibition Against Donor or Beneficiary Serving as Trustee §18.114
g. Income of Beneficiaries Based on Rate of Return §18.115
h. Termination of Life Income Interest §18.116
3. Use of Sample Document §18.117
B. Charitable Gift Annuity
1. Contractual Gift to Charity §18.118
2. Comparison With Charitable Remainder Trust §18.119
3. Income Tax Considerations §18.120
4. Estate and Gift Taxes §18.121
C. Qualified Terminable Interest Property Trust for Spouse With Charitable Remainder §18.122
D. Remainder Interest in Personal Residence or Farm With Retained Estate §18.123

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§18.1 I. GOALS OF CHARITABLE REMAINDER TRUSTS

A charitable remainder trust is an estate planning device that serves several useful purposes for the client who creates it. Often the donors, commonly a husband and wife, act as trustees and are the lifetime income recipients. Wealthy clients aim to achieve the following primary goals in creating a charitable remainder trust:

- Obtaining an income tax deduction for the value of the remainder interest as a charitable contribution in the year of the transfer to the trust. See §18.20.
- Obtaining a charitable gift tax or estate deduction for the value of the remainder interest given to the charitable remainder trust. See §§18.21-18.30.
- Avoiding capital gains taxes on highly appreciated assets (*e.g.,* real property or closely held businesses), which may be sold by the trust with reduced or no income tax consequence to the donor or the trust. See §18.33.
- Providing income to one or more persons during their lifetimes or for a period of years. See §§18.15-18.17.
- Directing some of their wealth to charitable organizations of their own choice. See §18.19.

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§18.2 II. BASIC CHARACTERISTICS OF CHARITABLE REMAINDER TRUSTS

A remainder interest passing to charity will be deductible for federal and California income, federal estate, and federal gift tax purposes only if it is made in one of the following forms:

- A charitable remainder annuity trust (IRC §664(d)(1));
- A charitable remainder unitrust (or its alternative, a charitable remainder income-only unitrust) (IRC §664(d)(2)-(3));
- A pooled income fund (IRC §642(c)(5)); or
- A remainder interest in a personal residence or farm (IRC §170(f)(3)(B)(i)).

The statutes, the regulations, and numerous interpretive rulings have developed a rigid and complex set of rules for qualifying a gift of a remainder interest for the charitable income, gift, and estate tax deductions. See §§18.3-18.6.

Because charitable remainder annuity trusts and charitable remainder unitrusts are designed for and created by the donor, they are of more general application than the pooled income fund, which is designed by and maintained by the charity, or the remainder interest in a personal residence or farm, which is a legal life or specified term estate created by deed. Most of this chapter deals with charitable remainder annuity trusts and charitable remainder unitrusts. Although there are basic differences between these forms of trust, many of the rules governing them are the same. When appropriate, they are discussed together in this chapter.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

A charitable remainder trust provides payments to one or more noncharitable beneficiaries (*i.e.,* recipients) for their lifetimes or a term of years. On the death of the final recipient or at the end of the term, the trust terminates and the balance of the principal is distributed to charity. Recipients may obtain further income and gift tax deductions by making gifts of annuity or unitrust interests to charity (Rev Rul 86-60, 1986-1 Cum Bull 302; IRS Letter Ruling 200633011) or by assigning to charity a unitrust interest in exchange for the right to receive an annuity of lesser value (IRS Letter Ruling 200152018). See also IRS Letter Ruling 200834013 (deductions allowed for gift of donor's entire income interest in grantor retained income trust). The major difference between charitable remainder annuity trusts and charitable remainder unitrusts is the form of the distributable amount payable to the "recipient," the term used by the Internal Revenue Service in its model trust forms to describe the noncharitable beneficiary receiving current distributions. This term is also used in this chapter. The recipient may be the donor and/or any other person or persons that the donor selects.

The terms "annuity amount" and "unitrust amount" (or its variant, "income-only unitrust amount," called "the net income exception" in the tax regulations) describe the two basic forms of charitable remainder trust and also the two permissible distributable amounts to the recipient. Other provisions may differ in the two basic forms of charitable remainder trust, but most of them serve to implement the basic difference in distributable amounts.

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§18.3 A. Deduction Must Be Allowable

A charitable remainder trust must satisfy IRC §664 and the regulations promulgated under that statute. Because the regulations are promulgated at the direction of IRC §664, they are considered to be "legislative regulations": more akin to law than to interpretation of law.

Treasury Regulation §1.664-1(a)(1)(iii)(a) defines a charitable remainder trust as a trust with respect to which a deduction is allowable under IRC §170, §2055, §2106, or §2522 and that meets the description of a charitable remainder annuity trust (as described in Treas Reg §1.664-2) or a charitable remainder unitrust (as described in Treas Reg §1.664-3). In revenue rulings and letter rulings, the IRS has strictly upheld the requirement of the allowability of some deduction. See, *e.g.,* Rev Rul 88-81, 1988-2 Cum Bull 127, modified by Rev Rul 92-57, 1992-2 Cum Bull 123. Thus, unless the drafter ensures that a deduction under one of the specified Code sections is allowable, the trust will be deemed not to meet the definition of a charitable remainder trust. See Teitell, *If It's Broke, Sometimes You Can't Fix It*, 141 Tr & Est 44 (Mar. 2002).

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§18.4 B. Must Be Annuity Trust or Unitrust

A charitable remainder trust must be either an annuity trust or a unitrust in every respect. Treas Reg §1.664-1(a)(2). In other words, it cannot be a hybrid of the two forms. It must meet the definition of an annuity trust contained in Treas Reg §1.664-2 or a unitrust contained in Treas Reg §1.664-3. See *Estate of Tamulis v Commissioner* (7th Cir 2007) 509 F3d 343 (doctrine of substantial compliance does not excuse failure to reform defective trust into unitrust). In *Galloway v U.S.* (3d Cir 2007) 492 F3d 219, the court held that no charitable deduction was allowed for a trust that provided for two scheduled distributions after which the trust would terminate and required 50 percent of each distribution be divided between two charities.

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§18.5 C. Provisions to Restrict or Control Trustee Prohibited

No form of charitable remainder trust may include a clause that "restricts the trustee from investing the trust assets is a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets." Treas Reg §1.664-1(a)(3). This rule has been interpreted broadly to include powers held in a nonfiduciary capacity by anyone, including the donor, that could result in control of the trustee's investment discretion or in veto power over the trustee's choice of investments. Such a power held in a nonfiduciary capacity violates this basic rule and therefore disqualifies the trust as a charitable remainder trust. See, *e.g.,* IRS Letter Ruling 9442017 (trust not disqualified).

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§18.6 D. Must Function Exclusively as Charitable Remainder Trust From Time of Its Creation

A trust will not qualify as a charitable remainder trust unless it meets the definition of and functions exclusively as a charitable remainder trust from its creation. Treas Reg §1.664-1(a)(4). "Creation" is defined as the earliest time that the trust is not treated as a grantor trust under IRC §§671-679, but in no event before the time that property is first transferred to the trust. In *Estate of Atkinson v Commissioner* (11th Cir 2002) 309 F3d 1290, cert denied (2003) 540 US 946, 157 L Ed 2d 276, 124 S Ct 388, the court held that no charitable deduction was allowable for a charitable remainder trust that failed to make the noncharitable distributions required by the trust instrument. The trust provided that the decedent was to receive an annuity equal to 5 percent of the initial value of the trust estate, but at the time of her death the decedent had not received any annuity payments.

Certain rules apply to charitable remainder trusts that are to be created on the date of death of a decedent, notwithstanding the rule governing creation of the trust, described above. The trust will be deemed to be created on the date of death of the decedent, even though it is not funded until later in the process of estate administration, if the obligation to pay the annuity or unitrust amount with respect to the property passing at death begins with the date of death of the decedent. The actual payment may be deferred until the end of the taxable year in which the funding of the trust is completed only if the *obligation* to pay it from the date of death exists and then if the deferral of such payment is permitted by local law or authorized by the trust instrument. Treas Reg §1.664-1(a)(5). For further discussion and forms, see §§18.45, 18.75, 18.89-18.92.

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§18.6A E. Payment and Term Limitations for CRATs and CRUTs

Charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs) must satisfy five requirements related to the values of the various interests:

- *Five-percent minimum payment requirements*. The unitrust amount paid to a CRUT's noncharitable beneficiaries cannot be less than 5 percent of the value of the trust assets valued annually, and the annuity amount of a CRAT cannot be less than 5 percent of the initial value of the trust assets. IRC §664(d)(1)(A), (2)(A).
- *Fifty-percent maximum payment limitations.* The unitrust amount paid to a CRUT's noncharitable beneficiaries cannot exceed 50 percent of the value of the trust assets valued annually, and the annuity amount of a CRAT cannot exceed 50 percent of the initial value of the trust assets. IRC §664(d)(1)(A), (d)(2)(A).
- *Term of years limitation*. A CRAT or CRUT may have a term equal to the life or lives of individuals living when the trust is created, but if the term is for a term of years, the number of years cannot exceed 20. IRC §664(d)(1)(A), (2)(A).
- *Ten-percent minimum charitable benefit rule.* The value of the charitable remainder in a CRAT must be at least 10 percent of the initial net fair market value of the trust. The same rule applies to a CRUT, but because additional contributions can be made to a CRUT, the 10-percent test must be met for each contribution. IRC §664(d)(1)(D), (2)(D). *Warning!* A CRUT that passes the test when initially funded may fail the test when additional contributions are made, because the interest rate used to compute the value of the remainder under IRC §7520 changes monthly. See §6.9. In IRS Letter Ruling 200022014, the IRS approved a plan for rescuing an addition to a CRUT that failed the 10-percent test.
- *Five-percent probability of exhaustion test.* The IRS takes the position that a CRAT does not qualify if there is more than a 5-percent chance that the annuity will exhaust the trust before the recipient's death, leaving nothing for charity. Rev Rul 77-374, 1977-2 Cum Bull 329. See §18.46.

These five restrictions are interrelated. For example, the 10-percent minimum charitable benefit rule can indirectly limit the term of the trust, the annual payout amount, or both. In some circumstances it is impossible to establish a trust that will make annuity or unitrust payments for the lifetimes of one or more persons without violating the 10-percent minimum charitable benefit rule, even if the annuity or unitrust amount is the minimum 5 percent. Under current actuarial tables, a unitrust for the life of a single individual who is younger than age 25 cannot qualify, nor can a unitrust benefiting two persons and the survivor if both are under age 37.

It is possible to pass the 10-percent minimum charitable benefit test but fail the 5-percent probability of exhaustion test only in situations involving life annuities. The 10-percent test uses actuarial life expectancy; the 5-percent test assesses the risk that the annuitant will outlive actuarial life expectancy.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.6B F. Spousal Waiver of Any Right to Trust Property on Donor's Death

§18.6B F. Spousal Waiver of Any Right to Trust Property on Donor's Death

Under IRC §664(d)(1)(B) and (d)(2)(B), no amount other than the annuity or unitrust amount (and qualified gratuitous transfers described in §664(d)(1)(C) and (d)(2)(C)) may be paid to or for the use of any person other than a charitable organization described in IRC §170(c). In Rev Proc 2005-24, 2005-1 Cum Bull 909, the IRS provided a safe harbor procedure under which this requirement is not satisfied unless the donor's spouse waives any right to have the trust included in the donor's probate estate for elective share purposes. In some states (not California), the spouse is entitled to a share of an "augmented estate" that includes not only probate property but also nonprobate transfers at death and, in varying degrees, inter vivos transfers that depleted the decedent's estate before death.

NOTE: After a number of commentators asserted that Rev Proc 2005-24 placed an undue burden on taxpayers and trustees, the IRS indefinitely extended the June 28, 2005, grandfather date for trusts that do not comply with the safe harbor procedure. Until further guidance is published regarding the effect of a spousal right of election on a trust's qualifications as a CRT, the IRS will disregard the existence of a spousal right of election, even without the waiver required by Rev Proc 2005-24, but only if the surviving spouse does not exercise the right of election. Notice 2006-15, 2006-1 Cum Bull 501.

Under Rev Proc 2005-24, the trust will not meet the statutory requirements for a charitable remainder trust (CRT) unless the spouse irrevocably waives the right of election to whatever extent necessary to ensure that no part of the trust (other than the annuity or unitrust interest of which the spouse is the named recipient) may be used to satisfy the elective share. The waiver must be valid under applicable state law, in writing, and signed and dated by the spouse. The trustee must be provided with a copy.

The waiver requirements must be satisfied on or before the date that is 6 months after the due date (excluding extensions) of Form 5227, Split-Interest Trust Information Return, for the year in which the last of the following occurs (Rev Proc 2005-24, §3.03, 2005-1 Cum Bull 909, 910):

- The creation of the trust;
- The date of the donor's marriage to the spouse;
- The date the donor becomes domiciled or resident in a jurisdiction the law of which provides a right of election that could be satisfied from assets of the trust; or
- The effective date of applicable state law creating a right of election.

Because California law does not provide for a traditional statutory election, it is not necessary to comply with the Revenue Procedure at the time California-domiciled donors establish a CRT, although it probably would be a good idea to obtain a waiver of the Prob C §102 restoration right if the donor creates a CRT funded with property that will be quasi-community property if the donor remains domiciled in California until death. It probably also would be desirable to make sure that the donors and trustee are carefully advised in writing that a waiver may be needed in the event of a future change of domicile. On a surviving spouse's right under Prob C §102 to compel restoration of quasi-community property transferred by the decedent, see California Decedent Estate Practice, chap 2 (2d ed Cal CEB 2009).

Another possible precaution, in situations involving a California separate property CRT, is to have the spouse sign a document indicating that he or she joins in or consents to the transfer. In many states, the augmented estate that determines the property subject to a statutory election will not include gifted property if the spouse joined in the gift or consented to it. See, *e.g.,* Mont Code Ann §72-2-222(3)(b).

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III. OVERVIEW: TYPES OF QUALIFIED CHARITABLE REMAINDER TRUSTS

§18.7 A. Charitable Remainder Annuity Trust

A charitable remainder annuity trust (often referred to as a CRAT, with the acronym being pronounced as a word) pays the recipient a fixed annuity each year for the recipient's life or for a term of years (not to exceed 20 years), with the property remaining in the trust passing to charitable beneficiaries on the recipient's death or the expiration of the term of years.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

A CRAT is defined in IRC §664(d)(1) as a trust from which a sum certain is to be paid, not less often than annually, to one or more persons, at least one of which is not a charitable organization. The sum must be at least 5 percent and not more than 50 percent of the initial net fair market value of the trust. This annuity amount may be paid to any person, as defined in IRC §7701(a)(1). If the person is other than an individual, the term of the trust may not exceed 20 years. If the person is an individual, the trust term may run for the life or lives of the individual or individuals in being when the trust is created or for a term not to exceed 20 years. The value of the charitable remainder must be at least 10 percent of the initial fair market value of the trust assets, and the probability that the annuity will exhaust the trust cannot exceed 5 percent. IRC §664(d)(1)(D); Rev Rul 77-374, 1977-2 Cum Bull 329. See §18.46.

No amounts other than the annuity amount may be paid other than to the charity. Thus, there may be no invasion of principal. Purchase of assets for full and adequate consideration is excepted from this rule. After the specified trust term, all amounts must be paid to a charity, retained in trust for the use of charity, or partly paid to a charity and partly retained for the use of charity.

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B. Charitable Remainder Unitrust

§18.8 1. Standard Type Unitrust

A charitable remainder unitrust (often referred to as a CRUT, with the acronym being pronounced as a word) pays the recipient a fixed percentage of the annually determined net fair market value of the trust assets for the recipient's life or for a term of years (not to exceed 20 years), with the property remaining in the trust passing to charitable beneficiaries on the recipient's death or the expiration of the term of years.

A CRUT is defined in IRC §664(d)(2) as a trust from which a fixed percentage is paid, not less often than annually, to one or more persons, at least one of which is not a charitable organization. The percentage must be at least 5 percent and not more than 50 percent of the net fair market value of the assets valued annually. This unitrust amount may be paid to any person, as defined in IRC §7701(a)(1). If the person is other than an individual, the term of the trust may not exceed 20 years. If the person is an individual, the trust term may run for the life or lives of the individual or individuals in being when the trust is created or for a term not to exceed 20 years. The value of the charitable remainder must be at least 10 percent of each contribution to the trust. IRC §664(d)(2)(D).

No amounts other than the unitrust amount, or amounts paid for fair and adequate consideration, may be paid other than to the charity. After the specified trust term, all amounts must be paid to a charity, retained in trust for the use of charity, or partly paid to and partly retained for the use of charity.

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§18.9 2. Income-Only Unitrust

An alternative form of CRUT (but not of a CRAT) is the charitable remainder income-only unitrust. The Internal Revenue Code refers to this trust under the heading "Exception" to the standard unitrust (IRC §664(d)(3)), and the regulations refer to it as "income exception." Another name commonly used for this sort of unitrust is the net income unitrust. This type of trust pays the recipient the lesser of the fixed percentage of the annually determined net fair market value of the trust assets and the income of the trust each year. "Income" refers to trust accounting income, not "taxable income."

Internal Revenue Code §664(d)(3) contains the following exception to the definition of a unitrust (but not an annuity trust) described in IRC §664(d)(2):

> [T]he trust instrument may provide that the trustee shall pay the income beneficiary for any year—
> (A) the amount of the trust income, if such amount is less than the amount required to be distributed under paragraph (2)(A) [relating to the unitrust amount definition], and
> (B) any amount of the trust income which is in excess of the amount required to be distributed under paragraph (2)(A), to the extent that (by reason of subparagraph (A)) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

Under Treas Reg §1.664-3(a)(1)(i)(b), the income-only trust may, but need not, contain a clause for making up prior years' deficiencies in future payments to the recipient out of future income in excess of the amount required to be distributed in each respective future year. Under Treas Reg §1.664-3(a)(1)(i)*(b)(3),* precontribution gain cannot be allocated to income. However, the governing instrument may allow the allocation of postcontribution capital gains to trust income. Because the settlor of a CRUT obviously does not intend to create a trust that would pay the lesser of two different unitrust amounts, the income of an income-only unitrust may not be defined by using a unitrust amount as authorized by the regulations for other purposes if state law so provides, which California law currently does not.

The deficiency amount is the unpaid increment between the aggregate of the income actually paid in prior years and the aggregate amount determined by applying the fixed percentage to the value of the trust assets each year. This trust is referred to by many names, such as the income exception unitrust, the net income unitrust, or (if there is no makeup clause) the NICRUT and (if there is a makeup clause) the NIMCRUT, with either of these two acronyms being pronounced as a word. In IRS Letter Ruling 200218008, the IRS agreed to honor the judicial modification of a standard CRUT into a NIMCRUT based on scrivener error, as long as the modification complied with properly applied state law. In IRS Letter Ruling 200338006, the IRS agreed to honor the judicial modification of a NIMCRUT into a standard CRUT based on scrivener error. The trust had been administered as a standard CRUT rather than a NIMCRUT for several years before the error was discovered. In IRS Letter Ruling 200649027, however, the IRS declined to honor a judicial modification of a NIMCRUT into a standard CRUT because the proposed reformation would not be made for the purpose of correcting a scrivener's error.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.9A 3. Flip Unitrust

§18.9A 3. Flip Unitrust

A "flip unitrust" is a charitable remainder unitrust (CRUT) that starts off as a "net income (with makeup)" charitable remainder unitrust (NIMCRUT), also called an "income exception (with makeup) trust," which pays the lead beneficiary the lesser of net income or the unitrust amount. If income is less than the unitrust amount, the deficiency can be paid to the lead beneficiary in later years under the "makeup" provision when the income exceeds the unitrust amount. The trust later "flips" and becomes a standard unitrust, paying the unitrust amount each year regardless of income. The arrangement is desirable when a CRUT is initially funded with property that does not produce income.

Treasury Regulation §1.664-3(a)(1)(i)*(c)* specifically authorizes flip unitrusts, subject to four requirements:

(1) The instrument must specify a flip trigger date or provide that the flip is triggered by the occurrence of an event that is not within the control of the trustee or other persons. Permitted triggering events include the sale of unmarketable assets, marriage, divorce, death, or the birth of a child.

(2) The actual flip (change of distribution method) is to be effective as of the beginning of the year following the occurrence of the triggering event.

(3) The flipped trust must exclusively use the fixed-percentage method for calculating distributions, starting with the taxable year after the flip.

(4) The right to makeup distributions is forfeited once the trust flips.

The regulations make clear that the only permitted "flip" is from a net income unitrust (with or without a make-up provision) to a regular unitrust. Only one flip is permitted.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.9B d. Accelerated Charitable Trust

§18.9B d. Accelerated Charitable Trust

An accelerated charitable trust (ACT) is a short-term, high-payout CRUT principally designed to transfer highly appreciated assets to a private foundation. Under IRC §170(e), the charitable income tax deduction for contributions of long-term capital gain property to a private foundation is limited to the donor's basis in the property. If the donor contributes highly appreciated assets to a private foundation, the donor loses most of the deduction. On the other hand, if the donor sells the property and contributes the net proceeds to the foundation, the donor receives a full deduction but is liable for capital gains tax.

If the donor contributes the property to an ACT with the foundation as the charitable remainder beneficiary, however, the trust can sell the assets without incurring capital gains tax. The trust makes unitrust payments to the donor and the donor pays tax at the capital gains rate on the portion of the payments attributable to gain from the sale of the property. The donor in turn contributes the unitrust payments to the foundation and receives a full deduction against ordinary income under IRC §170(a). The trust has the shortest term and largest payout that will give the foundation a minimum 10-percent remainder interest and will not exceed the 50-percent maximum payment limitation under IRC §664(d). See §18.6A. The donor still does not receive a charitable deduction for the gift of the remainder interest, but the lost deduction is limited to 10 percent of the value of the property.

EXAMPLE: The donor contributes property with a fair market value of $100,000 and a basis of zero to a CRUT with a 4-year term. The unitrust amount is 43.75 percent. The value of the charitable reminder interest is $10,000. The CRUT sells the property and invests the proceeds in assets yielding a return of 10 percent. The foundation invests the donor's contributions at the same rate of return. Over 4 years, the donor receives unitrust payments and income tax deductions of $107,726. Of these payments, $85,343 is treated as principal for trust accounting purposes and taxed as capital gains. At the end of 4 years, the foundation receives the remaining $14,657 from the CRUT and has assets of $146,407. If instead the donor contributes the property to the foundation, the donor will receive no income tax deduction and the foundation will still have assets of $146,407 after 4 years. If the donor sells the property, pays tax at a combined federal and state tax rate of 26.5 percent, and donates the net proceeds to the foundation, the donor will pay $26,500 in tax and contribute $73,500 in cash to the foundation, receiving an income tax deduction for the same amount. After 4 years, the foundation will have assets of $107,611.

While a conventional CRT can obtain similar results over a longer period of time, an ACT compresses the benefits. The practitioner should be cautious because the IRS has not ruled on the effectiveness of ACTs. For further discussion, see Cline, *Charitable Remainder Trusts: State of the Art?*, 28 Tax Mgmt Est, Gifts & Tr J 147, 156 (2003); Cline, *Accelerated Charitable Trusts Provide New Gift Giving Opportunities*, 26 Est Plan 59 (1999).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.10 C. Summary of Differences Between Annuity Trust and Unitrust

§18.10 C. Summary of Differences Between Annuity Trust and Unitrust

Both the annuity trust and the unitrust have a mandatory payment each year. The basic difference between the annuity trust and the unitrust is that the annuity trust pays the recipient a fixed amount each year, regardless of inflation or changes in the value of trust assets from year to year. The unitrust pays the recipient a fixed percentage of the annually determined fair market value of the trust assets. The unitrust provides some hedge against inflation, but it also risks a decrease in payments if the trust assets decline in value. The annuity trust, however, risks depletion of the trust principal while the unitrust does not, even if the payout is a fixed percentage of a smaller and smaller principal amount. Accordingly, the annuity trust may be satisfactory for individuals who desire constant annual payments, assuming that the trust principal is not depleted, while the unitrust may be desirable for those who believe that the trust's investments will keep pace with inflation and provide a stream of constant buying power to the recipient.

As opposed to the "straight" or "mandatory-pay" unitrust, the income-only unitrust, with or without deficiency makeup, provides income only up to the fixed percentage, plus the deficiency makeup, if applicable. If trust income is low, such as in years when interest rates or dividends are low, the distributable amount is also low and possibly well below the stated percentage in the trust instrument. The difference between this income payment and the unitrust fixed percentage payment must be explained to a client when using an income-only unitrust.

The most important practical differences that the client should keep in mind in choosing between a CRAT and a CRUT are:

- With its fixed payments, the CRAT provides security in a declining market, but it cannot keep pace with inflation. Because the unitrust amount increases with appreciation in the value of the trust assets, the CRUT provides a hedge against inflation. In a declining market, however, the unitrust amount is not cushioned by a floor as is the annuity amount.
- The CRAT may provide a higher charitable deduction than the CRUT at younger beneficiary ages.
- The CRAT may work well for fixed income investments or other assets that will not fluctuate in value.
- NIMCRUTS are better suited for illiquid assets.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.11 IV. PLANNING CONSIDERATIONS

§18.11 IV. PLANNING CONSIDERATIONS

Before creating a charitable remainder trust, the attorney should inform the client that no amounts other than the specified annual payment may ever be paid to the recipient. Treas Reg §§1.664-2(a)(4), 1.664-3(a)(4). Unless principal must be used to pay the annuity or unitrust amount (and principal is not available in the income-only unitrust), principal cannot be invaded for the recipient. This factor alone may dissuade many clients from placing a significant portion of their assets in a charitable remainder trust. If the recipient is a spouse, an alternative form of trust may be more appropriate for the clients' needs. On qualified terminable interest property trusts with charitable remainders, see §18.122.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

Before starting to draft the trust, the practitioner must carefully consider the form of the charitable remainder trust that will suit the needs of the donor as well as the recipient and the charity. To make the best choice, the drafter should consider the following issues:

- The selection of the form of trust from those outlined above;
- The beneficiaries and their needs;
- Who will act as trustee;
- Who will be named as charitable remainder beneficiaries;
- Certain tax considerations of the donor, the beneficiaries, and the trust itself; and
- Application of the excise taxes in IRC §§4940-4948.

For a summary of practical differences between a CRAT and a CRUT, see §18.10.

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A. Choice of Form of Trust

§18.11A 1. Issues Relating to Estate Tax Repeal

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38) provides for the repeal of the estate tax and the generation-skipping transfer (GST) tax effective for transfers in 2010. The law also provides for a "carryover basis" regime to replace the customary "step up" in basis at death. The provisions of EGTRRA-2001 have a significant impact on the desirability and drafting of charitable remainder trusts. As a result, practitioners should exercise caution in recommending and implementing charitable remainder trusts until the IRS issues additional guidance or there is a permanent reinstatement (or repeal) of the estate tax.

The most pressing issue under EGTRRA-2001 in 2010 arises from IRC §2511(c). As amended, that section provides as follows:

> Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1 [IRC §§671-679].

This provision is very problematic for most lifetime charitable remainder trusts. Charitable remainder trusts are generally designed to be nongrantor trusts for income tax purposes, because the trust is exempt from income taxation. Grantor trust status would result in the income and capital gains of the trust being taxable to the grantor—a highly undesirable result. Because charitable remainder trusts are not grantor trusts, IRC §2511(c) applies to contributions to them. Further, the IRS has stated (Notice 2010-19, 2010-7 Int Rev Bull 404):

> Section 2511(c) broadens the types of transfers subject to the transfer tax under Chapter 12 to include certain transfers to trusts that, before 2010, would have been considered to be incomplete and, thus, not subject to the gift tax. Accordingly, each transfer made in 2010 to a trust that is not treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1 is considered to be a transfer by gift of the entire interest in the property under section 2511(c).

Practitioners are concerned that IRC §2511(c) could be construed as treating an entire transfer to a charitable remainder trust as a gift. Ordinarily, prior to amended §2511(c), an annuity or unitrust interest retained by the donor would not be subject to gift tax, and the donor would receive a gift tax deduction for the gift of the remainder interest to the charitable remainder beneficiaries. Unfortunately, §2511(c) raises the possibility that the retained annuity or unitrust interest will be subject to gift tax. This is an absurd result from a tax perspective, and practitioners expect the issue to be resolved soon. However, until it is resolved, charitable remainder trusts in which the donor retains the annuity or unitrust interest are not advisable.

In addition, it has been common for donors to establish charitable remainder trusts with the annuity or unitrust interest continuing for the life of the surviving spouse. Generally, the continuing interest was subject to the donor's power to revoke the interest because, in the absence of that power of revocation, the gift to the spouse would have been complete as of the funding of the trust and no marital deduction would have been available. The power of revocation causes inclusion of the interest in the donor's estate, for which a QTIP election is made. However, §2511(c) would cause the incomplete gift in favor of the spouse to be a taxable gift upon funding the trust. As a result, this technique is also not advisable until further guidance is issued.

It is worth noting that some charitable remainder trusts appear unaffected by §2511(c). For example, a charitable remainder trust in which the donor and the donor's spouse do not retain the annuity or unitrust interest would be treated the same under amended §2511(c) as it would have been under prior law.

EXAMPLE: Donor establishes a charitable remainder unitrust for the benefit of her father *A*. The trust provides that a unitrust amount equal to 6 percent of the trust assets valued from year to year shall be distributable to *A* for life, and upon *A*'s death the remaining assets are to pass to charity. Under prior law, *A*'s interest would constitute a taxable gift at funding, and the charitable remainder interest would receive a gift tax deduction. Under current law, the result is the same. The entire transfer in trust is treated as a completed gift, but the portion arising in favor of

the charity receives a gift tax deduction.

Other issues with respect to charitable remainder trusts arise from repeal of the estate tax. For example, EGTRRA-2001 repealed the estate tax effective beginning January 1, 2010, and in the absence of further legislation, the estate tax will remain repealed for 1 year. The estate tax is scheduled to return in 2011. Because there is no estate tax, there is no need for an estate tax charitable deduction. As a result, for testamentary charitable remainder trusts, it is uncertain whether the normal estate tax benefits will be available for any given client.

Another issue involves drafting charitable remainder trusts in 2010. Often practitioners refer to organizations described in IRC §§170(c), 2055, and 2522. However, while the estate tax is repealed, arguably no organizations are described in IRC §2055. As a result, practitioners should carefully consider their descriptions of charitable organizations. One way to resolve the issue is to provide that references to §2055 refer to law as in effect on December 31, 2009, during any period when the estate tax is not in effect.

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§18.12 2. Donor Considerations

No statute, regulation, ruling, or case has defined or restricted the definition of "donor." Although the recipient of the current distribution from a charitable remainder trust must be a person as defined in IRC §7701(a)(1), the settlor of a trust generally has no such statutory definition. Thus, over the years, the donor to a charitable remainder trust has been allowed to be anyone or any entity.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

In IRS Letter Ruling 9547004, however, the IRS held that a charitable remainder trust created by eight individuals, grandparents and grandchildren, was not a trust at all but instead an "association" with a business purpose, to be treated for tax purposes as a corporation. This position is entirely inconsistent with previous practice and cannot be so defined by mere statement of the IRS. Privately, the IRS has said that this rule does not apply to husband-wife settlors, because they are deemed to be an economic unit. It would, however, apply to brother-sister settlors. The letter ruling has been widely criticized as having no basis in the law.

NOTE: A private letter ruling is not precedent and does not apply to any taxpayer other than the one requesting the ruling. However, it gives insight into the likely position of the IRS on an issue.

PRACTICE TIP: In California, husbands and wives may want to establish a joint charitable remainder trust to which they contribute community property and of which they are joint and survivor noncharitable recipients. Some practitioners prefer a division of community property into separate property portions and the creation of two charitable remainder trusts. This approach may be preferable particularly if (a) there are children from previous marriages whom the donors wish to include as noncharitable recipients or (b) a future dissolution of the marriage is feared. However, the use of an IRC §664(f) qualified contingency may solve the problem while permitting survivorship income to the spouse. Also, if the donors are giving each other the right to revoke, one-donor charitable remainder trusts are somewhat simpler.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/ 3. Nature of Funding Asset/§18.13 a. Effect on Choice of Type of Charitable Remainder Trust

3. Nature of Funding Asset

§18.13 a. Effect on Choice of Type of Charitable Remainder Trust

The nature of the funding asset may have an effect on the drafter's choice of form of charitable remainder trust. If the asset is easy to liquidate, such as publicly traded securities, any form may be used that meets the needs of the settlor, the beneficiaries, and the charitable remainder beneficiary. If the asset is illiquid, however, the possible time lag between funding the trust and the sale of the asset may be critical to maintaining the qualification of the trust.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

When an illiquid and underproducing asset that may not be readily sold is transferred to an annuity trust or a unitrust that must make a mandatory periodic payment, the periodic payment may require that the settlor contribute additional funds to principal, unless the trust is (1) an annuity trust to which no additional contributions are allowed or (2) a unitrust drafted to prohibit additional contributions. Alternatively, the trustee may need to distribute a fractional interest in property transferred to the trust or otherwise distribute assets transferred to the trust to the recipients in satisfaction of the annuity or unitrust amount. Such distribution is deemed to be a sale or exchange to the trust. If there is gain, it is treated as distributed to the beneficiary. See Treas Reg §1.664-1(d)(5).

PRACTICE TIP: If the funding asset is illiquid, it may be advisable to choose the income-only unitrust or the income-only unitrust with a makeup clause. For non-income or low-income-producing funding assets that may not sell immediately, the practitioner should consider this variation on the unitrust. If the trust contains a makeup clause, the shortfall while the property is non-income-producing may be made up after those assets are sold and the proceeds invested in income-producing assets. A makeup clause for payments passed may be added.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.14 b. Specific Assets

§18.14 b. Specific Assets

The following issues should be considered when deciding which assets to transfer to the charitable remainder trust:

- *Appreciated property.* One of the most common uses of a charitable remainder trust is to transfer appreciated property to the trust, with the trustee instructed to sell the property. The trust is tax exempt and does not pay capital gains taxes. See §§18.33-18.35. However, the transaction must be carefully structured to avoid anticipatory assignment of income by the transferor on sale of the property. See §18.20. A variation on this technique is the transfer of undeveloped land to a CRUT followed by sale of a conservation easement by the trust. See Di Cola, *Alternatives to Donating a Conservation Easement*, 31 Est Plan 489 (Oct. 2004).
- *Mortgaged real estate.* A trust that otherwise qualifies as a charitable remainder trust under IRC §664 will not so qualify if it is funded with mortgaged real estate, the settlor remains personally liable, and the mortgage payments are to be made out of the trust income. IRS Letter Ruling 9015049, citing Treas Reg §§1.664-1(a)(4), 1.677(a)-1(d). The explanation in the ruling states that the trust will not qualify if the payments for which the donor is liable are made from the trust. Internal Revenue Code §677(a)(1) makes it clear, however, that the payments may not be made from trust income (*i.e.,* ordinary and capital gain for the purpose of that section).
- *Tangible personal property.* Funding the charitable remainder trust with tangible personal property has a pitfall, described in IRC §170(a)(3). If the settlor retains an income interest in the transferred asset, no deduction for income tax purposes is allowed.
- *Closely held stock.* Closely held stock may not be freely transferable, which may pose a problem for the trustee. An appraisal of the company is required for the income tax deduction and is costly. In addition, the donor may not want to part with voting rights or voting control. If the donor retains the voting rights in a nonfiduciary capacity, the donor will be treated as the owner of the trust to the extent of the stock, and the trust will be disqualified as a charitable remainder trust. IRC §675(4)(A); Treas Reg §1.664-1(a)(4).
- *Retirement plan assets.* A retirement plan may be transferred to a CRUT created on the death of the settlor as a planning device to eliminate income in respect of a decedent (IRD) and reduce or eliminate estate taxes on large retirement plans. IRS Letter Rulings 9253038, 9237020. The asset is included in the settlor's gross estate for estate tax purposes, but it will qualify for a charitable deduction to the extent of the value of the charitable remainder as long as the plan's beneficiary designation causes the retirement plan distributions to be included in the CRUT's income and not the income of the estate. This technique may be especially useful if the plan assets would otherwise be distributed shortly after death, as may occur if the plan does not permit a contingent beneficiary other than the participant's spouse. Even if the CRUT is designed to give the remainder beneficiary the minimum 10-percent charitable interest (see §18.6A) and 90 percent of the assets will therefore be included in the estate, no income tax will be payable on the IRD until distribution of the unitrust amount. Similarly, in IRS Letter Ruling 200617020, the IRS ruled that the personal representative could use an IRA payable to the decedent's estate to partially fund a charity's right to receive a fractional share of the residuary estate. Under Treas Reg §1.691(a)-4(b), if an estate transmits the right to receive IRD to a specific or residuary legatee, only the legatee must include the income in gross income when received.
- *Assets without a readily ascertainable fair market value.* When the donor is also the trustee, there are special requirements for valuing assets without a readily ascertainable fair market value. See §18.17.
- *S corporation stock*. A charitable remainder trust may not be a shareholder of S corporation stock. Rev Rul 92-48, 1992-1 Cum Bull 301.

NOTE: Assets that generate unrelated business taxable income (UBTI) should not be used to fund a charitable remainder trust because UBTI is subject to a 100-percent excise tax under IRC §664(c). See §§18.33-18.35.

For discussion of other types of specific assets that may be considered for transfer to a charitable remainder trust, see Greene, *Charitable Trusts a Viable Alternative in Planning Real Estate Transfers?* 48 USC Tax Inst ¶1900 (1996).

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§18.15 4. Needs of Beneficiary

If the recipient does not need substantial distributions in early years, the income-only unitrust may be useful when the principal of the trust consists of low-current-yield assets that cannot be readily liquidated to make up a deficiency between the actual current income of the trust and the unitrust amount payable to the recipient. Examples are low-dividend-yielding stock of a closely held corporation and vacant real property. The income-only unitrust permits retention of a controlling interest in the corporation and, during the period in which the unitrust qualifies as a charitable remainder trust under IRC §664, it is not subject to the excess-business-holdings rule of IRC §4943. IRC §§4947(a)(2), (b)(3)(B). See also Prob C §16103. If the stock or the proceeds of its sale later produces substantial current income in excess of the unitrust amount, the unitrust amount deficiency may be made up if the instrument so provides.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

Often an older recipient prefers a fixed amount on which the recipient can rely in planning. If that is the case, an annuity trust is preferable. If the recipient prefers to live with the fluctuations of a unitrust, the possibility for growth of the payment amount exists. An equal possibility exists, however, that the value of the unitrust (on which the distribution is based) may decrease, causing a decreased distribution to the unitrust beneficiary. This risk does not exist for the fixed annuity of an annuity trust.

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B. Beneficiaries and Their Payments

§18.16 1. To Whom Payments Will Be Made; Length of Payment Period

The provisions of IRC §664(d)(1)-(3) permits the distribution from an annuity trust or unitrust to be made to any person. "Person" is defined in IRC §7701(a)(1) as an individual, a trust, an estate, a partnership, an association, a company, or a corporation, when not otherwise distinctly or manifestly incompatible with the intent of a particular section of the Internal Revenue Code.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

Annuity or unitrust payments may be made for the life or lives of specified individuals or for a specified term of years not to exceed 20 years. Payments to nonnatural entities are limited, however, to a period not to exceed 20 years. Lives and term of years may be combined, but the maximum length of the trust term may not extend beyond *either* the lives in being at the creation of the trust or 20 years. Treas Reg §§1.664-2(a)(5), 1.664-3(a)(5).

The payment to the recipient begins with the creation of the trust and continues for the life or lives of named individuals in being at the creation of the trust or for a specified term of years not to exceed 20 years. Specified trusts for mentally disabled beneficiaries, including a special needs trust, may receive benefits from charitable remainder unitrusts (CRUTS) that provide for a lead term for the life of the beneficiary. Rev Rul 2002-20, 2002-1 Cum Bull 794.

PRACTICE TIP: The planner might find that the value of the deduction available to the settlor is greater if the term is limited to the specified term of years, *e.g.,* if the life expectancy of the recipient is longer than the term of years. If a specified term is acceptable to the settlor for the recipient (*e.g.,* when the recipient is a child or grandchild), it is advisable to consider this alternative.

The statutory minimum percentage is 5 percent for all charitable remainder trusts, although the income-only unitrust need not currently distribute the fixed percentage if the trust income is less than the stated percentage in the trust instrument. The maximum percentage is 50 percent. It is necessary to use terms and percentages which result in a minimum charitable benefit of 10 percent of the value of the transferred assets. IRC §664(d)(1)(D), (d)(2)(D). In an annuity trust, the risk that the annuity will exhaust the trust cannot exceed 5 percent. See §18.6A.

For further discussion of beneficiaries and payout periods, see §§18.46-18.59.

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§18.17 2. Valuation for Computing Payment Amount

The trustee must establish the value of the trust assets for purposes of computing the annuity or unitrust amount. When valuing a charitable remainder trust's assets, the value to be used is the net (*i.e.*, assets minus liabilities) fair market value of the assets. Valuation of the assets in a charitable remainder trust ordinarily poses no problem if the assets are cash or securities traded on a recognized securities exchange. Trusts funded with assets such as (a) securities subject to restrictions on sale (such as Rule 144 (17 CFR §230.144) under the Securities Act of 1933 (15 USC §§77a-77aa)), (b) real property, or (c) interests in closely held corporations are more difficult to value.

The donor is required by Treas Reg §1.170A-13 to obtain a qualified appraisal for his or her deduction from income; however, the trustee is not subject to a similar requirement unless it has trust powers and must comply with banking regulations. It nevertheless has a fiduciary duty to value trust assets and substantiate the amount and method of arriving at this amount. For further discussion of valuation of unitrust assets, see §18.60.

CAVEAT: An individual donor may serve as trustee and also be the recipient of the charitable remainder trust. No deduction will be allowed, however, for unmarketable assets unless an independent trustee values such property or the trustee obtains a qualified appraisal from a qualified appraiser. Treas Reg §1.664-1(a)(7)(i). Under Treas Reg §1.664-1(a)(7)(ii), unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely held stock, and an unregistered security for which there is no available exemption permitting public sale. A person is not an independent trustee if the person is related or subordinate to the grantor's spouse. Treas Reg §1.664-1(a)(7)(iii).

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§18.17A 3. Division of Trust Into Separate Trusts for Individual Recipients

Often, married settlors wish to create a trust in which both spouses receive the annuity or unitrust payments, first paid jointly and then all to the survivor. However, marital difficulties may cause problems in the administration of such trusts. Similar problems can arise with respect to trusts created for two or more unmarried beneficiaries. One solution is to divide the trust into separate charitable remainder trusts with the same remainder beneficiaries paying the same total annuity amount or unitrust percentage as the original trust.

The IRS has issued guidance for making such a division that generally requires that each asset be divided pro rata between the separate trusts and requires the assets to be divided pro rata and transferred to the separate trusts of the surviving recipients on the death of a recipient. The income tax basis of each separate trust's share of each asset is the same as its share of the basis of that asset in the hands of the predivision trust. The separate trusts may have different trustees. Each separate trust has only one annuity or unitrust recipient and is administered and invested independently. The IRS guidance also permits a division of the trust into separate trusts, each providing for distribution of the trust assets to the charitable remainder beneficiaries on the death of an individual recipient, although no additional charitable deduction is permitted for the survivor's relinquished interest in the predeceasing recipient's share of the predivision trust. Rev Rul 2008-41, 2008-30 Int Rev Bull 170.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.18 C. Who May Serve as Trustee

§18.18 C. Who May Serve as Trustee

Many charitable remainder trusts are created with the charitable remainder beneficiary acting as the trustee. Corporations Code §5140(k) permits a nonprofit public benefit corporation to act as trustee of any trust that is incidental to the principal objects of the corporation and to receive, hold, administer, exchange, and expend funds and property subject to such trust. Any corporation with trust powers may serve as trustee of a charitable remainder trust.

NOTE: An individual nonindependent trustee (*e.g.,* the donor) serving as trustee of the charitable remainder trust whose assets do not have a readily ascertainable fair market value may not value the assets for purposes of determining the annuity or unitrust amount. See §18.17. In IRS Letter Ruling 200029031, the IRS ruled that the settlors could be sole trustees of a charitable remainder unitrust that prohibited the trustees from accepting, investing in, or holding any assets that did not have an objectively ascertainable market value. In addition, a settlor should not retain any power to sprinkle the annuity or unitrust amount among the noncharitable beneficiaries. Rev Rul 77-285, 1977-2 Cum Bull 213.

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§18.19 D. Selection of Remainder Beneficiary

The trust instrument must provide that, on termination of all interests other than those held by the charitable organizations, the entire principal of the trust will be irrevocably transferred to or for the use of one or more charitable organizations described in IRC §170(c) or retained in trust for the exclusive use of such organization or organizations. IRC §664(d)(1)(C), (2)(C); Treas Reg §§1.664-2(a)(6)(i), 1.664-3(a)(6)(i). For further discussion of the technical regulations and drafting considerations, see §§18.64-18.69.

PRACTICE TIP: It is advisable, but not required, for the drafter to verify with the named remainder beneficiary any specific or restricted purpose for which the remainder interest must be used. If the restricted purpose specified in the trust does not exist, a charity wishing to use the funds will be forced to petition a court to allow the trustee to change the restricted purpose. It is also important to establish the correct name of the organization, *e.g.,* whether the intended organization is the American Red Cross, Los Angeles chapter of the American Red Cross, or the International Red Cross.

The drafter should be aware that the charitable organizations may be changed after the execution of the trust instrument by the settlor (Rev Rul 76-8, 1976-1 Cum Bull 179; IRS Letter Ruling 200034019), the income recipient (Rev Rul 76-7, 1976-1 Cum Bull 179), or the trustee (Rev Rul 76-371, 1976-2 Cum Bull 305) if the power to make the change is set forth in the trust instrument and the new remainder beneficiaries are qualified charitable organizations. If the income recipient is someone other than the donor, the donor should not retain the power to change the charitable beneficiary, because the power will result in the trust assets' being taxable in the donor's estate with only a partial offsetting deduction for the charitable interest in the trust. IRC §2036.

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E. Tax Treatment of Transaction Creating Charitable Remainder Trust

§18.20 1. Settlor's Income Tax Deduction

For federal and California income tax purposes, the value of the remainder interest in a charitable remainder trust is deductible as a charitable contribution in the year of the transfer to the trust, subject to the normal limitations on charitable contributions (IRC §170(e), (f)(2)(A); Rev & T C §17201) and to the applicable provisions for carryover of excess contributions (IRC §170(d); Rev & T C §17201).

Determination of the settlor's percentage limitations depends on the settlors' other charitable contributions during the year and on the nature of the remainder beneficiaries of the trust as public charities or as private foundations. If the remainder beneficiaries must be public charities, the limitations applicable to public charities apply. See Rev Rul 74-53, 1974-1 Cum Bull 60.

If any person has the power to change the charitable remainder beneficiaries so that a private foundation might become a charitable remainder beneficiary, the deduction will be limited to the percentages applicable to gifts to private foundations. See Rev Rul 79-368, 1979-2 Cum Bull 109. See also §18.66. If the donor wishes to ensure that the maximum percentage limitation will apply, the donor should specify in the trust that any subsequently named charitable beneficiary be an IRC §170(c) and IRC §170(b)(1)(A) charity.

In any case, if the settlor transfers appreciated property to the trust and the value of the property exceeds the settlor's percentage limitations, the settlor may incur a tax liability under the anticipatory assignment of income doctrine if the property is subject to a purchase agreement or other arrangement that is "practically certain" to result in a sale of the property by the trust. See *Ferguson v Commissioner* (9th Cir 1999) 174 F3d 997. In IRS Letter Ruling 200321010, the IRS ruled that the settlor did not assign income because the trust was not legally obligated to sell the property. The ruling was based on the decision in *Gerald A. Rauenhorst* (2002) 119 TC 157. In that decision, which was appealable to the Fifth Circuit and was based on the decision in *Daniel D. Palmer* (1974) 62 TC 684, aff'd (8th Cir 1975) 523 F2d 1308, acq 1978-1 Cum Bull 2, and the IRS acquiescence in Rev Rul 78-197, 1978-1 Cum Bull 83, however, the Tax Court noted that cases in other circuits including *Ferguson* treated the legal obligation of the donee as only one factor to consider in connection with assignment of income. See also *Blake v Commissioner* (2d Cir 1982) 697 F2d 473 (contribution of substantially appreciated property sold by donee charity recharacterized as sale by taxpayer followed by contribution of property acquired by donee charity when there was reasonable expectation on donor's part, with advance understanding that donee charity would purchase property with proceeds of donated property).

Appraisals generally must accompany charitable deductions for gifts of property in excess of $5000. See Treas Reg §1.170A-13. See also California Estate Planning, chap 23 (Cal CEB 2002). The regulations apply to deductions for remainder interests in charitable remainder trusts as well as to outright gifts.

Under IRC §170(f)(8), no income tax charitable deduction will be allowed for contributions of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization. Donors should obtain a written acknowledgment from the trustee of the charitable remainder trust.

Under IRC §170(f)(10), no deduction will be allowed if the donee organization pays any premiums on a life insurance, annuity, or endowment contract for the benefit of the donor, any member of the donor's family, or any other person designated by the donor.

Under IRC §170(f)(12), the deduction for contributions of motor vehicles, boats, and airplanes with a claimed value in excess of $500 generally cannot exceed the gross proceeds received from the sale of the vehicle by the donee organization.

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§18.21 2. Settlor's Gift Tax Deduction

The settlor is entitled to a charitable gift tax deduction for the value of a remainder interest given to the charitable remainder beneficiaries. IRC §2522(c). If the settlor is the sole noncharitable beneficiary of the trust payout or if the settlor and a spouse are the sole recipients, no gift tax will be payable.

Any gift of the right to the annuity or unitrust payouts to a settlor's spouse who is a United States citizen will qualify for the unlimited marital gift tax deduction, and no gift tax is payable. IRC §2523(g), (i). The gift to a noncitizen United States spouse of a present interest of $134,000 (plus further cost-of-living adjustments after 2010) per year is excludable from tax if the gift would otherwise qualify for a marital deduction. IRC §§2503(b), 2523(i)(2). A gift of income wholly to the settlor and subsequently to the spouse is not a present interest, however.

If the trust is a charitable remainder trust as defined in IRC §§2056(b)(8)(B) (which refers to an IRC §664 trust) and 2523(g), the gift tax marital deduction is available whether or not a United States citizen spouse has an interest for life or for a term of years. No election to treat the trust as a qualified terminable interest property (QTIP) trust is required, as is the case with a QTIP trust that gives the spouse an "income" interest. IRC §2523(f). Also, unlike a QTIP trust, the IRC §664 charitable remainder trust having a settlor's spouse as a recipient is not includable in the recipient's estate on the recipient's death. IRC §2044(b)(1)(B). If the recipient's estate will take advantage of IRC §6166 (relating to extensions of time to pay the estate tax attributable to a closely held business), the recipient's gross estate will not be augmented by the IRC §664 trust, thus making it easier to qualify for IRC §6166.

The creation of a charitable remainder trust with anyone other than a settlor and/or his or her spouse as a recipient is a taxable gift of the value of the recipient's interest at the time of the transfer to the trust. To avoid making a taxable gift, a settlor may retain the power, exercisable only by will, to revoke or terminate the interest of any recipient who is not a charitable organization. Treas Reg §§1.664-2(a)(4), 1.664-3(a)(4); Rev Rul 74-149, 1974-1 Cum Bull 157. The reservation of a lifetime power to revoke will disqualify the trust. Treas Reg §§1.664-2(a)(4), 1.664-3(a)(4). See §18.96. In addition, if the recipient other than the settlor or spouse receives payments from the trust during the settlor's lifetime, the power to revoke will not prevent a taxable gift; there is no current gift, but there is an annual gift as the recipient is paid.

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3. Estate Tax Treatment in Settlor's Estate

§18.22 a. Trust Must Be Includable in Decedent's Gross Estate for Deduction

For estate tax purposes, the value of the remainder interest in a charitable remainder trust qualifies for the estate tax charitable deduction under IRC §2055(e). To obtain an estate tax deduction for the value of the remainder interest, the trust must be includable in the decedent's gross estate. Generally, unless a settlor has retained either an interest in or a power over the charitable remainder trust during his or her lifetime, the trust will not be included in the estate.

For example, if the settlor has reserved to himself or herself the lead annuity or unitrust interest, this would otherwise cause inclusion under IRC §2036(a). If the settlor is a trustee of the charitable remainder trust and the settlor retains the power to vote stock in a closely held corporation in his or her capacity as trustee, the trust will be included in the settlor's estate under IRC §2036(b). Likewise, if the settlor retains the right to change charitable remainder beneficiaries of the trust, regardless of whether the settlor and spouse are the only recipients, the trust will be included in the settlor's estate under IRC §2036(a)(2). See §18.23.

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§18.23 b. Determination of Estate Tax Charitable Deduction

If a settlor is the only recipient of the trust besides the charitable remainder beneficiaries, the trust assets are included in the settlor's gross estate but qualify in full for the estate tax charitable deduction. The amount included in the settlor's estate is the amount of trust corpus necessary to yield the annuity or unitrust payments determined by dividing the trust's equivalent income interest rate by the IRC §7520 rate. See Treas Reg §20.2036-1(c); Rev Rul 82-105, 1982-1 Cum Bull 133; Rev Rul 76-273, 1976-2 Cum Bull 268. If a settlor retains an interest in the trust but another recipient has an interest that continues after the settlor's death, the estate tax charitable deduction is the value of the trust assets includable in the decedent's estate, reduced by the actuarial present value of the remaining recipient's interest at the time of the decedent's death.

NOTE: A trust will not qualify as a charitable remainder trust and no charitable or income tax deduction will be allowed if federal estate and state death taxes may be payable from the trust assets. Rev Rul 82-128, 1982-2 Cum Bull 71. See §18.84.

If the interest that precedes the remainder belongs to the settlor's spouse and the spouse is the only noncharitable beneficiary, the unlimited marital deduction is available and no estate tax is payable on the interest. IRC §2056(b)(8). This may have the consequence that there is a partial loss of a new date-of-death income tax basis on the settlor's death when there is only partial inclusion of the trust assets in the settlor's estate because the trust's equivalent income interest rate is less than the IRC §7520 rate. Note, however, that the unlimited estate tax marital deduction is not available for transfers to a surviving spouse if a succeeding interest is given to another beneficiary such as a child or if the surviving spouse is not a United States citizen unless a qualified domestic trust (QDOT) is used. IRC §§2056(d), 2056A. For a letter ruling approving the use of QDOT language in a charitable remainder trust, see IRS Letter Ruling 9244013.

For an example of the computation of the estate tax credit allowed for gift taxes paid on the creation of a charitable remainder unitrust, see Rev Rul 74-491, 1974-2 Cum Bull 290. For an estate tax charitable deduction to be available for the remainder interest, the charitable remainder beneficiaries must be qualified under IRC §2055. Although IRC §§170 and 2055 are similar, they are not identical, and an organization that qualifies for income tax deductibility under §170 may not qualify for an estate tax charitable deduction under §2055. For instance, a foreign charity is a permissible recipient under §2055 but not under §170. In Rev Rul 77-385, 1977-2 Cum Bull 331, the IRS disallowed an estate tax charitable deduction for a remainder interest for a cemetery corporation that qualified under IRC §170(c) but did not qualify under IRC §2055. See form 18.71-1, which includes the qualification of the charitable remainder beneficiaries under IRC §2055 as a criterion for payment to the charitable remainder beneficiaries.

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§18.24 F. Computing Amount of Deduction

For transfers after April 30, 2009, tables for the valuation of remainder, income, and annuity interests were established, reflecting the mortality experience based on the 2000 census. These valuation tables contain actuarial factors for one life and terms certain, based on interest rates ranging from 2.2 percent to 22.0 percent. Treas Reg §§1.664-4(e), 20.2031-7(d); Temp Treas Reg §20.2031-7T(d); IRS Pubs 1457-1458. See chap 6.

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§18.25 1. Annuity Trust

The amount of the charitable deduction under IRC §§170(a) (income tax), 2055 (estate tax), and 2522 (gift tax) is the fair market value of the trust assets less the present value of the annuity. For income and gift tax purposes, the fair market value is determined as of the date the property is transferred to the trust. For estate tax purposes, the determination is made as of either the date of death or the alternate valuation date. Treas Reg §1.664-2(c). If the decedent retained the noncharitable interest in the trust, the value of the annuity will be zero.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

For transfers after April 30, 2009, the fair market value of annuities is determined by use of tables derived by using the applicable IRC §7520 interest rate, which is adjusted on a monthly basis. The tables are found in Temp Treas Reg §20.2031-7T(d) and IRS Pub 1457, Actuarial Valuations Version 3A (2009).

PRACTICE TIP: In Rev Rul 77-374, 1977-2 Cum Bull 329 (see §18.46), the IRS took the position that if there is more than a 5-percent chance that the charitable remainder annuity trust will be exhausted before a recipient's death with no payment of any remainder to the charity, the trust will not qualify as a charitable remainder annuity trust. Although this ruling will have no effect on the computation of the deduction for a remainder interest in a charitable remainder annuity trust, it may affect the qualification of the trust. Therefore, the computations required by Rev Rul 77-374 should be made before the trust is created.

The present value of the annuity will vary depending on the frequency of the payments during the year. The later the payments are made during the year, the larger the value of the charitable remainder interest. In the author's experience, however, the difference usually is insignificant. The payments during the year should be structured primarily for the recipient's convenience rather than to increase the amount of the charitable deduction. The adjustment factors for payments during different periods are provided in Table K in Treas Reg §20.2031-7(d)(6).

PRACTICE TIP: To avoid requiring a special factor from the IRS (see §18.28), it is suggested that the trust contain one of the payout frequencies provided in Table F and that the trust not contain a custom payout frequency (*e.g.*, weekly, biweekly) unless necessary.

For an example of how to calculate the deduction using the applicable tables, see §6.29.

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§18.26 2. Unitrust

The amount of the charitable deduction for a remainder interest in a unitrust, for transfers made after April 30, 2009, is the value of the remainder interest determined under Treas Reg §1.664-4(a). Under Treas Reg §1.664-4(a), the present value is based on the following factors:

- *Life contingencies of recipients*. See Table 2000CM in Temp Treas Reg §20.2031-7T(d)(7).
- *Interest rate*. Under IRC §7520, the interest rate for calculating the value of the charitable deduction is 120 percent of the federal midterm rate, compounded annually, rounded off to the nearest two-tenths of 1 percent, for the month when the gift is made or the two prior months.
- *Payout frequency*. The regulations assume that the unitrust amount will be distributed to the recipients according to the payout frequency described in the trust (*e.g.*, monthly, quarterly, semiannually, annually). If the trust does not describe when payments must be made, the payments are considered to be payable on the first day of the period for which the payments actually are made. Treas Reg §1.664-4(a)(3).

Although the unitrust amount paid to a recipient will vary each year, depending on the value of the trust assets during that year, the initial computation of the charitable deduction is made using the fair market value of the assets transferred to the trust on the applicable valuation date (*i.e.*, date of transfer, date of death, or alternate valuation date). The variation of the fair market value of the trust property during the trust term is not taken into account in computing the charitable deduction.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

For an example of how to calculate the deduction using the applicable tables, see §§6.30-6.35.

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§18.27 a. Maximizing the Deduction

The charitable deduction for a unitrust may be maximized by using an annual payout frequency and by providing that the annual valuation date for valuing the trust assets precedes the date of the payment of the unitrust amount to the recipient. The greater the number of months by which the valuation date precedes the first payment date, the greater the value of the remainder interest.

PRACTICE TIP: In the author's experience, the additional deduction caused by differing payout frequencies usually is insignificant, and the payout frequency should be designed for the recipient's convenience rather than to maximize the charitable deduction.

PRACTICE TIP: If the valuation of an interest is dependent on either the continuation or the termination of more than one life, or on a term certain concurrent with one or more lives, a special factor must be used. This factor must be computed on the basis of the interest rate determined under IRC §7520(a) (equal to 120 percent of the federal midterm rate for the month in which the valuation date falls or either of the two preceding months). Life contingencies must be determined for each person involved, from the values published in Table 2000CM. IRS Pub 1457 contains tables with factors for one and two lives based on Table 2000CM at interest rates from 2.2 to 26.0 percent. The frequency of payouts must be factored in whether the term is for a number of years or for life.

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§18.28 b. Using Special Factor for Payout Frequency

If a special mathematical factor is needed to compute the value of a remainder interest in a charitable remainder unitrust, the IRS will supply it on request for a ruling. The ruling request should be accompanied by a statement of the date of birth and gender of each individual whose life may affect the value of the remainder interest and by copies of the relevant instruments. Payment of the required user fee should be included. If the IRS furnishes a factor, a copy of the letter supplying the factor should be attached to the tax return on which the deduction is claimed. Treas Reg §1.664-4(b). If the computation for a unitrust deduction is made by the taxpayer, a statement showing the calculation must be attached to the return. Treas Reg §1.664-4(c).

Although rarely used, if a special factor will be requested, the trust should not be funded before obtaining the factor, because a request for a factor will result in an examination of the instrument by the IRS. If defects are found, the deductions will not be allowed unless the trust can be reformed. See §§18.101-18.102. See also Godshall, *Reforming and Modifying Irrevocable Trusts: Navigating the Waters and Avoiding the Shoals*, Estate Planning 2005, chap 6 (Cal CEB 2005). If the trust is not already funded, a new trust can be created that is free from the defects.

PRACTICE TIP: To avoid requiring a special factor from the IRS, it is suggested that the trust contain one of the payout frequencies provided in Table F and that the trust not contain a custom payout frequency (*e.g.*, weekly, biweekly) unless necessary.

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§18.29 c. Method of Calculation

The first step in calculating the charitable deduction is to determine the interest rate to be used. The interest rates available are the published rates for the month of the transfer and the two preceding months. To achieve the largest charitable deduction, the highest rate should be selected. The next step is to compute the adjusted payout rate (*i.e.,* the percentage of the value of the trust assets, multiplied by the factor for the payout frequency provided in the trust), using Table F. Then, the remainder factor for the annuitant is calculated by interpolation from Table U(1).

For an example and sample calculations, see §§6.30-6.35.

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§18.30 3. Commercial Software

Several software programs are available that perform the calculations to determine the value of the remainder interest in a charitable remainder trust literally at the push of a button. Particularly for the drafter who is examining alternatives from a planning perspective, these programs can be valuable tools. A primary advantage is the ease with which one variable may be changed. For a general discussion of factors to consider in choosing estate planning software, see §6.39.

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G. Income Taxation of Recipients

§18.31 1. Governing Law

The federal and California income tax treatment of distributions to recipients of payouts from charitable remainder trusts is governed by IRC §664(b) and Rev & T C §17731, not by the normal subchapter J rules applicable to trusts. Internal Revenue Code §664(b) and Rev & T C §17731 apply even if the trust itself is subject to the normal subchapter J rules because it has unrelated business taxable income in a given year. See Treas Reg §1.664-1(c)-(d). Under the four-tier system of IRC §664(b), distributions are characterized and taxed to recipients in the following "worst in—first out" sequence:

(1) As ordinary income to the extent of the trust's current year's ordinary income and its undistributed ordinary income for earlier years;

(2) After all income described in (1) has been distributed (including qualified dividends), as capital gain to the extent of the trust's net cumulative capital gain, short term first, then long term, with long-term gains and losses netted before netting short-term capital loss against any class of long-term gain, and then with the long-term gain taxable at the highest rates being distributed before long-term gain taxable at lower rates (Treas Reg §1.664-1(d)(1));

(3) After all income in categories (1) and (2) has been distributed, as other income (*e.g.*, tax-exempt interest) to the extent of the trust's other income for the current year and such undistributed other income for earlier years;

(4) After all income in the previous three categories has been distributed, as a tax-free distribution of trust principal.

The determination of the character of amounts distributed or deemed distributed by the trust at any time during the taxable year of the trust is made as of the end of that taxable year, and the tax rates to be used in computing the tax are those applicable in the year of the distribution rather than the year the income was received by the trust. Treas Reg §1.664-1(d)(1)(ii). For further discussion of these rules, see Fox, *New Prop. Regs. on Distributions From CRTs Provide Opportunity*, 31 Est Plan 172 (Apr. 2004).

A recipient must include the appropriate annuity or unitrust amount for a given trust year in his or her gross income for the recipient's taxable year during which or with which the trust's tax year ends. Treas Reg §1.664-1(d)(4). The applicable trust year is the year in which the trust is required to make the distributions, regardless of the year in which the recipient actually receives the distributions. Treas Reg §1.664-1(d)(4). The recipient is advised of the amount to include on a Schedule K-1, which is prepared in connection with the trust's annual report on IRS Form 5227 (Split Interest Trust Information Return).

NOTE: As a result of this four-tier system, charitable remainder trusts are not tax avoidance vehicles, although they can serve as tax deferral devices. If, *e.g.,* appreciated property is contributed to the trust and then sold and the proceeds invested entirely in tax-exempt bonds, the distribution will be treated as taxable capital gain under the four-tier system if there is insufficient ordinary income from other trust assets to fund a required distribution to a recipient. In IRS Letter Ruling 200219102, the IRS recognized a state-court-ordered rescission of a charitable remainder trust because the charity allegedly incorrectly represented that there would be no distributions until the stock contributed to the trust was sold and that there would be no tax consequences if any stock was distributed in kind. The stock was not sold by the trust and eventually lost most of its value. The IRS has issued regulations concerning abusive transactions in which donors contribute appreciated assets to the trust and attempt to avoid distributions carrying out capital gains by causing the trust to make large early-year distributions using funds that are borrowed or otherwise acquired without current recognition of income. The regulations treat the transaction as a deemed sale that results in the distribution carrying out capital gains. Treas Reg §1.643(a)-8.

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§18.32 2. Income-Only Unitrusts

To some commentators, the income taxation of distributions from income-only unitrusts is not clear. Some persons have argued that the IRC §664(b) tier system applies only to standard unitrusts and to annuity trusts. See Moore, *Income Taxation of Charitable Trusts*, 37 NYU Inst Fed Tax §41.03 (1979).

If the distribution rules of IRC §664(b) do not apply to income-only unitrusts, the normal subchapter J rules apply. Treasury Regulation §1.664-1(d), however, seems to refer to distributions from all charitable remainder trusts, including income-only unitrusts. The IRS's position is that all charitable remainder trusts are subject to the distribution rules of IRC §664(b). See Treas Reg §1.664-1(d)(1)(iv).

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§18.33 H. Taxation of Charitable Remainder Trusts and Trustees

A charitable remainder trust created after July 31, 1969, is exempt from all income tax on its income for any taxable year of the trust, but the trust is subject to a 100-percent excise tax on unrelated business taxable income (UBTI). IRC §664(c); Rev & T C §17731. See §18.34. Note, however, that the usual 3-year limitation period on refunds for overpayment of tax under IRC §6511(a) applies to a tax-exempt trust that files returns and pays tax on its regular income by mistake. *Wachovia Bank v U.S.* (11th Cir 2006) 455 F3d 1261.

PRACTICE TIP: Because any unrelated business taxable income will trigger the excise tax, the trustee of a charitable remainder annuity trust or unitrust should be advised to analyze carefully every proposed investment to make certain that there is no hidden debt-financed income (*e.g.,* mortgaged property; limited partnership interests, which are frequently debt-financed). The trustee should also be advised against borrowing by the charitable remainder trust for the purpose of acquiring or improving property, which may result in unrelated business taxable income. On a transfer of mortgaged property to a charitable remainder trust, see §18.14.

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§18.34 1. Definition of Unrelated Business Taxable Income (UBTI)

"Unrelated business taxable income" (UBTI) subject to a 100-percent excise tax under IRC §664(c) (see §18.33) is defined in IRC §§511-514, Treas Reg §§1.512(a)-1—1.512(c)-1, and Rev & T C §§23732-23735. In general, UBTI includes gross income derived from any unrelated trade or business regularly carried on by the trust, less the deductions directly connected with carrying on that trade or business. IRC §512(a)(1). UBTI generally does not include dividends, interest, annuities, royalties measured by production or by gross or taxable income from property, whether from real or personal property (with certain limitations), rents from real estate, or gains or losses from the sale, exchange, or other disposition of most capital gains property. IRC §512(b)(1)-(3), (5). Income from (1) sale or disposition of inventory or property held primarily for sale to customers in the ordinary course of a trade or business and (2) debt-financed property is also considered UBTI. IRC §512(b)(4)-(5). Debt-financed property is property that is held to produce income and for which there is an acquisition indebtedness, with certain exceptions. IRC §514(b).

In computing UBTI, a specific deduction of $1000 is allowed in each taxable year of the trust. IRC §512(b)(12). Notwithstanding IRC §512(b)(1)-(3), UBTI includes specified payments from controlled (more than 50-percent ownership) entities. IRC §512(b)(13).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.35 2. Tax Treatment of Unrelated Business Taxable Income (UBTI)

§18.35 2. Tax Treatment of Unrelated Business Taxable Income (UBTI)

Apart from paying a 100-percent excise tax on unrelated business taxable income (UBTI) under IRC §664(c)(2), the charitable remainder trust will not pay tax on any income of the trust for the year in which the trust has UBTI. IRC §664(c)(1). A trust that has UBTI in one year and no UBTI in a later year will not be subject to the excise tax for the year in which it has no UBTI. The excise tax is treated as paid from trust corpus, and the UBTI is included in trust income for purposes of determining the character of distributions to noncharitable beneficiaries. Prop Treas Reg §1.664-1(c)(1).

NOTE: Placing mortgaged property in the charitable remainder trust creates the risk not only of unrelated debt-financed income but also that the charitable remainder trust will incur a tax for self-dealing. Treas Reg §§1.514(c)-1(b), 53.4941(d)-2(a)(2).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.36 3. Excise Taxes on Prohibited Transactions

§18.36 3. Excise Taxes on Prohibited Transactions

The governing instrument must contain certain required provisions to prevent the imposition of excise taxes under IRC §§4940-4948. Required provisions include those relating to IRC §§4941 (prohibition against self-dealing) and 4945 (taxes on taxable expenditures). If amounts remain undistributed for a period of time after the termination of the noncharitable interest, IRC §4942 (failure to distribute income) may be applicable. For discussion of the mandatory clause regarding prohibited transactions, exceptions, and a sample form, see §§18.79-18.81.

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§18.36A 4. Tax Treatment on Termination of Trust

In IRS Letter Ruling 200314021, the grantor of a charitable remainder unitrust (CRUT) proposed to terminate the trust and divide the trust assets between the grantor and a private foundation named as the charitable remainder beneficiary, according to the current value of the lead and remainder interests valued under IRC §7520. The IRS ruled that the transaction is to be treated as a sale by the grantor that is governed by IRC §1001. The sale of an income interest in a trust is a sale of a capital asset within the meaning of IRC §1221. Under IRC §1001(e), the grantor's basis in the income interest is disregarded. Thus, the grantor has no basis in the unitrust interest and the amounts received by the grantor will be taxed as long-term capital gains.

NOTE: California law permits the termination of a trust on petition to the court if all beneficiaries consent, unless the continuance of the trust is necessary to carry out a material purpose of the trust and the court, in its discretion, determines that the reason for terminating the trust does not outweigh the interest in accomplishing a material purpose of the trust. Prob C §15403.

The ruling also notes that the grantor is potentially subject to the IRC §4941 excise tax on acts of self-dealing between a disqualified person and a private foundation. See §18.36. The trust is treated as a private foundation and the grantor is treated as a disqualified person. The IRS ruled that the proposed transaction will not result in an act of self-dealing as long as the state law allows the early termination, all beneficiaries favor the early termination, the amounts distributed to the grantor and the foundation are determined under Treas Reg §1.664-4 and IRC §7520, and the grantor is not aware of any medical condition that would result in a shorter-than-average longevity.

In Notice 2008-99, 2008-47 Int Rev Bull 1194, the IRS identified certain transactions involving sales of charitable remainder trust interests as "transactions of interest" for purposes of Treas Reg §1.6011-4(b)(6). The transaction in question begins with a donor transferring low basis property to a charitable remainder trust. The trust sells the property but does not recognize gain because of its exempt status. The trust then acquires new assets and has a basis in those assets equal to the purchase price. Thereafter, in a single transaction, the donor and the charitable remainder beneficiary sell or otherwise dispose of their respective interests in the trust to an unrelated third party. The trust is then terminated and its assets are distributed to the third party. The donor then takes the position that, because there was a sale of all interests in the trust, IRC §1001(e)(1), which disregards basis in the case of a sale of a term interest, does not apply under the exception in IRC §1001(e)(3). Instead, the donor asserts that he or she is entitled to the trust's basis in the new asset held by the trust at the time of sale. The arguable net result of the transaction is that the gain on the sale of the originally donated appreciated assets is never taxed, even though only a small portion of the proceeds of the sale of the interests ends up in the hands of the charity. As a result of the transaction being designated a "transaction of interest," persons engaging in such transactions must report them on their income tax returns using IRS Form 8886. Failure to comply can result in imposition of penalties under IRC §6707A.

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V. DRAFTING CHARITABLE REMAINDER TRUSTS

§18.37 A. Drafting Sources

The charitable remainder trust is primarily a tax creature in that it must follow the rigid tax rules embodied in the Internal Revenue Code, the regulations, and in certain revenue rulings that operate more like regulations than positions of the IRS. Thus, the drafting attorney must be aware of a very scattered body of tax law pertaining to these trusts, in addition to the California laws regarding trusts.

The requirements for drafting charitable remainder trusts are set forth in IRC §664 and Treas Reg §§1.664-1—1.664-3. Because the provisions relating to charitable remainder trusts are complex, the IRS has issued a series of revenue rulings that add or interpret clauses and revenue procedures that contain approved sample forms for drafting charitable remainder trusts. These rulings and procedures are complex in themselves: Rev Rul 72-395, 1972-2 Cum Bull 340, modified by Rev Rul 80-123, 1980-1 Cum Bull 205; Rev Rul 82-128, 1982-2 Cum Bull 71; Rev Rul 82-165, 1982-2 Cum Bull 117; Rev Rul 88-81, 1988-2 Cum Bull 127, and Rev Rul 92-57, 1992-2 Cum Bull 123; Rev Proc 2003-53—2003-56, 2003-2 Cum Bull 230; and Rev Proc 2005-52—2005-55, 2005-2 Cum Bull 326. Over the years, the IRS has also issued many other revenue rulings interpreting the charitable remainder trust rules in a hypertechnical manner.

A defective charitable remainder trust often can be reformed to meet the technical requirements of the statute, regulations, and revenue rulings and procedures. IRC §2522(c)(4). See §§18.101-18.105. The availability of reformation, however, is not a substitute for careful adherence to the requirements for drafting valid charitable remainder trusts, and it does not cover faulty choice of form, asset transfer, or implementation.

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§18.38 1. Basic Approach of Regulations and Rulings

The basic approach of the regulations and rulings is that every charitable remainder trust must contain certain mandatory clauses to qualify for the charitable deduction. In addition, if specified optional clauses are selected, additional clauses may become mandatory. For complete sample documents that include clauses designated as "optional" in rulings issued between 1972 and 2005, see Rev Rul 72-395 §§4, 6, modified by Rev Rul 82-165, Rev Rul 82-128, and Rev Rul 92-57; Rev Proc 2003-53—2003-56; and Rev Proc 2005-52—2005-55.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

Documents based on the earlier rulings usually will be accepted as meeting the requirements of IRC §664 and the regulations (Rev Rul 72-395 §1), but the sample forms provided in those rulings were neither exhaustive nor exclusive.

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§18.39 2. Sample Forms

The IRS issued new sample forms for charitable remainder annuity trusts in October 2003. The annuity trust forms are:

- Rev Proc 2003-53, 2003-2 Cum Bull 230: Inter vivos CRAT for one measuring life.
- Rev Proc 2003-54, 2003-2 Cum Bull 236: Inter vivos CRAT for a term of years.
- Rev Proc 2003-55, 2003-2 Cum Bull 242: Inter vivos CRAT with consecutive interests for two measuring lives.
- Rev Proc 2003-56, 2003-2 Cum Bull 249: Inter vivos CRAT with concurrent and consecutive interests for two measuring lives.

The IRS issued new sample forms for charitable remainder unitrusts in 2005. The unitrust forms are:

- Rev Proc 2005-52, 2005-2 Cum Bull 326: Inter vivos CRUT with one measuring life.
- Rev Proc 2005-53, 2005-2 Cum Bull 339: Inter vivos CRUT for a term of years.
- Rev Proc 2005-54, 2005-2 Cum Bull 353: Inter vivos CRUT with consecutive interests for two measuring lives.
- Rev Proc 2005-55, 2005-2 Cum Bull 367: Inter vivos CRUT with concurrent and consecutive interests for two measuring lives.

Section 3 of Rev Proc 2003-53—2003-56, and §3 of Rev Proc 2005-52—2003-55 provide that documents that are substantially similar to the IRS samples contained in those procedures will be recognized as satisfying all the statutory and regulatory requirements for these trusts. Documents that contain additional substantive clauses (other than clauses necessary to establish a valid trust under local law) or omit clauses given in the samples will not necessarily be disqualified, but they will not be assured of qualification under these "safe-harbor" samples. For further discussion, see Fox, *A Guide to the IRS Sample Charitable Remainder Trust Forms*, 33 Est Plan 13 (Jan. 2006). See also Hester, *Using Charitable Gifts in Estate Planning to Maximize Tax-Efficient Results*, 104 J Tax 94 (Feb. 2006).

CAUTION: For the most part, the forms in this chapter follow the language of the sample clauses of the revenue rulings and procedures, but modifications have been made to them when appropriate. Specifically, the statute, regulations, and procedures do not consider (a) the problems of drafting for community property or (b) the trust laws of states in general. The forms and comments in this chapter that were modified to take community property into account were prepared without advance IRS guidance. The sample forms of CRUTs in Rev Procs 2005-52—2005-55 and CRATs in Rev Procs 2003-53—2003-56, respectively, are reproduced in Apps G and H.

Since the release of the sample forms, the IRS will not ordinarily issue rulings or determination letters on whether an inter vivos trust that provides for annuity or unitrust payments for one or two measuring lives qualifies as a charitable remainder trust under IRC §664, or whether contributions to such a trust are deductible for income or gift tax purposes. See Rev Proc 2010-3, §4.01(37), (51), 2010-1 Int Rev Bull 110. Other questions may be addressed in a request for a private letter ruling.

PRACTICE TIP: Many practitioners use the appropriate IRS form and only add trust administration clauses to it, such as trustee powers and successor trustee clauses.

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§18.40 B. Need for Initial and Continued Qualification

To obtain the charitable deduction, an inter vivos or testamentary charitable remainder trust initially must meet each statutory requirement. Treas Reg §1.664-1(a)(4). For trust income to continue to be nontaxable, the trust must also continue to qualify as a charitable remainder trust. There are no published rules on whether the failure to continue to qualify as a charitable remainder trust after the initial qualification will result in a permanent loss in the trust's exemption from income tax.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

PRACTICE TIP: The author understands that the IRS's current unpublished position is that loss of exemption from federal income tax for 1 year will result in a permanent, future loss of the exemption. An exception to this position is that unrelated business taxable income in 1 year will not result in the loss of the trust's exemption from federal income tax in later years.

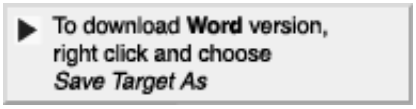
Besides revoking the trust's exemption from income tax, the IRS may impose the sanctions available in IRC §§4941 and 4945, relating to taxes and penalties imposed on private foundations that engage in specified prohibited conduct.

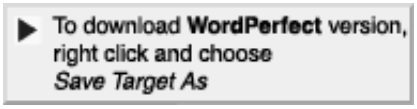
NOTE: Because a trust must function exclusively as a charitable remainder trust from its creation, and a trust is considered created only when property is first transferred to it, the trust is not considered created until it is funded, as evidenced, *e.g.,* by the trustee's signature on Schedule A, attached to the instrument. See App F.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.41 C. Form: Trust Is Irrevocable

§18.41 C. Form: Trust Is Irrevocable





***Irrevocability of Trust*. This trust is irrevocable and may not be altered or amended in any respect except as specifically authorized by this instrument. It may not be terminated except through distributions permitted by this instrument.**

Comment: Many drafters include this form, which states some of the requirements for a charitable remainder trust.

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D. Savings Clause

§18.42 1. Effect on Qualification of Trust

Some savings clauses are effective to protect the qualification of the charitable remainder trust, but other savings clauses can actually disqualify the trust. Generally, savings clauses designed to protect the settlors by making the trust void if it does not qualify for the charitable deduction have not fared well in the rulings, and the very presence of certain types of savings clauses may disqualify the trust even if the trust otherwise is qualified.

A trust clause that voids the trust if the IRS disallows a charitable deduction for the remainder prevents the trust from qualifying as a valid charitable remainder trust even if it would otherwise qualify, but a clause that makes the creation of the trust contingent on a favorable ruling from the IRS will not disqualify the trust. Rev Rul 76-309, 1976-2 Cum Bull 196.

A clause such as the one found in §18.43, which permits or directs the trustee to amend or reform a charitable remainder trust to qualify it under IRC §664, does not disqualify the trust and is helpful in construing a trust and permitting the reformation of a trust. Probate Code §§16105 and 17200 give the superior court jurisdiction to hear matters relating to charitable remainder trusts and, specifically, to amend and reform the trusts to comply with the provisions of IRC §664. Prob C §17200(b)(15).

The reformation statute (see §§18.101-18.105) allows defective trusts to be amended to permit the charitable deduction to be obtained for income, gift, and estate tax purposes. A savings clause authorizing and directing this amendment should indicate to the court the settlors' intentions for the trust and should aid the court in finding that an amendment or reformation is appropriate.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.43 2. Form: Savings Clause

§18.43 2. Form: Savings Clause

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

18.43-1 Savings clause

***Purpose of Trust*. The settlor(s) _ _**[*intends/intend*]**_ _ that this trust shall qualify as a charitable remainder _ _**[*annuity trust/unitrust*]**_ _ under Internal Revenue Code §664, and all clauses of this instrument shall be interpreted according to this intention. The trustee shall have the power to amend the terms of this instrument in writing without application to any court to the extent permitted by the Internal Revenue Code and applicable Treasury Regulations to qualify and continue to qualify the trust as a charitable remainder _ _**[*annuity trust/unitrust*]**_ _ under Internal Revenue Code §664. The powers conferred by this paragraph include, but are not limited to, the power to treat contributions to this trust as separate trusts when the contributions are so treated under Internal Revenue Code §664(d)(4).**

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§18.44 E. Overview: Mandatory Clauses for Instrument

Every charitable remainder trust must contain mandatory clauses regarding the following issues, all of which are described in more detail in subsequent sections of this chapter. Revenue Procedures 2003-53—2003-56, 2003-2 Cum Bull 230, contain sample language for use in charitable remainder annuity trusts; these revenue procedures should be reviewed before the trust is drafted. Revenue Procedure 2005-52—2005-55, 2005-34 Int Rev Bull 326, contain sample language for use in charitable remainder unitrusts.

The subjects of mandatory clauses are:

- *Payments and recipients* (see §§18.46-18.59, 18.64-18.69);
- *Valuation (s*ee §§18.60-18.61);
- *Proration* (see §§18.62-18.63);
- *Charitable remainder beneficiaries* (see §§18.64-18.69);
- *Adjustment for incorrect valuation of trust assets* (see §§18.70-18.71);
- *Additions after initial contribution* (see §§18.72-18.78);
- *Trustee prohibitions: applicable private foundation rules* (see §§18.79-18.81);
- *No investment restrictions on trustee* (see §§18.82-18.83);
- *Death taxes* (see §§18.84-18.85);
- *Revocable trusts* (see §§18.89-18.90); and
- *Testamentary charitable remainder trusts* (see §§18.91-18.92).

Other clauses included in the IRS sample forms are those defining the taxable year of the trust (see §18.87) and a clause regarding the governing law (see §18.88).

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F. Specific Mandatory Clauses

§18.45 1. Payment to Recipient: Annuity Trusts and Unitrusts

The trust instrument must provide for payment to the recipient of a sum certain (the annuity or unitrust amount) not less frequently than annually. Treas Reg §1.664-1(a)(1). The statutory minimum percentage is five percent for all charitable remainder trusts, although the income-only unitrust need not currently distribute the fixed percentage if the trust income (determined for trust accounting purposes under applicable state law) is less than the stated percentage in the trust instrument. The maximum percentage is 50 percent and the chosen percentage must result in a minimum charitable benefit of 10 percent. IRC §664(d)(1)(D), (d)(2)(D). In the case of an annuity trust, the risk that the annuity will exhaust the trust cannot exceed 5 percent. Rev Rul 77-374, 1977-2 Cum Bull 329. See §§18.6A, 18.46.

Other than payments made for adequate consideration, no payments other than the annuity or unitrust amount may be made to or for the benefit of any recipient who is not a charitable organization described in IRC §170(c). Treas Reg §§1.664-2(a)(4), 1.664-3(a)(4). See §18.86.

The payment of the annuity or unitrust amount must be either for a term not to exceed 20 years or for the life or lives of the recipients. IRC §664(d)(1)(A), (d)(2)(A); Treas Reg §§1.664-2(a)(5), 1.664-3(a)(5). The trust cannot provide, *e.g.,* for a payout to *A* for life and then a payout to *B* for 20 years. The payment period must be for the life of the recipient and cannot be measured by the life of another individual.

The period of payment must begin with the creation of the trust. Treas Reg §§1.664-2(a)(5)(i), 1.664-3(a)(5)(i). In the case of a testamentary charitable remainder trust or a trust created as of the decedent's death (such as a typical revocable inter vivos trust), the payment of the annuity or unitrust amount may be deferred for a reasonable period of time. For a clause required in all such trusts, see Treas Reg §1.664-1(a)(5)(i) and Rev Rul 80-123, 1980-1 Cum Bull 205.

The annuity or unitrust amount may be paid within a reasonable time after the close of the year in which it is due if (a) the character of the annuity or unitrust amount in the recipient's hands is income under IRC §664(b)(1), (2), or (3), or (b) the trust distributes property (other than cash) that it owned as of the close of the taxable year to pay the annuity and the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due or the trust distributes cash that was contributed to the trust (or cash received as a return of basis in any asset contributed to the trust and sold by the trust during the year for which the annuity or unitrust amount was due) and a deduction was allowable with respect to the contribution under IRC §170, §2055, §2106, or §2522. Treas Reg §§1.664-2(a)(1)(i)(*a*), 1.664-3(a)(1)(i)(*g*).

A grandfather provision applicable to annuity trusts and fixed-percentage unitrusts created before December 10, 1998, permits payments within a reasonable time if the annuity or unitrust amount is 15 percent or less. Treas Reg §§1.664-2(a)(1)(i)(*b*), 1.664-3(a)(1)(i)(*h*). Generally, a "reasonable time" will not extend beyond the date (including extensions) by which the trustee is required to file Form 5227 (Split-Interest Trust Information Return) for the taxable year. Treas Reg §§1.664-2(a)(1)(i)(*c*), 1.664-3(a)(1)(i)(*k*).

The recipient or recipients of the annuity or unitrust amount must include "a named person or persons, at least one of which is not an organization described in IRC §170(c)." Treas Reg §§1.664-2(a)(3), 1.664-3(a)(3). The term "person" is broader than the term "individual" and could include organizations not described in IRC §170(c), *e.g.*, a corporation. The recipient is almost always an individual, however. Any individual recipient must be alive and ascertainable when the trust is created. IRC §664(d)(1)(A), (d)(2)(A). For permissible gifts to a class, see §§18.94-18.95.

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a. Annuity Trust

§18.46 (1) Payments

An annuity trust must require payment of a fixed annuity amount at least annually to one or more recipients. The annuity amount may be expressed either as (a) a percentage (not less than 5 percent or more than 50 percent) of the initial net fair market value of the assets placed in trust, or (b) a fixed dollar amount that must be at least 5 percent, but less than 50 percent, of the initial net fair market value of the assets placed in trust. IRC §664(d)(1)(A); Treas Reg §1.664-2(a)(2)(iii). The trust may not provide for the payment each year of the greater of a sum certain and a fixed percentage of the annual value of the trust assets. Treas Reg §1.664-1(a)(2). The chosen percentage must result in a minimum charitable benefit of 10 percent. IRC §664(d)(1)(D), (2)(D). See §18.6A.

There is an upper limit to the percent payable from an annuity trust based on the life or lives of individuals. The theory is that setting a payment at too high a level could cause the trust assets to be exhausted before the death of the recipient, resulting in no distribution to the charity, for which a deduction was allowed. Under Treas Reg §25.2522(a)-2(b), no deduction is allowed unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.

In Rev Rul 77-374, 1977-2 Cum Bull 329, the IRS took the position that if there is more than a 5-percent chance that the charitable remainder annuity trust would be exhausted before a recipient's death with no payment of any remainder to the charity, the trust will not qualify as a charitable remainder annuity trust. In *Estate of George H. Moor,* TC Memo 1982-299, the court held that the determination of whether the chance of the charity not taking is negligible was to be made after reviewing the facts of a particular situation rather than by the mechanical approach of Rev Rul 77-374. See also Rev Rul 85-23, 1985-1 Cum Bull 327.

If the annuity is to be payable for the lives of more than one recipient, the total (*i.e.,* combined) annuity amount payable each year must not be less than 5 percent of the initial net fair market value of the assets placed in trust. The total annuity amount may be expressed either as a fixed dollar amount or as a fractional percentage of the initial net fair market value of the trust assets. Treas Reg §1.664-2(a)(2)(i). If, on a recipient's death, the settlor desires to reduce the annuity amount payable to the surviving recipient, a distribution of trust principal to charity is required. Treas Reg §1.664-2(a)(2)(ii). See Rev Rul 72-395 §5.04, 1972-2 Cum Bull 340, 345, for an example of this type of payment clause.

NOTE: If the form does not specify whether payments are to be made at the beginning or end of each payment period, Treas Reg §1.664-4(a)(3) provides that if a unitrust instrument is silent, the payment will be considered payable, for purposes of computing the charitable deduction, on the first day of the period. Even though there is no corresponding regulation for annuity trusts, presumably the same rule applies.

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§18.47 (2) Valuation

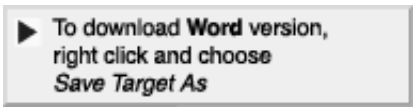
The trust assets are valued as of the date that the assets are placed in trust. Treas Reg §1.664-2(c). In an annuity trust, valuation must be based on the initial net value. "Value" is fair market value as determined in accordance with the nature of the asset. For example, publicly traded securities will be valued based on their trading price, while real estate will be based on the willing buyer-willing seller test or on one or more of the methods used by an appraiser to value real estate.

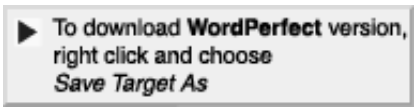
PRACTICE TIP: There is a danger in expressing the annuity amount as a stated dollar amount in a charitable remainder annuity trust that consists of the residue of an estate or a revocable trust, because the stated dollar amount might be less than 5 percent of the initial value of the trust assets. In Rev Rul 78-283, 1978-2 Cum Bull 243, the stated dollar amount was less than 5 percent of the residual estate, and the IRS allowed an estate tax deduction for only the minimum amount of property that would have resulted in funding the trust in an amount that would satisfy the 5-percent test. The same danger exists if the trust is funded with assets whose value could be subject to challenge (*e.g.,* real property) and whose value could be raised as a result of an estate or gift tax audit.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.48 (3) Form: Payment of Sum Certain (One Life)

§18.48 (3) Form: Payment of Sum Certain (One Life)





18.48-1 Payment of sum certain (one life)

[*Use one of the following alternatives*]

[*Alternative 1: Fixed dollar amount*]

***Payment of Annuity Amount*. The trustee shall pay to** _ _[*name of recipient*]_ _ **in each taxable year of the trust, in** _ _[*an annual/equal* _ _[*semiannual/quarterly/monthly*]_ _]_ _ **payment(s) during** _ _[*his/her*]_ _ **lifetime, an annuity amount of** _ _[*specify amount that is not less than 5 percent of initial net market value of trust assets*]_ _**.**

[*Alternative 2: Fractional percentage*]

***Payment of Annuity Amount*. The trustee shall pay to** _ _[*name of recipient*]_ _ **in each taxable year of the trust, in** _ _[*an annual/equal* _ _[*semiannual/quarterly/monthly*]_ _]_ _ **payment(s) during** _ _[*his/her*]_ _ **lifetime, an annuity amount equal to** _ _[*specify percentage that is not less than 5 percent*]_ _ **percent of the initial net fair market value of the trust assets.**

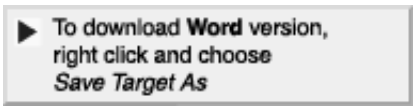
Comment: See Rev Rul 72-395 §§4.01, 5.01, 1972-2 Cum Bull 340. Alternative 2 is preferable because it eliminates the risk that the specified payment will be less than the required 5 percent by reason of an asset valuation adjustment in audit or insufficient assets left at the recipient's death.

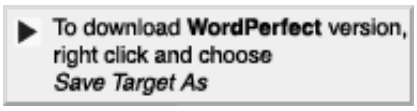
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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/ (4) Joint and Survivor Recipients/§18.49 (a) Form: Introduction

(4) Joint and Survivor Recipients

§18.49 (a) Form: Introduction





18.49-1 Introduction

***Payment of Annuity Amount*. The trustee shall pay the following annuity in each taxable year of the trust, in** _ _[*an annual/equal* _ _[*semiannual/quarterly/monthly*]_ _]_ _ **payment(s), to the following persons:**

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.50 (b) Form: Payment During Joint Lifetimes

§18.50 (b) Form: Payment During Joint Lifetimes

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18.50-1 Payment during joint lifetimes

[*Use one of the following alternatives*]

[*Alternative 1: Fixed dollar amount*]

(1) During the joint lifetimes of _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _**, to** _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _ **in equal shares an annuity amount of** _ _[*specify amount that is not less than 5 percent of initial net fair market value of trust assets*]_ _**.**

[*Alternative 2: Fractional percentage*]

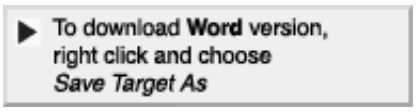
(1) During the joint lifetimes of _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _**, to** _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _ **in equal shares an annuity amount equal to** _ _[*specify percentage that is not less than 5 percent*]_ _ **percent of the initial net fair market value of the trust assets.**

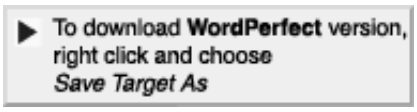
Comment: See Comment to §18.48.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.51 (c) Form: Payment After First Death

§18.51 (c) Form: Payment After First Death





18.51-1 Payment after first death

[*Use one of the following alternatives*]

[*Alternative 1: Fixed dollar amount*]

(2) After the death of the first to die of _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _**, the trustee shall pay to the survivor of** _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _ **an annuity amount of** _ _[*specify amount that is not less than 5 percent of initial net fair market value of trust assets*]_ _**.**

[*Alternative 2: Fractional percentage*]

(2) After the death of the first to die of _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _**, the trustee shall pay to the survivor of** _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _ **an annuity amount equal to** _ _[*specify percentage that is not less than 5 percent*]_ _ **percent of the initial net fair market value of the trust assets.**

Comment: See Comment to §18.48.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.52 (5) Form: Time of Payment; From Income, Then Principal

§18.52 (5) Form: Time of Payment; From Income, Then Principal

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18.52-1 Payment from income, then principal

***Time of Payment*. The annuity amount shall be paid at the _ _[*beginning/end*]_ _ of each payment period from income and, to the extent that that income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal.**

Comment: This clause should be used in all annuity trusts, whether based on one life or joint and survivor recipients.

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b. Unitrust

§18.53 (1) Payment of Fixed Percentage

A unitrust must pay to the recipient or recipients, at least annually, a fixed percentage of the net fair market value of all assets of the trust, valued annually. Treas Reg §1.664-3(a)(1)(i)(a), (a)(1)(ii). On valuation, see §18.60. See also §§6.30-6.35. The fixed percentage must be at least 5 percent and not more than 50 percent. The trust instrument may not provide for payment of the greater of a fixed amount and a fixed percentage of the annual value of the trust assets (*i.e.*, a combination annuity trust and unitrust), because this arrangement is not a fixed percentage of the annual value of the trust assets. Treas Reg §1.664-1(a)(2). The selected percentage must result in a minimum charitable benefit of not less than 10 percent. IRC §664(d)(2)(A).

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

On reducing the unitrust amount on the death of a settlor who has exercised the power to revoke the surviving settlor's interest in the deceased settlor's property (see §§18.96-18.97), see Treas Reg §1.664-3(a)(2)(ii) and Rev Rul 72-395 §7.04, 1972-2 Cum Bull 340, 351 (reduction of unitrust amount if part of principal is paid to charity on first recipient's death). For discussion and forms concerning partial distributions to be made because an interest is revoked, see §§18.98-18.99.

NOTE: The unitrust is not subject to the probability test in Rev Rul 77-374, 1977-2 Cum Bull 329 (see §18.46), because the annual payment amount is based on a percentage or fraction of the value of the trust assets and, technically, the trust could never be entirely exhausted before its termination.

If the unitrust instrument does not specify whether payments are to be made at the beginning or end of each payment period, the payment will be considered payable, for purposes of computing the charitable deduction, on the first day of the period. Treas Reg §1.664-4(a)(3). Even though there is no corresponding regulation for annuity trusts, presumably the same rule applies.

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§18.54 (2) Joint Recipients

A percentage is considered to be fixed if it is fixed for each recipient or if the total percentage payable in each taxable year of the payment period is constant for all recipients.

EXAMPLE 1: A fixed percentage of at least 5 percent to *A* and *B* for their joint lives and then to the survivor satisfies this rule. In addition, a percentage that is the same every year for *A* until his or her death and concurrently a percentage that is the same every year for *B* until his or her death, with the fixed percentage to each recipient terminating at his or her death, satisfies this rule if the total percentage payable to *A* and *B* is 5 percent or more. Treas Reg §1.664-3(a)(1)(ii). Because on the death of either *A* or *B,* the amount payable to the survivor for the remainder of his or her lifetime is reduced, a portion of the unitrust must be distributed to charity on the death of either *A* or *B*. See Treas Reg §1.664-3(a)(2)(ii). See also Rev Rul 80-104, 1980-1 Cum Bull 136; Rev Rul 76-291, 1976-2 Cum Bull 284; Rev Rul 74-19, 1974-1 Cum Bull 155, for examples of payout clauses that do not qualify as fixed percentages within the meaning of IRC §664.

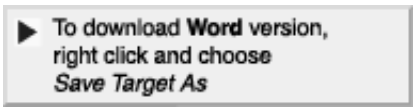
The aggregate of the percentages payable to both recipients must be at least 5 percent.

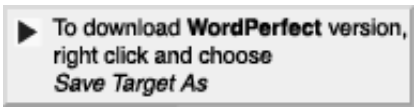
EXAMPLE 2: The trust may provide that a unitrust amount of 2 percent of trust assets be payable to *A* during his or her lifetime and 3 percent of trust assets be payable to *B* during his or her lifetime. On the death of either *A* or *B,* 5 percent of the annual value of the trust assets must be payable to the survivor during his or her lifetime unless the payment to the survivor is reduced according to Treas Reg §1.664-3(a)(1)(ii), (2)(ii). The regulation requires that (a) the reduced amount be the same for each recipient or for the total amount payable for each year, (b) a distribution be made to a charity on the death of the first recipient to die, and (c) the percentage of reduced assets payable to the survivor be at least 5 percent.

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§18.55 (3) Form: Payment of Fixed Percentage (One Life)





***Payment of Unitrust Amount*. The trustee shall pay to _ _**[*name of recipient*]**_ _ in each taxable year of the trust, in _ _**[*an annual/equal _ _*[*semiannual/quarterly/monthly*]**_ _]_ _ payment(s) during _ _**[*his/her*]**_ _ lifetime, a unitrust amount equal to _ _**[*specify percentage that is not less than 5 percent or more than 50 percent*]**_ _ percent of the fair market value of the trust assets valued on the _ _**[*e.g., first/last*]**_ _ day of each taxable year of the trust.**

Comment: The payment period must be either the recipient's lifetime or a term of not more than 20 years, and must not result in the charitable benefit being less than 10 percent of the value of the transferred assets. IRC §664(d)(2)(A), (D).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.56 (4) Form: Joint and Survivor Recipients

§18.56 (4) Form: Joint and Survivor Recipients

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***Payment of Unitrust Amount*. The trustee shall pay the following unitrust amount(s) in each taxable year of the trust, in** _ _[*an annual/equal* _ _[*semiannual/quarterly/monthly*]_ _]_ _ **payment(s), to the following persons:**

(1) During the joint lifetimes of _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _ **to** _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _ **in equal shares a unitrust amount of** _ _[*specify percentage that is not less than 5 percent or more than 50 percent*]_ _ **percent of the fair market value of the trust assets valued on the** _ _[*e.g., first/last*]_ _ **day(s) of each taxable year of the trust.**

(2) After the death of the first to die of _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _**, to the survivor of** _ _[*name of recipient*]_ _ **and** _ _[*name of recipient*]_ _ **the entire unitrust amount.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.57 (5) Form: Time of Payment; From Income, Then Principal

§18.57 (5) Form: Time of Payment; From Income, Then Principal

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***Time of Payment*. The unitrust amount shall be paid at the _ _[*beginning/end*]_ _ of each payment period from income and, to the extent that income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal.**

Comment: This clause should be used in all unitrusts (except income-only unitrusts, including NIMCRUTs), whether the unitrust is based on one-life or joint and survivor recipients.

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c. Income-Only Unitrust

§18.58 (1) Requirements

Instead of a fixed percentage of the net fair market value of the trust's assets, valued annually, the trust instrument may provide for payment to the recipient of the lesser of (a) the trust income (as defined in IRC §643(b)) for the trust's taxable year and (b) the fixed percentage for the trust's taxable year. For a clause that disqualified an otherwise qualifying charitable remainder unitrust by providing that the trust principal be divided into two shares and administered separately, thus making it possible for less than the aggregate income to be paid to the two recipients, see Rev Rul 76-310, 1976-2 Cum Bull 197.

In addition, the trust instrument *may* provide that the recipients *shall* also receive the trust income for the trust's taxable year in excess of the unitrust amount payable for that year, to the extent that total payments to the recipients for past years were less than the total fixed percentage amounts for past years. Such a provision is often called a deficiency or deficit makeup clause. The instrument need not require that the deficiencies between the unitrust amount and the actual income of the trust in any given year be made up in later years; the makeup clause is optional. Once it is included, however, the trustee is obligated to make the deficiency payments in all years. See Treas Reg §1.664-3(a)(1)(i)(*b*).

NOTE: The unitrust interest in an income-only unitrust is valued at zero if there is a noncharitable beneficiary other than the grantor and the grantor's spouse, unless there are only two noncharitable beneficial interests and the grantor holds the second of the two interests. Treas Reg §25.2702-1(c)(3).

The drafter of an income-only unitrust will need to consider the current IRS position on altering the definition of "income" under the terms of the trust from the provisions of the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). Treasury Regulation §1.664-3(a)(1)(i)(b) provides that "income" is defined in IRC §643(b) and the regulations under that section, which state that income in this context will be determined under the terms of the governing trust instrument and applicable local law. If applicable state law provides that income is a unitrust amount, however, the trust instrument must contain its own definition of trust income. Treas Reg §1.664-3(a)(1)(i)(*b*)(*3*).

For purposes of determining the unitrust amount payable to the recipient, the IRS has agreed to the redefinition of "income" to include gain realized by the trustee on the sale of trust assets but only to the extent of postcontribution gain. Treas Reg §1.664-3(a)(1)(i)(*b*)(*3*).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.59 (2) Form: Income-Only Unitrust

§18.59 (2) Form: Income-Only Unitrust

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***Payment of Unitrust Amount*. The trustee shall pay to _ _**[*name of recipient*]**_ _ in each taxable year of the trust, in _ _**[*an annual/equal _ _*[*semiannual/quarterly/monthly*]**_ _]**_ _ payment(s) during _ _**[*his/her*]**_ _ lifetime, an amount equal to the lesser of (1) the trust income (as defined in Internal Revenue Code §643(b)) for that taxable year and (2) _ _**[*specify percentage that is not less than 5 percent and not more than 50 percent*]**_ _ percent of the net fair market value of the trust assets valued on the _ _**[*e.g., first/last*]**_ _ day of each taxable year of the trust.**

[*If appropriate, add the following option*]

If the trust income of any taxable year exceeds the amount determined under (2), payment to _ _[*name of recipient*]**_ _ shall also include the excess income to the extent that the aggregate of the amounts paid to _ _**[*him/her*]**_ _ in past years is less than _ _**[*specify same percentage as above*]**_ _ percent of the aggregate net fair market values of the trust for those years.**

Comment: See §§18.96-18.97 for optional power to revoke a recipient's interest and the required clause in §18.99A if partial distribution is made because that interest is revoked.

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2. Valuation of Unitrust if Other Than First Day of Trust's Taxable Year

§18.60 a. Requirements

A unitrust's assets may be valued either on any one day of the taxable year or by using the average of valuations made on more than one day during the year. The method employed must be used consistently in each taxable year. If the trust instrument does not specify the valuation date or dates, the trustee selects the date or dates on the first fiduciary income tax return (Form 5227) filed by the trust. Treas Reg §1.664-3(a)(1)(iv). For valuation of additional contributions to unitrusts, see §§18.76-18.78.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

Administratively, valuation on the first day of the trust's taxable year is preferable because the trustee will know at once the unitrust amount for the year. Also, valuation on the first day and payment on the last day of a taxable year will maximize the value of the charitable remainder and, thus, the charitable contributions deduction. However, the deduction is maximized at the expense of a delay in the recipient's enjoyment of the unitrust amount.

NOTE: For charitable remainder unitrusts only, the trust must also provide that when no valuation date occurs in a short taxable year of the trust or in a taxable year in which the recipient's interest terminates (*i.e.,* the death of the recipient or expiration of a term of years), the trust assets are valued on the last day of the short taxable year or on the day on which the recipient's interest terminates. Treas Reg §1.664-3(a)(1)(v)*(a)(3)*, *(b)(1)(iii)*.

If a valuation date other than the first day of the taxable year is selected (*e.g.,* on the first business day of the taxable year), the trust must include certain clauses relating to valuation of additional contributions in short taxable years. Rev Rul 82-165, 1982-2 Cum Bull 117. See §§18.76-18.78.

Election of the income-only unitrust does not affect the value of the remainder interest or the charitable deduction. The deduction is based on the present value of the remainder interest as computed under Treas Reg §1.664-4, even though the charity ultimately may receive a greater amount of property because the income of the trust never exceeded the unitrust amount or no makeup clause was included.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.61 b. Form: Unitrust Mandatory Clause (Valuation Date Does Not Occur on First Day of Each Taxable Year)

§18.61 b. Form: Unitrust Mandatory Clause (Valuation Date Does Not Occur on First Day of Each Taxable Year)

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***Valuation Date*. If no valuation date selected by the trustee occurs in a taxable year of the trust that is a short taxable year or that is the taxable year in which the noncharitable interests terminate, the trust assets shall be valued as of the earlier of the last day of that short taxable year or as of the day on which such noncharitable interests terminate.**

Comment: This clause is a slightly modified version of the form required by Rev Rul 72-395 §6.05, 1972-2 Cum Bull 340, 348, modified by Rev Rul 82-165, 1982-2 Cum Bull 117. It is not required unless the trust provides for valuation on other than the first day of the trust's taxable year.

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3. Proration of Annuity or Unitrust Amount

§18.62 a. Requirements

The trust instrument must provide for proration of the annuity or unitrust amount for a taxable year of the trust that is less than 12 months and for the year in which all recipients' interest terminate. Treas Reg §§1.664-2(a)(1)(iv), 1.664-3(a)(1)(v). Failure to provide for proration will disqualify the trust as a charitable remainder trust. Treas Reg §§1.664-2(a)(1)(iv), 1.664-3(a)(1)(v); Rev Rul 79-428, 1979-2 Cum Bull 253.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

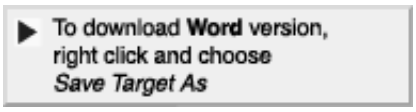
The proration is made on a daily basis, using a 365-day year unless the year is a leap year, when a 366-day year is used. Treas Reg §§1.664-2(a)(1)(iv), 1.664-3(a)(1)(v). In short taxable years, the annuity amount paid will be the sum certain multiplied by a fraction, the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (or 366 if February 29 is a day included in the numerator). Treas Reg §1.664-2(a)(1)(iv)(a). In the year of termination of the trust, the annuity amount is the sum certain multiplied by a fraction, the numerator of which is the number of days between the beginning of that taxable year and the termination of the noncharitable interest and the denominator of which is 365 (or 366 if February 29 is a day included in the numerator). Treas Reg §1.664-2(a)(1)(iv)(b).

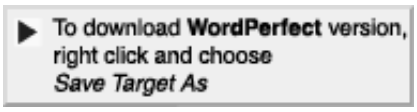
NOTE: Instead of prorating the annuity or unitrust amount in the year in which a recipient's interest terminates, the instrument may provide that, in that year, payment of the annuity or unitrust amount terminates with the regular payment immediately preceding termination of all recipients' interests. Treas Reg §§1.664-2(a)(5)(i), 1.664-3(a)(5)(i). Revenue Ruling 74-386, 1974-2 Cum Bull 189, states that a charitable remainder trust providing for termination of successive recipients' life interests with the payment next preceding each recipient's date of death complies with this rule. For sample, see §18.67.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.63 b. Form: Proration of Annuity or Unitrust Amount

§18.63 b. Form: Proration of Annuity or Unitrust Amount





[*Use one of the following alternatives*]

[*Alternative 1a: Proration of annuity amount for short taxable year and for year recipient's interest terminates (one life)*]

***Proration of Annuity Amount*. In determining the annuity amount, the trustee shall prorate the same on a daily basis for a short taxable year of the trust and for the taxable year of the trust in which the interest of _ _[*name of recipient*]_ _ terminates.**

[*Alternative 1b: Proration of annuity amount for short taxable year and for year recipient's interest terminates (joint and survivor recipients)*]

***Proration of Annuity Amount*. In determining the annuity amount, the trustee shall prorate the same on a daily basis for a short taxable year of the trust and for the taxable year of the trust in which the interest of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ terminates.**

[*Alternative 2a: Proration of unitrust amount for short taxable year and for year recipient's interest terminates (one life)*]

***Proration of Unitrust Amount*. In determining the unitrust amount, the trustee shall prorate the same on a daily basis for a short taxable year of the trust and for the taxable year of the trust in which the interest of _ _[*name of recipient*]_ _ terminates.**

[*Alternative 2b: Proration of unitrust amount for short taxable year and for year recipient's interest terminates (joint and survivor recipients)*]

***Proration of Unitrust Amount*. In determining the unitrust amount, the trustee shall prorate the same on a daily basis for a short taxable year of the trust and for the taxable year of the trust in which the interest of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ terminates.**

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4. Distribution to Charitable Remainder Beneficiaries

a. Requirements

§18.64 (1) On Termination of Noncharitable Interest

The trust instrument must provide that, on termination of all interests other than those held by the charitable organizations, the entire principal of the trust will be irrevocably transferred to or for the use of one or more charitable organizations described in IRC §170(c) or retained in trust for the exclusive use of such organization or organizations. IRC §664(d)(1)(C), (d)(2)(C); Treas Reg §§1.664-2(a)(6)(i), 1.664-3(a)(6)(i). The IRS will not ordinarily issue rulings or determination letters on whether termination of the trust before the end of the trust term in a transaction in which the beneficiaries receive their actuarial shares of the value of the trust assets causes the trust to have ceased to qualify. See Rev Proc 2010-3, §4.01(39), 2010-1 Int Rev Bull 110. A partial payment of principal to an individual on termination of the trust will disqualify it. See *Eager v U.S.* (CD Cal 1978) 79-1 USTC ¶13,289, 43 AFTR2d 1287 (80 percent of principal to charity and 20 percent to an individual).

On termination of the noncharitable recipients' interests, all the principal of the trust must be disposed of in one or more of the following ways:

- By distribution outright to one or more charitable organizations;
- By retention in trust exclusively for the benefit of one or more named charitable organizations;
- Partly by each of the methods described above; or
- By retention in trust for charitable purposes (*i.e.*, by the trust acting as disbursing agent to the ultimate donees).

If the trust provides for retention of any amounts in trust, the gift will be treated as a gift "for the use of" charity and not as a gift "to" charity. For the consequences of such a gift, see IRC §170(b); California Estate Planning, chap 23 (Cal CEB 2002). Additionally, IRC §§4940-4945 will apply.

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§18.65 (2) Alternative Charitable Organizations

The trust instrument must provide that if a named remainder beneficiary is not a qualified charitable organization when any amount is to be transferred irrevocably to it or for its use, that amount must instead be transferred to or for the use of, or retained for the use of, one or more alternative charitable organizations that are IRC §170(c) organizations at that time. Treas Reg §§1.664-2(a)(6)(iv), 1.664-3(a)(6)(iv).

No specific method of selecting alternative charitable organizations is required by the regulations. The trust instrument may name a specific successor charitable organization to receive the property. However, even if several charitable organizations are named in the alternative, the trust instrument still must deal with the possibility that all named charitable organizations will not be qualified under IRC §§170(c), 2055(a), and 2522(a) when property is to be distributed to them. The most flexible method is to allow the trustees to select the alternative charitable organizations if necessary when the principal is to be transferred. The settlor may prefer, however, to include in the instrument a direction or suggestion that the alternative charity have similar purposes to the named charity.

NOTE: The settlor may retain the power to amend and revoke the charitable remainder beneficiary designation by adding or substituting other charitable remainder beneficiaries and changing the shares of any of one or more of the charitable remainder beneficiaries. If such a clause is included, it should require a specific written instrument referring to the clause in the charitable remainder trust authorizing the change. In Rev Rul 76-7, 1976-1 Cum Bull 179, and Rev Rul 76-8, 1976-1 Cum Bull 179, the IRS ruled that the power to designate qualified charitable remainder beneficiaries, reserved to the settlor of an inter vivos charitable remainder trust or granted to a beneficiary of a testamentary charitable remainder trust, does not disqualify a trust as a charitable remainder trust. In IRS Letter Ruling 200034019, the IRS ruled that a CRUT permitting the settlor to change charitable beneficiaries was qualified. Also, the trustee's power to add or substitute additional organizations described in IRC §170(b)(1)(A) during the settlor's lifetime does not disqualify a trust. Rev Rul 76-371, 1976-2 Cum Bull 306. See Rev Rul 77-385, 1977-2 Cum Bull 331. The settlor may also include a clause restricting the use of the gift to specific purposes. See §18.69.

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§18.66 b. Tax Considerations

If the settlor desires a tax deduction both for income taxes under IRC §170(c) and for estate and gift taxes under IRC §§2055(a) and 2522(a), the ability to designate other charitable remainder beneficiaries should be limited to the designation of organizations described in all three sections to avoid limiting the settlor's income tax deduction under IRC §170(c) at the time of the gift. Rev Rul 80-38, 1980-1 Cum Bull 56; Rev Rul 79-368, 1979-2 Cum Bull 109.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

If the settlors desire that, for income tax purposes, the maximum percentage limitation apply, the trust instrument should require that charitable remainder beneficiaries be limited to organizations described in IRC §§170(b)(1)(A) and 170(c). This is particularly true if someone has the ability to change the charitable remainder beneficiary. Arguably, the deduction for a contribution of stock to a trust that could have a non-operating private foundation as a charitable remainder beneficiary also might be limited to the adjusted basis of the stock unless market quotations for the stock are readily available on an established securities market. See IRC §170(e)(1)(B)(ii), (e)(5)(B); *John C. Todd* (2002) 118 TC 334.

When a charitable remainder trust instrument provided that the ultimate remainder beneficiaries had to be organizations described in IRC §170(c) only, the IRS ruled that the trust qualified for a gift tax charitable deduction because the possibility that the property would pass to an organization that qualified under IRC §170(c) but did not qualify under IRC §2522 was so remote as to be negligible. Rev Rul 76-307, 1976-2 Cum Bull 56. The ruling also stated that an estate tax charitable deduction would be allowed on the settlor's death if the remainder beneficiary qualified under IRC §2055 at the time of the settlor's death.

CAVEAT: Revenue Ruling 76-307 should not be relied on in drafting the remainder clauses because not all charitable organizations that qualify as such under IRC §170(c) (income tax) also qualify under IRC §§2055(a) (estate tax) and 2522(a) (gift tax). For example, gifts to certain cemetery associations described in IRC §170(c)(5) are not deductible for estate or gift tax purposes under IRC §2055(a) or §2522(a). Rev Rul 77-385, 1977-2 Cum Bull 331. Also, a gift to a foreign charity may be deductible for estate tax purposes under IRC §2055(a), but an income tax deduction is available under IRC §170(c) only for a contribution to a domestic organization.

PRACTICE TIP: To ensure the maximum charitable deduction to the extent of 50 percent of adjusted gross income (30 percent for a transfer of appreciated property), the drafter should also include a requirement that the organization be one described in IRC §170(b)(1)(A). Without this reference, the charitable deduction could be limited to 30 percent or 20 percent of adjusted gross income. With this reference, however, the charitable remainder beneficiary cannot be a private foundation.

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§18.67 c. Form: Charitable Remainder Beneficiaries and Alternative Remainder Beneficiaries

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[*Use one of the following alternatives*]

[*Alternative 1: Trustee chooses successor organization (one life)*]

***Distribution of Remainder*. On the death of _ _[*name of recipient*]_ _, the trustee shall distribute free of trust all the then income and principal of the trust estate, other than any amount due to _ _[*name of recipient*]_ _ to _ _[*name of charity*]_ _. If _ _[*name of charity*]_ _ is not an organization described in Internal Revenue Code §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) when any income or principal of the trust is to be distributed to it, the trustee shall distribute the income or principal to one or more organizations that are then so described, as the trustee, in the trustee's discretion, shall select.**

[*If appropriate, add one of the following options*]

[*Option 1: Annuity amount terminates with regular payment immediately preceding termination of all noncharitable interests*]

***Termination of Annuity Payment*. In the year in which the death of _ _[*name of recipient*]_ _ occurs, the trustee's obligation to pay the annuity amount shall terminate with the regular payment immediately preceding _ _[*his/her*]_ _ death.**

[*Option 2: Unitrust amount terminates with regular payment immediately preceding termination of all noncharitable interests*]

***Termination of Unitrust Payment*. In the year in which the death of _ _[*name of recipient*]_ _ occurs, the trustee's obligation to pay the unitrust amount shall terminate with the regular payment immediately preceding _ _[*his/her*]_ _ death.**

[*Alternative 2: Trustee chooses successor organization (joint and survivor)*]

[*Use subparagraph (1) if trust contains optional power to revoke*]

***Distribution of Remainder*. (1) On the death of the first to die of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ and if that person exercises the power granted in _ _[*insert paragraph number of power to revoke; see §18.96*]_ _, half of the remaining principal and accumulated income of the trust estate, other than any payment due to _ _[*name of deceased recipient*]_ _, shall be distributed as provided in paragraph (3).**

[*Continue*]

([2]) On the death of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _, the entire remaining principal and accumulated income of the trust estate, other than any payment due to that survivor, shall be distributed as provided in paragraph _ _[*(2)/(3)*]_ _.

([3]) Any portion of the trust estate directed to be disposed of under this paragraph shall be distributed to _ _[*name of charity*]_ _. If _ _[*name of charity*]_ _ is not an organization described in Internal Revenue Code §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) when any income or principal of the trust estate is to be distributed to it, the trustee shall distribute the income or principal to one or more organizations selected by the trustee, in the trustee's discretion, which are then so described.

[*If appropriate, add one of the following options*]

[*Option 1: Annuity amount terminates with regular payment immediately preceding termination of all noncharitable interests*]

***Termination of Annuity Payment*. In the year in which the death of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ occurs, the trustee's obligation to pay the annuity amount shall terminate with the**

regular payment immediately preceding _ _[*his/her*]_ _ death.

[*Option 2: Unitrust amount terminates with regular payment immediately preceding termination of all noncharitable interests*]

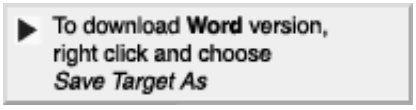
***Termination of Unitrust Payment*. In the year in which the death of _ _[*name of recipient*]_ _ occurs, the trustee's obligation to pay the unitrust amount shall terminate with the regular payment immediately preceding _ _[*his/her*]_ _ death.**

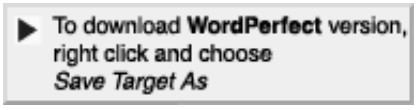
Comment: Alternatives 1 and 2 apply to both annuity trusts and unitrusts. Option 1 is used with an annuity trust and Option 2 is used with a unitrust. The references to IRC §§2055(a) and 2522(a) are necessary to ensure the estate and gift tax charitable deduction. See Treas Reg §20.2055-2(e)(2)(v). Subparagraphs (2) and (3) of Alternative 2 are designed for a husband and wife charitable remainder trust to which the spouses have contributed community property. If there are two settlors who are not husband and wife, or if they are husband and wife but there is a possibility of dissolution of the marriage, the power to revoke should be included, as provided in subparagraph (1) of Alternative 2, to avoid a completed gift at the time of creation of the trust. For discussion and form of power to revoke, see §§18.96-18.97.

CAVEAT: If a private foundation is or may be the remainder beneficiary at the time when any income or principal of the trust is to be distributed to it, the drafter should omit the reference to IRC §170(b)(1)(A).

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§18.68 d. Form: Power to Amend Charitable Remainder Beneficiary Designation





***Settlor's Power to Amend or Revoke Beneficiary Designation*. All charitable remainder beneficiary designations set forth in this instrument may be amended or revoked by the last-dated written instrument specifically referring to the power conferred in this paragraph, including a will (whether or not admitted to probate) and delivered by the settlor to the trustee, adding or substituting other charitable remainder beneficiaries and/or changing the shares of any one or more charitable remainder beneficiaries. If this amendment is made by the settlor's will, however, it shall only be effective if (1) notice of the amendment is received by the trustee within six months of the date of death of the settlor and (2) the settlor's will specifically refers to the power conferred in this paragraph.**

On the termination of the noncharitable interests, the trustee shall distribute any undesignated portion of the income and principal of the trust, other than any amount due to the noncharitable recipients, free of trust to the organization(s) appointed by the last-dated written instrument specifically referring to the power conferred in this paragraph, including a will (whether or not admitted to probate) and delivered by the settlor to the trustee. For this appointment to be effective, (1) notice of the appointment must be received by the trustee within six months of the date of death of the settlor and (2) the settlor's will must specifically refer to the power conferred in this paragraph.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.69 e. Form: Restricted Purpose

§18.69 e. Form: Restricted Purpose

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Restriction on Use of Funds. **_ _[*Name of charity*]_ _ shall use the funds distributed to it under the terms of this instrument for the following restricted purpose(s): _ _[*Specify*]_ _. If at any time in the judgment of the _ _[*name of person or officer of charity*]_ _ it is impossible or impracticable to carry out exactly the above purpose in the above manner, a purpose and manner as near as is practicable to the above purpose and manner shall be determined by the _ _[*name of person or officer of charity*]_ _.**

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5. Adjustment for Incorrect Valuation of Trust Assets

§18.70 a. Requirements

The trust must provide that if the annuity or unitrust amount paid to a recipient is incorrect because of incorrect valuation of trust assets, the recipient must pay to the trust or be repaid by the trust an amount that will correct the error. Treas Reg §§1.664-2(a)(1)(iii), 1.664-3(a)(1)(iii). Revenue Ruling 88-81, 1988-2 Cum Bull 127, modified by Rev Rul 92-57, 1992-2 Cum Bull 123, provides sample clauses that, if used, will eliminate the need to amend governing instruments to comply with future changes to the applicable interest rate specified in Treas Reg §1.664-1(a)(5)(iv). The trust assets should be valued according to federal estate and gift tax principles. See Rev Rul 74-403, 1974-2 Cum Bull 381.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

In all unitrusts and in annuity trusts in which the annuity amount is expressed as a percentage of the initial fair market value of the trust assets, the trust instrument must provide for adjustment of the annuity or unitrust amount paid to the recipient in case of incorrect valuation. The adjustment is made by payment by the trust to the recipient or by the recipient's repayment to the trust within a reasonable time after the final determination of value. See Treas Reg §§1.664-2(a)(1)(iii), 1.664-3(a)(1)(iii); Rev Rul 80-123, 1980-1 Cum Bull 205.

The regulations do not permit the administratively simpler approach of adjusting the next payment due to the recipient. This simpler approach carries the danger, if there has been an overpayment by the trustee and the time until the next regular payment is comparatively long, that the trustee could expose the trust to the penalties for self-dealing imposed by IRC §4941 on the theory that the overpayment left outstanding represents a loan to a disqualified person. For definition of disqualified person, see IRC §4946. It could also have made a taxable expenditure in IRC §4945.

An adjustment clause is not required in an inter vivos annuity trust in which the fixed amount is expressed as a fixed dollar amount rather than as a percentage of the initial value of the trust assets. If the annuity amount is expressed as a stated dollar amount and a good-faith undervaluation causes the annuity amount to be less than 5 percent of the initial fair market value of the trust assets, the 5-percent test is considered to be satisfied if the settlors or their representative accept, as the value of the property placed in trust to compute the charitable contributions deduction, an amount equal to 20 times the annual annuity amount. Treas Reg §1.664-2(a)(2)(iii). Although helpful, this clause does not make the settlors completely whole, because they will lose part of the charitable contributions deduction that a correct initial valuation would have produced. See Rev Rul 78-283, 1978-2 Cum Bull 243.

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§18.71 b. Form: Adjustment for Incorrect Valuation

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[*Use one of the following alternatives*]

[*Alternative 1: Adjustment for incorrect valuation in unitrust*]

***Adjustment for Incorrect Valuation*. If the net fair market value of the trust assets is incorrectly determined, then, within a reasonable period after the value is finally determined for federal tax purposes, the trustee shall pay to _ _[*name of recipient*]_ _ (in the case of an undervaluation) or receive from _ _[*name of recipient*]_ _ (in the case of an overvaluation) an amount equal to the difference between the unitrust amount properly payable and the unitrust amount actually paid.**

[*Alternative 2: Adjustment for incorrect valuation in annuity trust*]

***Adjustment for Incorrect Valuation*. If the initial net fair market value of the trust assets is incorrectly determined, then, within a reasonable period after the value is finally determined for federal tax purposes, the trustee shall pay to _ _[*name of recipient*]_ _ (in the case of an undervaluation) or receive from _ _[*name of recipient*]_ _ (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.**

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§18.72 6. Additions After Initial Contribution

An annuity trust must contain a clause prohibiting additional contributions from being made to the trust. Treas Reg §1.664-2(b). See §§18.73-18.75. A unitrust must contain either (a) a clause prohibiting additional contributions or (b) a formula for determining the payment to the recipient in the year in which additional contributions are made and a procedure for valuation of the additional contribution. Treas Reg §1.664-3(b)(1), (2). See §§18.76-18.78.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

All property passing to a charitable remainder annuity trust (Treas Reg §1.664-2(b)) or a unitrust (Treas Reg §1.664-3(b)) by reason of death of the grantor shall be considered one contribution.

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a. Annuity Trust

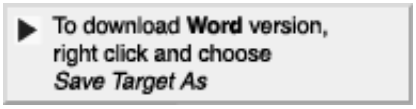
§18.73 (1) Requirements

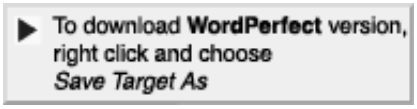
The annuity trust instrument must provide that no additional contributions may be made to the trust after the initial contribution. All property passing to an annuity trust as a result of a settlor's death is considered to be one contribution even though it passes to the trust through several distributions from the settlor's estate. Treas Reg §1.664-2(b). Inability to make additional contributions to an annuity trust is a distinct disadvantage of this trust as compared with a unitrust, which permits additional contributions.

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§18.74 (2) Form: Additional Contributions Prohibited



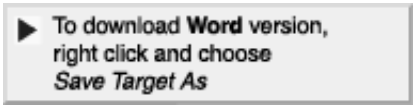


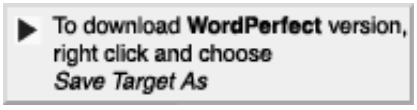
***Additional Contributions Prohibited*. No additional contributions shall be made to the trust after the initial contribution.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.75 (3) Form: Assets From Testamentary Trust Are One Contribution; No Additional Contributions Permitted

§18.75 (3) Form: Assets From Testamentary Trust Are One Contribution; No Additional Contributions Permitted





18.75-1 Assets from testamentary trust are one contribution; no additional contributions permitted

***Additional Contributions Prohibited*. The assets of this trust shall consist only of property passing to the trust by reason of _ _[*my/a settlor's*]_ _ death, and no additional contributions shall be made to the trust.**

Comment: A testamentary annuity trust should include this clause to make it clear that all property passing to the trust because of the testator's death is one contribution and that no additional contributions can be made to the trust. This clause may also be used in a revocable trust creating a charitable remainder trust at the settlor's death.

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b. Unitrust

§18.76 (1) Requirements

Additional contributions may be made to a unitrust. See §10.122 for a form authorizing additions to the trust. If additional contributions are permitted, however, the trust instrument must contain a formula for determining the unitrust amount to be paid to the recipient each year. The formula provides that, in the year of an additional contribution, the unitrust amount consists of the normal unitrust amount plus an amount equal to the unitrust percentage, multiplied by the value of the additional property, prorated on the basis of the number of days remaining in the trust's taxable year after the date of the additional contribution. See Rev Rul 74-481, 1974-2 Cum Bull 190, for examples of how to compute the amount payable to the noncharitable recipient of a unitrust when an addition to the trust is made in a short taxable year.

When the regular valuation date for the trust's taxable year during which the additional contribution is made occurs after the additional contribution is made, the value of the additional property is computed as of the regular valuation date. If the regular valuation date does not occur after the additional contribution is made, the additional property is valued as of the date of contribution. Treas Reg §1.664-3(b).

As an alternative to allowing additional contributions, the unitrust instrument may provide that no additional contributions shall be made to the unitrust after the initial contribution.

NOTE: The unitrust instrument must contain either a prohibition against additional contributions or the formula for valuing additional contributions. The form for a unitrust clause prohibiting additional contributions is the same as the form for this clause in an annuity trust. See form 18.75-1.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.77 (2) Form: Formula for Determining Unitrust Amount If Additional Contributions Permitted

§18.77 (2) Form: Formula for Determining Unitrust Amount If Additional Contributions Permitted

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18.77-1 Formula for determining unitrust amount if additional contributions permitted

***Determination of Unitrust Amount on Contributions*. If any additional contributions are made to the trust after the initial contribution, the unitrust amount for the taxable year in which the additional contributions are made shall be determined as follows:**

(1) If no valuation date occurs after the date of the contribution and during the taxable year in which the contribution is made, the additional contribution shall be valued at the time of the contribution; and

(2) The unitrust amount for such year shall be _ _[*specify applicable percentage*]_ _ of the sum of (a) the fair market value of trust assets (excluding the assets so added and any income from or appreciation on such assets) plus (b) that proportion of the value of the assets so added that was excluded under (a) that the number of days in the period that begins with the date of contribution and ends with the earlier of the last day of the taxable year of the trust or

[*Add one of the following alternatives*]

[*Alternative 1: Individual or joint and survivor annuity; power to revoke not included*]

the death of _ _[*name of recipient/the survivor of _ _[name of recipient*]_ _ *and _ _[name of recipient*]_ _]_ _ bears to the number of days in the period that begins on the first day of that taxable year and ends with the earlier of the last day in the taxable year or death of _ _[*name of recipient/the survivor of _ _[name of recipient*]_ _ *and _ _[name of recipient*]_ _]_ _.

[*Alternative 2: Joint and survivor annuity; power to revoke included*]

whichever of the following is then applicable: (i) the death of the survivor of _ _[*name or recipient*]_ _ and _ _[*name of recipient*]_ _; or (ii) if the power granted in _ _[*insert paragraph number of power to revoke*]_ _ is exercised, the death of the first to die of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _, bears to the number of days in the period that begins on the first day of the taxable year and ends with the earlier of the last day of the taxable year or whichever of the following then applies: (i) the death of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ or (ii) if the power granted in _ _[*insert number of power to revoke*]_ _ is exercised, the death of the first to die of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _.

Comment: It is suggested that the drafter permit additions to a unitrust and provide for computation of the unitrust amount in years when there are additional contributions. Either form 18.75-1 or this clause is required in every unitrust instrument.

Alternative 1 is usually the proper form to use for determining the unitrust amount. If the recipients of a joint and survivor unitrust retain the testamentary power to revoke each other's interest in the trust, Alternative 2 must be used.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.78 (3) Form: Additional Contributions at Death

§18.78 (3) Form: Additional Contributions at Death

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18.78-1 Additional contributions at death

***Payment Deferred on Contributions at Death*. If any additional contribution is made by will or other testamentary device that causes an additional contribution to be transferred at death, the obligation to pay the unitrust amount with respect to that additional contribution shall begin as of the date of the decedent's death, but payment of that unitrust amount may be deferred until the end of the taxable year in which the complete funding of the additional contribution occurs. Within a reasonable period after that, the trustee shall pay (in the case of an underpayment) or shall receive from the recipient (in the case of an overpayment) the difference between:**

(1) Any unitrust amounts actually paid, plus interest compounded annually, computed for any period at the rate of interest that the federal income tax regulations under Internal Revenue Code §664 prescribe for the trust for this computation for that period; and

(2) The unitrust amounts payable determined under the method described in Treasury Regulation §1.664-1(a)(5)(ii). The unitrust amounts payable shall be retroactively determined by using the trust's taxable year, valuation method, and valuation date and following the rules for retroactively determining the amounts payable specified in Treasury Regulation §1.664-1(a)(5)(i)-(ii).

Comment: This clause must be included, if additional contributions are allowed by will or other testamentary device, to conform to the mandatory forms provided in Rev Rul 88-81, 1988-2 Cum Bull 127, modified by Rev Rul 92-57, 1992-2 Cum Bull 123.

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7. Prohibited Transactions: Private Foundation Restrictions

§18.79 a. Rules

The complex private foundation rules specifically apply to all charitable remainder trusts. IRC §4947(a)(2). However, a complex trust for which no type of charitable deduction was allowed for contributions to the trust is not a split-interest trust and therefore is not treated as a private foundation even if the trust receives income tax deductions for distributions to charity. IRS Letter Ruling 200714025. Because the charitable remainder trust is treated as a private foundation in some respects (at least while noncharitable interests are present), the governing instrument of the charitable remainder trust must contain some of the prohibitions in IRC §508(e). Section 508(e) provides that the trustee of a private foundation may not distribute income in a way that would subject the foundation to a tax under IRC §4942 for failure to distribute income, engage in any act of self-dealing (as defined in IRC §4941(d)), retain any excess business holdings (as defined in IRC §4943(c)), make an investment that jeopardizes its charitable purpose (IRC §4944), or make any expenditures that would subject the trust to tax (IRC §4945).

Internal Revenue Code §4947(b)(3) provides that when a charitable deduction is allowed for all the remainder interest, IRC §§4943 (requiring disposition of excess business holdings) and 4944 (prohibiting jeopardizing investments) does not apply. Thus, for the typical charitable remainder trust that pays to an individual and does not retain the principal in trust for the benefit of a charity at the end of the trust term, only IRC §§4941 and 4945 apply. This permits the charitable remainder trust to retain closely held stock or other business interests.

Although not required, IRC §4942 should nevertheless ordinarily be included to cover the possibility of a delay in the distribution to the charity at the end of the trust term. Sections 4943-4944 are required in the event a charity is named as a recipient of a portion of the annuity or unitrust amount. These sections should also be included when, after the annuity trust or unitrust term terminates, this trust continues on as a wholly charitable trust, which is treated under the tax law as a private foundation.

Self-dealing under IRC §4941 is one of the most common problems and is often difficult to discern. For example, the settlor who contributes a home to a charitable remainder trust may not reside in the home, whether or not the settlor pays reasonable rent. Rent-free use of the home is payment other than an annuity or unitrust amount. See Rev Rul 77-58, 1977-1 Cum Bull 175.

If the settlor uses the asset (the residence) of the trust, the use will be an act of self-dealing under IRC §4941. If the settlor pays a fair market rental, the payment will be an act of self-dealing under IRC §4941, and the settlor and trustee will be subject to penalties and additional taxes. The appropriate way to make a contribution of a remainder in a personal residence or farm is to give a remainder interest not in trust, retaining a life or term of years tenancy (see IRC §170(f)(3)(B); see also §18.123) or by creating a qualified personal residence trust (see chap 17). For further discussion, see Silk & Lintott, *How to Ensure a Private Foundation Meets Compliance Requirements*, 27 Est Plan 369 (2000).

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§18.80 b. Exceptions

If state law satisfies the requirements of IRC §508(e), the various prohibitions applicable to private foundations need not be included in the trust instrument. Probate Code §16102 makes IRC §§4941, 4943, 4944, and 4945 applicable to a split-interest trust (not further defined in the section). However, Prob C §16103 exempts from application of IRC §§4943 and 4944 the trusts described in IRC §4947(b)(3). Thus, if the drafter fails to include the appropriate sections, Prob C §§16102-16103 make the appropriate clauses applicable.

PRACTICE TIP: A clause containing the private foundation prohibitions usually is not required in any trust instrument that is governed by California law. See Rev Rul 75-38, 1975-1 Cum Bull 161, indicating that California and most other states have adopted legislation satisfying the requirements of IRC §508(e). It is advisable, however, to include the prohibitions in the instrument to alert the trustee to the restrictions on his or her powers and to call these restrictions to the settlors' attention before they commit themselves irrevocably to a charitable remainder trust. See Rev Rul 74-368, 1974-2 Cum Bull 390.

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§18.81 c. Form: Annuity Trust or Unitrust Mandatory Clause (Private Foundation Prohibitions)

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18.81-1 Private foundation prohibitions

***Prohibited Transactions*. Except for the payment of the _ _**[*annuity/unitrust*]**_ _ amount to _ _**[*name(s) of recipient(s)*]**_ _, the trustee is prohibited from engaging in any act of self-dealing as defined in Internal Revenue Code §4941(d), from retaining any excess business holdings as defined in Internal Revenue Code §4943(c) that would subject the trust to tax under Internal Revenue Code §4943, from making any investments that would be subject to tax under Internal Revenue Code §4944, and from making any taxable expenditures as defined in Internal Revenue Code §4945(d). The trustee shall make distributions at such time and in such manner so as not to subject the trust to tax under Internal Revenue Code §4942.**

Comment: The last sentence of this clause should be included in any instrument when the trust is intended to stay in existence and operate as a private foundation after the recipient's interests have terminated. It is advisable to use the last sentence, whether or not the trust is intended to continue, because it is always possible that the trust will not terminate within what the IRS considers to be a reasonable time. See Treas Reg §§1.664-2(a)(6)(ii), 1.664-3(a)(6)(ii). Although it is not required for a trust governed by California law (see §§18.79-18.80), the author recommends the inclusion of the entire clause in every instrument.

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8. No Investment Restrictions on Trustee

§18.82 a. Requirements

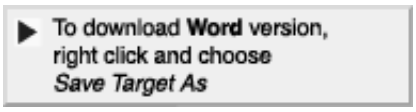
The trust instrument may not restrict the trustee from investing trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Treas Reg §1.664-1(a)(3).

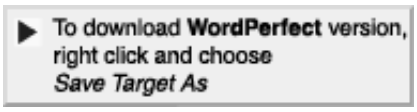
PRACTICE TIP: Because boilerplate trust powers and general clauses may be interpreted as restricting the trustee, form 18.83-1 should be included in every charitable remainder trust. Also, the trustee's powers and general clauses should be reviewed to ensure that they are consistent with this clause. For example, the trust instrument should not include a clause directing the trustee to retain non-income-producing assets. See §19.49.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.83 b. Form: Investment of Trust Assets

§18.83 b. Form: Investment of Trust Assets





18.83-1 Investment of trust assets

***No Investment Restriction on Trustee*. Nothing in this instrument shall be construed to restrict the trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.**

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9. No Payment of Gift, Estate, or Generation-Skipping Transfer Taxes From Trust

§18.84 a. Disqualification of Trust

Under Rev Rul 82-128, 1982-2 Cum Bull 71, an inter vivos charitable remainder trust will not be a qualified charitable remainder trust if any death taxes may be payable from the trust. If a settlor retains an interest in a charitable remainder trust, the trust will be included in his or her gross estate. If someone other than a settlor or a settlor's spouse has an interest in the trust after the settlor's death, the present value of that interest will be subject to estate tax at the time of the settlor's death.

Under Prob C §§20100-20125 and similar proration statutes of other states, the tax attributable to the secondary life recipient's interest is payable from the charitable remainder trust itself, and the trust therefore will not qualify initially as a charitable remainder trust. To overcome the apportionment of these taxes as provided in Prob C §20110, the revocable trust or will must require that the nonsettlor-recipient pay from other sources the tax attributable to his or her interest as a condition to receiving the interest. A possible alternative to such a clause is for the trust to obligate the settlor to provide for the payment of the tax attributable to that recipient's interest from other sources, such as the residue of the settlor's estate. The IRS may argue, however, that the settlor's estate may not have sufficient funds to pay the tax.

PRACTICE TIP: Revenue Ruling 82-128 does not discuss whether a clause such as that provided in the second paragraph of form 18.85-1 is by itself adequate to prevent the payment of death taxes from the charitable remainder trust. If the settlor's contractual promise is enforceable under state law, however, the author believes that such a clause should satisfy the requirements of Rev Rul 82-128 because the consideration is the trustee's promise to act as trustee. Although either of the paragraphs in form 18.85-1 may satisfy the requirements of Rev Rul 82-128, the author believes that either the first paragraph alone or both paragraphs of form 18.85-1 should be included in the instrument until the IRS approves a form such as the second paragraph of form 18.85-1.

NOTE: The creation of a charitable remainder trust will have generation-skipping transfer (GST) tax consequences only if one or more of the noncharitable recipients is a "skip" person. The charitable remainder beneficiary is deemed to be in the settlor's generation under IRC §2651(f)(3). Because the distributions from the trust to a skip person may be "taxable distributions" requiring payment of GST tax, the GST tax must be paid by the recipient rather than the trust, and the trust instrument should require this.

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§18.85 b. Form: No Taxes Payable From Trust

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18.85-1 No taxes payable from trust

[*Use one of the following alternatives*]

[*Alternative 1: One settlor*]

***Payment of Estate and Gift Taxes*. No gift, legacy, succession, inheritance, estate taxes, or generation-skipping transfer taxes that may be assessed against the property of the trust created by this instrument by reason of the settlor's transfer to the trust or the settlor's death shall be paid out of any property held in this trust. The settlor agrees on behalf of himself or herself, his or her heirs, legal representatives, successors and assigns to provide for payments of any such taxes from sources other than property held by this trust and to indemnify and hold harmless the trustee from any and all liability for such taxes. The settlor agrees that the trustee shall not be liable for any federal or state death taxes or generation-skipping transfer taxes payable. The settlor imposes an obligation on _ _[*his/her*]_ _ estate to pay all such taxes, and the settlor agrees to provide for the payment of all such taxes from sources other than the trust estate.**

The settlor has provided for the payment of any death taxes and generation-skipping transfer taxes from sources other than this trust. Nevertheless, if for any reason the charitable remainder _ _[*annuity trust/unitrust*]_ _ becomes liable for such taxes on the death of the settlor, the interest of _ _[*name of secondary recipient*]_ _ shall not take effect unless _ _[*name of secondary recipient*]_ _ agrees to pay and pays federal or state death and generation-skipping transfer taxes for which the trustee may be liable on the settlor's death. If _ _[*name of secondary recipient*]_ _ fails to agree to pay and to pay all such taxes, _ _[*name of secondary recipient*]_ _ shall be considered to have predeceased the settlor for all purposes of this instrument.

[*Alternative 2: Two settlors*]

No gift, legacy, succession, inheritance, estate taxes, or generation-skipping transfer taxes that may be assessed against the property of the trust created by this instrument by reason of a settlor's transfer to the trust or a settlor's death shall be paid out of any property held in this trust. Each settlor agrees on behalf of himself or herself, his or her heirs, legal representatives, successors and assigns, to provide for payments of any such taxes from sources other than property held by this trust and to indemnify and hold harmless the trustee from any and all liability for such taxes. Each settlor agrees that the trustee shall not be liable for any federal or state death taxes or generation-skipping transfer taxes payable. Each settlor imposes an obligation on his or her estate to pay all such taxes, and each settlor agrees to provide for the payment of all such taxes from sources other than the trust estate.

Each settlor has provided for the payment of any death taxes and generation-skipping transfer taxes resulting from his or her death from sources other than this trust. Nevertheless, of for any reason, the charitable remainder unitrust becomes liable for such taxes on the death of the first settlor to die, the interest of _ _[*name of secondary recipient*]_ _ shall not take effect unless _ _[*name of secondary recipient*]_ _ agrees to pay and pays federal or state death and generation-skipping transfer taxes for which the trustee may be liable on the death of the first the settlor to die. If _ _[*name of secondary recipient*]_ _ fails to agree to pay and to pay all such taxes, _ _[*name of secondary recipient*]_ _ shall be considered to have predeceased the first settlor to die for all purposes of the part of this trust attributable to the deceased settlor's contribution.

Comment: The second paragraph of each alternative is based on Situation (2) in Rev Rul 82-128, 1982-1 Cum Bull 71. For either alternative, the author suggests that both paragraphs be included in the instrument.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.86 10. Form: No Other Noncharitable Payments

§18.86 10. Form: No Other Noncharitable Payments

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18.86-1 No other noncharitable payments

***No Other Noncharitable Payments*. No amount other than the amount described in _ _**[*insert paragraph number*]**_ _ of this instrument or an amount transferred for full and adequate consideration may be paid to or for the use of any person other than an organization described in Internal Revenue Code §§170(b)(1)(A), 170(c), 2055(a), and 2522(a).**

Comment: This clause states the applicable rule found in Treas Reg §§1.664-2(a)(4) (charitable remainder annuity trust) and 1.664-3(a)(4) (charitable remainder unitrust) that no other noncharitable payments may be made unless for adequate consideration. If a non-operating private foundation is or may be the remainder person at the time when any income or principal of the trust is to be distributed to it, the drafter should omit the reference to IRC §170(b)(1)(A).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.87 11. Form: Taxable Year

§18.87 11. Form: Taxable Year

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18.87-1 Taxable year

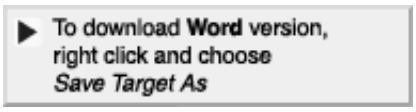
***Calendar Year*. The taxable year of the trust shall be the calendar year.**

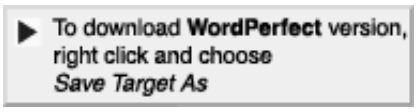
Comment: Whether or not this clause is included, IRC §644 requires that the trust report its information on a calendar-year basis. Therefore, this clause is not a mandatory governing clause that must be included in the trust instrument. The drafter should be aware that if the clause is included and the statutory clause is later deleted, the trustee will be bound by this clause if it is included in the trust.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.88 12. Form: Governing Law

§18.88 12. Form: Governing Law





18.88-1 Governing law

***Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state*]_ _. The trustee is prohibited, however, from exercising any power or discretion granted under those laws that would be inconsistent with the qualification of the trust under Internal Revenue Code §664 and the corresponding regulations.**

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13. Charitable Remainder Trusts Created at Death

a. Revocable Trusts

§18.89 (1) Requirements

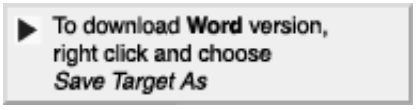
One requirement for a qualified charitable remainder trust is that the trust function as a charitable remainder trust from its inception. Treas Reg §1.664-1(a)(4). If the clients' primary estate planning document is a revocable trust rather than a will, and if a charitable remainder trust is created after one or both settlors' deaths, a mandatory clause is required in the trust instrument. The provisions in Rev Rul 72-395 §§5.09, 7.09, 1972-2 Cum Bull 340, 346, 352, require (a) the payment of all debts, administration expenses, and taxes before the complete funding of the charitable remainder trust and (b) that whatever assets are ultimately transferred to the charitable remainder trust be transferred to a separate trust that will not be liable for such expenditures. Revenue Ruling 72-395 §§5.09, 7.09 specifically provide that the same governing instrument may provide for both the revocable inter vivos trust and the charitable remainder trust and that both trusts may have the same trustee.

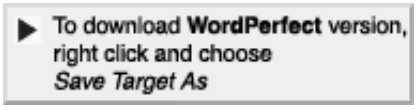
In addition to the requirements discussed above, a modified version of form 18.92-1 should be included in a charitable remainder trust created in a revocable trust to allow deferral of payments from the charitable remainder trust until the close of the trust administration period. This will fulfill the requirement that the charitable remainder trust function exclusively as a charitable remainder trust from the time of its creation. For a charitable remainder trust created in a revocable trust (unlike a testamentary charitable remainder trust), no official IRS form has been specifically designed to address this issue. See §§18.91-18.92.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.90 (2) Form: Charitable Remainder Trust Created in Revocable Trust

§18.90 (2) Form: Charitable Remainder Trust Created in Revocable Trust





18.90-1 Charitable remainder trust created in revocable trust

***Creation of Charitable Remainder Trust*. On the death of the _ _**[*settlor/surviving settlor*]**_ _, all trusts created under this instrument (other than the _ _**[*name of trust that will remain revocable*]**_ _) shall become irrevocable, and the trustee shall pay all debts, taxes, and other expenses of administration that shall be payable from the trust estate. After the payment or satisfaction of all such debts, taxes, and expenses, the trustee shall transfer _ _**[*e.g., all/a specified percentage/a specific dollar amount*]**_ _ of the income and principal of the trust to the trustee of the charitable remainder trust established in _ _**[*article or paragraph number*]**_ _, to be held, administered, and distributed in the manner and according to the terms and conditions provided in this instrument.**

Comment: This clause should be modified to take into account the particular plan that is being implemented by a revocable trust, but the drafter must adhere to the principle that none of the settlor's debts, taxes, or other expenses may be payable out of the charitable remainder trust after it is funded. Rev Rul 72-395 §§5.09, 7.09, 1972-2 Cum Bull 340, 346, 352.

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b. Testamentary Charitable Remainder Trusts

§18.91 (1) Requirements

In testamentary charitable remainder trusts, the trust must provide for the makeup of underpayments or overpayments to the noncharitable beneficiaries if the payment of the annuity or unitrust amount is deferred. Rev Rul 80-123, 1980-1 Cum Bull 205. Interest is required. Sample clauses are provided in Rev Proc 2005-56—2003-59, 2003-2 Cum Bull 383.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.92 (2) Form: Deferred Payments

§18.92 (2) Form: Deferred Payments

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18.92-1 Deferred payments

***Deferred Payments*. The obligation to pay the unitrust amount shall commence with the date of my death, but payment of the unitrust amount may be deferred from this date until the end of the taxable year of the trust in which the complete funding of the trust occurs. Within a reasonable time after the end of the taxable year in which the trust is completely funded, the trustee must pay to _ _[*name of recipient*]_ _ (in the case of an underpayment) or receive from _ _[*name of recipient*]_ _ (in the case of an overpayment) the difference between any unitrust amounts actually paid, plus interest, and the unitrust amounts payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under Internal Revenue Code §664 prescribe for this computation.**

Comment: The language in this clause is from Rev Proc 2005-56, 2005-2 Cum Bull 383.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.93 G. Optional Clauses

§18.93 G. Optional Clauses

The mandatory clauses required in all charitable remainder trusts are discussed in §§18.46-18.92. Optional versions of these clauses have also been included whenever the mandatory requirement may be modified as provided in the statutes, the regulations, or Rev Rul 72-395, 1972-2 Cum Bull 340, modified by Rev Rul 82-165, 1982-2 Cum Bull 117.

The statutes and regulations provide for several truly optional (additional) clauses, which are discussed in §§18.94-18.99A.

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1. Sprinkling Powers Among Members of a Class

§18.94 a. Requirements

A trust will not qualify as a charitable remainder trust if any person has the power to alter the amount to be paid to a recipient other than a charitable organization and if that power will cause any person to be treated as the owner of all or part of the trust under the grantor-trust rules of IRC §§671-678; Treas Reg §§1.664-2(a)(3)(ii), 1.664-3(a)(3)(ii). See Rev Rul 77-285, 1977-2 Cum Bull 213, which provides that a trust permitting the trustee to allocate distributions among beneficiaries does not qualify as a charitable remainder trust if the settlor has the power to remove the trustee and substitute any person, including himself or herself, as trustee.

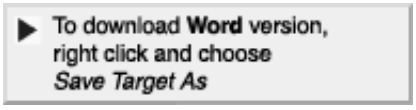
It is possible to grant to an independent trustee the power to allocate the annuity or unitrust amount among members of a class if this power comes within the exception in IRC §674(c), relating to certain powers held by independent trustees. In Rev Rul 77-73, 1977-1 Cum Bull 175, the IRS confirmed the fact that an independent trustee may have the power to sprinkle the annuity amount among several beneficiaries without adverse tax consequences. The same result also applies to sprinkling the unitrust amount.

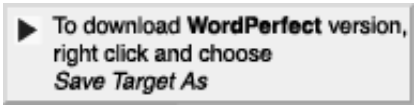
Members of the class must be living at the time of creation of the trust if the annuity or unitrust amount is payable for their lifetimes. The recipients of lifetime interests may be referred to as "children" or "issue" if the class is closed and all members of the class are living and ascertainable when the trust is created. If the charitable remainder trust is for a term of years (not to exceed 20 years), the members of the class need not be living or ascertainable at the creation of the trust. Treas Reg §§1.664-2(a)(3)(i), 1.664-3(a)(3)(i).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.95 b. Form: Allocation Among Class of Noncharitable Beneficiaries in Discretion of Trustee

§18.95 b. Form: Allocation Among Class of Noncharitable Beneficiaries in Discretion of Trustee





18.95-1 Allocation among class of noncharitable beneficiaries

***Allocation of Payments*. The trustee shall pay to member(s) of a class of persons living on the date of this instrument consisting of** _ _[*name of recipient*]_ _**,** _ _[*name of recipient*]_ _**, and** _ _[*name of recipient*]_ _ **in each taxable year of the trust, in** _ _[*annual/equal* _ _[*semiannual/quarterly/monthly*]_ _]_ _ **payment(s), in amounts and proportions as the trustee, in the trustee's discretion, from time to time determines until the termination of the noncharitable interests of the trust** _ _[*statement of annuity/unitrust amount (see §§18.45-18.59); e.g., an annuity amount of 6 percent of initial net market value of trust assets*]_ _**. The trustee may pay the** _ _[*annuity/unitrust*]_ _ **amount to one member of that class or may apportion it among the various members in any manner as the trustee, in the trustee's discretion, considers advisable.**

Comment: A named class may consist of "children" or "issue" as long as all are living and ascertainable at the creation of the trust. The power to allocate among the members of the class may not cause any person to be treated as owner of any part or all of the trust under IRC §§671-678.

The sprinkling power may be held without adverse tax consequences only by an independent trustee or a special trustee. See §§9.10-9.11, 10.25-10.26. For definition of "independent trustee," see §10.7. This clause may be used in place of the forms in §§18.48 and 18.55. See Rev Rul 77-73, 1973-1 Cum Bull 175, discussed in §18.94.

For how to state the annuity or unitrust amount, see §§18.45-18.59.

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2. Testamentary Power to Revoke Recipient's Interest

§18.96 a. Requirements

The settlor or settlors may retain the power exercisable only by will to revoke or terminate the interest of any recipient who is not a charitable organization. Treas Reg §§1.664-2(a)(4) (charitable remainder annuity trust), 1.664-3(a)(2)(ii) (charitable remainder unitrust), 1.664-3(a)(4) (charitable remainder unitrust); Rev Rul 72-395 §7.04, 1972-2 Cum Bull 340, 351 (reduction of unitrust amount if part of principal is paid to charity on first recipient's death). See also Rev Rul 74-149, 1974-1 Cum Bull 157. For definition of "charitable organization," see IRC §170(c).

It is not clear whether a settlor may revoke part of the recipient's interest or whether he or she must revoke all or nothing. If the settlor may revoke part of the interest, the regulations are silent concerning what happens to the trust assets if such a partial revocation occurs. In the author's opinion, when a partial revocation of a recipient's interest occurs, a partial distribution of principal to charity is required to maintain the required 5-percent minimum distribution.

The power must be exercisable only by will and not during the settlor's lifetime. Treas Reg §§1.664-2(a)(4), 1.664-3(a)(4); Rev Rul 74-149, 1974-1 Cum Bull 157; IRS Letter Ruling 8430006. Since the introduction of the unlimited marital deduction, a gift by one spouse to the other of an interest in a qualified charitable remainder trust qualifies for the unlimited marital deduction. IRC §2056(b)(8). Therefore, there is no taxable gift on the creation of a joint and survivor charitable remainder trust between a husband and wife. However, if persons other than husband and wife create a joint and survivor charitable remainder trust, the power to revoke must be included to avoid a taxable gift at the time of the creation of the trust.

PRACTICE TIP: It may be appropriate in any event to include the power to revoke in a trust between husband and wife in case the marriage is later dissolved.

The settlor's retention of a testamentary power to revoke may also avoid a taxable gift when the settlor contributes separate property to a charitable remainder trust, reserving for his or her lifetime an annuity or unitrust amount, with that amount to continue after his or her death for the lifetime of someone other than a spouse. Rev Rul 79-243, 1979-2 Cum Bull 343. The present value of the other recipient's interest on the date of contribution to the trust is a taxable gift of the settlor, absent the settlor's retention of the power. However, when the nonsettlor-recipient is to receive current payments from the trust (*i.e.*, a joint and survivor annuity trust funded with the separate property of one of the two current recipients), the settlor's retention of this power will not prevent a current gift. The current gift cannot be avoided by the settlor's retaining an inter vivos power to revoke the noncontributing recipient's interest, because such a power will disqualify the trust. Treas Reg §§1.664-2(a)(4), 1.664-3(a)(4).

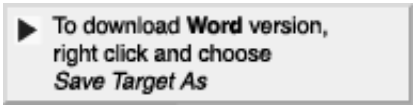
On the death of the first recipient exercising his or her power to revoke, a partial distribution of trust assets to the charitable organization will be required, unless another recipient has an interest that has not been revoked. Alternative 2 in §18.97 is coordinated with Alternative 2 in §18.67 to provide for the distribution.

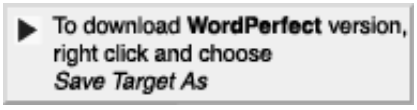
NOTE: If it is desired that the unitrust amount be reduced on the death of a settlor who has exercised the power to revoke the surviving settlor's interest in the deceased settlor's property, see sample form in Treas Reg §1.664-3(a)(2)(ii) and Rev Rul 72-395 §7.04, 1972-2 Cum Bull 340, 351 (reduction of unitrust amount if part of principal is paid to charity on first recipient's death).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.97 b. Form: Annuity Trust or Unitrust (Testamentary Power to Revoke)

§18.97 b. Form: Annuity Trust or Unitrust (Testamentary Power to Revoke)





[*Use one of the following alternatives*]

[*Alternative 1: One settlor*]

***Settlor's Power to Revoke*. The settlor expressly reserves the power, exercisable only by the settlor's will or a valid codicil to the will, to revoke and terminate the interest of _ _[*name of recipient*]_ _ under this trust. On the first to occur of (1) the death of the survivor of the settlor and _ _[*name of recipient*]_ _ and (2) the settlor's death if the settlor effectively exercises _ _[*his/her*]_ _ testamentary power to revoke under this paragraph, the trustee shall distribute all the then income and principal of the trust other than any amount due _ _[*name of recipient*]_ _ to _ _[*name of charity*]_ _.**

[*Alternative 2: Two settlors*]

***Settlor's Power to Revoke*. Each settlor expressly reserves the power, exercisable only by his or her will or a valid codicil to the will, to revoke and terminate the other settlor's interest under this trust in any property or the proceeds thereof transferred to this trust by the deceased settlor. On the first to occur of (1) the death of the first to die of _ _[*name of recipient*]_ _ or _ _[*name of recipient*]_ _ if the first to die effectively exercises his or her testamentary power under this paragraph and (2) the death of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _, the trustee shall distribute such portion of the trust estate as is provided in paragraph _ _[*number; see §18.67*]_ _ other than any amount due to either _ _[*name of recipient*]_ _ or _ _[*name of recipient*]_ _ to _ _[*name of charity*]_ _ as provided in paragraph _ _[*number*]_ _.**

Comment: If the trust continues for the life of a second recipient whose interest is not revoked, including the settlor's spouse, the second sentence of Alternative 1 should be modified to provide for the continuing interest. See Rev Rul 72-395 §§5.07, 7.07, 1972-2 Cum Bull 340, 346, 352.

If two settlors other than husband and wife are the recipients of a joint and survivor charitable remainder trust funded by them with property of both of them, this clause is necessary to prevent a taxable gift from one settlor to the other. Absent this clause, the gift will be from the settlor with the shorter life expectancy. See §18.21.

If the power to revoke is included in the trust instrument, Alternative 2 in §18.99 (CRAT) or §18.99A (CRUT) should also be included.

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3. Partial Distributions in Kind to Charitable Organizations

§18.98 a. Requirements

The trust instrument may provide that the trustee may pay any income of a charitable remainder trust in excess of the annuity or unitrust amount, as the case may be, to a charitable organization. If distributions in kind to charity may be made from the trust before the time that all the noncharitable interests terminate, the trust instrument must provide that the adjusted basis of the assets distributed to the charitable organization must be representative of the adjusted basis of all assets available for distribution. Treas Reg §§1.664-2(a)(4), 1.664-3(a)(4). Without this requirement, the trustee might distribute low-basis assets while retaining high-basis assets to reduce income realization on disposition. The safest approach is to distribute a proportionate part of each type of asset held in the trust. Alternative 1 in §18.99 (CRAT) or §18.99A (CRUT) should be used.

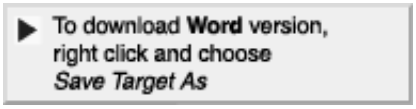
In addition to discretionary distributions to charity, distributions may be made from a joint and survivor charitable remainder trust if the first recipient to die has exercised a power to revoke the survivor's interest in the deceased recipient's property contributed to the trust.

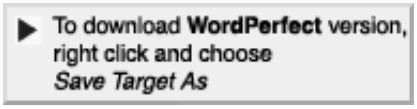
If discretionary distributions of trust assets to a charitable organization before termination of all noncharitable interests are not permitted, but it is anticipated that partial distributions of trust assets to charitable organizations will be made before the termination of all noncharitable interests, Alternative 2 in §18.99 (CRAT) or §18.99A (CRUT) must be included in the trust instrument. For example, if the first settlor-recipient of a joint and survivor charitable remainder trust has exercised his or her power to revoke the other recipient's interest in the assets contributed by the deceased settlor to the trust, a partial distribution to the charitable organization is required. See §§18.96-18.97.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.99 b. Form: Annuity Trust (Partial Distributions to Charitable Organization)

§18.99 b. Form: Annuity Trust (Partial Distributions to Charitable Organization)





[*Use one of the following alternatives*]

[*Alternative 1: Discretionary distributions before termination of all noncharitable interests permitted*]

***Discretionary Distributions*. During the lifetime of _ _**[*name of recipient*]**_ _, the trustee may pay to _ _**[*name of charitable organization*]**_ _ any income of the trust in excess of the annuity trust amount payable to _ _**[*name of recipient*]**_ _ for the taxable year of the trust in which the income is earned. The adjusted basis for federal income tax purposes of any trust property the trustee distributes in kind to _ _**[*name of charitable organization*]**_ _ during the lifetime of _ _**[*name of recipient*]**_ _ shall be fairly representative of the adjusted basis of all trust property available for distribution on the date of distribution.**

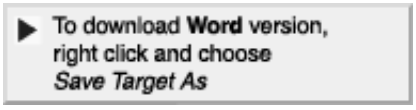
[*Alternative 2: Discretionary distributions before termination of all noncharitable interests not permitted but partial distributions are anticipated*]

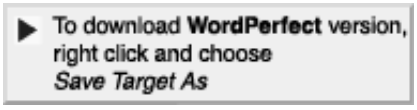
***Partial Distributions in Kind*. The adjusted basis for federal income tax purposes of any trust assets distributed in kind shall be fairly representative of the adjusted basis of all trust assets available for distribution on the date of distribution.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.99A c. Form: Unitrust (Partial Distributions to Charitable Organization)

§18.99A c. Form: Unitrust (Partial Distributions to Charitable Organization)





[*Use one of the following alternatives*]

[*Alternative 1: Discretionary distributions permitted before termination of all noncharitable interests permitted*]

***Discretionary Distributions*. During the lifetime of _ _**[*name of recipient*]**_ _, the trustee may pay to _ _**[*name of charitable organization*]**_ _ any income of the trust in excess of the unitrust amount payable to _ _**[*name of recipient*]**_ _ for the taxable year of the trust in which the income is earned. The adjusted basis for federal income tax purposes of any trust property the trustee distributes in kind to _ _**[*name of charitable organization*]**_ _ during the lifetime of _ _**[*name of recipient*]**_ _ shall be fairly representative of the adjusted basis of all trust property available for distribution on the date of distribution. After any distribution under this paragraph, payment of the amount referred to in paragraph _ _**[*number*]**_ _ of this instrument shall be calculated based on the remaining net fair market value of the trust assets as of the next succeeding valuation date.**

[*Alternative 2: Discretionary distributions before termination of all noncharitable interests not permitted but partial distributions are anticipated*]

***Partial Distributions in Kind*. The adjusted basis for federal income tax purposes of any trust assets distributed in kind shall be fairly representative of the adjusted basis of all trust assets available for distribution on the date of distribution. After any distribution under this paragraph, payment of the amount referred to in paragraph _ _**[*number*]**_ _ of this instrument shall be calculated based on the remaining net fair market value of the trust assets as of the next succeeding valuation date.**

Comment: If the trust instrument permits discretionary distributions of trust assets to a charitable organization before termination of all noncharitable interests, the second sentence of Alternative 1 in §18.99 (CRAT) and §18.99A (CRUT) is mandatory unless the governing instrument prohibits the trustee from satisfying the distributions in kind. Treas Reg §§1.664-2(a)(4), 1.664-3(a)(4).

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§18.100 H. No-Contest Clause

The IRS's informal position has been that inclusion of a no-contest clause in a charitable remainder trust will disqualify the trust. See, *e.g.,* IRS Letter Ruling 7942073. The rationale behind these rulings is that the existence of such a clause raises the possibility that the recipient's interest will terminate other than at his or her death or the expiration of the term of years. In the author's opinion, the IRS's position is incorrect. The addition of IRC §664(f) should make the issue moot because that section allows the recipient's interest to terminate on the happening of a contingency. To be safe, however, the author recommends omitting a no-contest clause from all inter vivos and testamentary charitable remainder trusts or making such a clause inapplicable to the charitable remainder beneficiary.

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§18.101 VI. REFORMATION OF CHARITABLE REMAINDER TRUSTS

Under IRC §§170(f)(7), 664(f), 2055(e)(3), and 2522(c), defective charitable remainder trusts can sometimes be reformed. An alternative to reformation is provided where a trust included in a decedent's estate is defective because the remainder interest does not satisfy the 10-percent minimum charitable benefit test under IRC §664(d)(1)(D) or §664(d)(2)(D). Such a trust may be declared "null and void ab initio." IRC §2055(e)(3)(J). Whether this alternative is actually available under state law is another matter. Generally one must show that such a declaration is necessary to correct a material mistake regarding a factor that was important in motivating the grantor's decision to make the transfer. *Walton v Bank of Cal*. (1963) 218 CA2d 527, 545, 32 CR 856.

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§18.102 A. Three Categories of Charitable Remainder Trusts

The reformation rules are quite complex. Charitable remainder trusts are divided into three categories:

- *Category One* includes trusts that comply with the post-TRA 1969 rules but lack technical compliance with IRC §664. Examples include a trust that does not provide for what happens in a short taxable year, lacks a clause relating to additional contributions, or has similar technical deficiencies. If the governing instrument provides for a power of invasion for a noncharitable beneficiary, the trust will not be considered a Category One trust.
- *Category Two* includes trusts that would have qualified under the pre-TRA 1969 law but were not intended to comply with the post-TRA 1969 law. An example of such a trust is one that pays the income to a beneficiary for life, with the remainder going to charity.
- *Category Three* includes trusts that would not even meet the pre-TRA 1969 rules for qualification of a charitable remainder trust. An example of such a trust is one that pays the income to a beneficiary for life, with the remainder going to charity, but allows invasions of principal under a nonascertainable standard. Unless the third category can be amended into a second category trust by disclaimer or otherwise, there can be no reformation of such trusts. Under a special rule, the trust may be reformed if the income beneficiary dies before the due date for filing the estate tax return (including extensions) but only if there has not been an actual invasion of principal for the benefit of the beneficiary. IRC §2055(e)(3)(F); *Harbison v U.S.* (ND Ga 2001) 2001-1 USTC ¶60,398, 87 AFTR2d 1523.

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B. Deadlines for Reforming Trust

§18.103 1. Category One Trusts

If the trust falls into the first category, there is no deadline for reforming the trust. The trust can be reformed at any time, although there may be some detriment to waiting to reform the trust. Even though the trust as reformed will qualify as a charitable remainder trust for estate, gift, and income tax purposes, the IRS's position is that interest is payable on any prereformation tax liability up to the date on which the instrument is reformed. This position, however, has been rejected by the courts. See, *e.g.*, *Oxford Orphanage, Inc. v U.S.* (4th Cir 1985) 775 F2d 570.

A trust will not fall into Category One unless the trust instrument before reformation pays a fixed percentage of the fair market value or a specified dollar amount to the life beneficiary. IRC §§2055(e)(3)(C)(ii), 2522(c)(4). It is not clear whether, once these criteria are met, reformation must begin within certain time limitations. It is therefore a good idea to begin reformation as soon as possible to avoid the argument that the trust is a Category Two trust and should have been reformed within the applicable time limitations for such trusts, as discussed in §18.104.

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§18.104 2. Category Two Trusts

If the trust is a Category Two trust and a federal estate tax return is due, reformation must begin within 90 days after the filing date, including extensions, of the federal estate or gift tax return. IRC §§2055(e)(3)(C)(iii)(I), 2522(c)(4). If no federal estate or gift tax return is required, reformation must begin within 90 days after the due date, including extensions, for the filing of the first income tax return for the trust. IRC §2055(e)(3)(C)(iii)(II).

If the will or trust in which a charitable remainder trust is included is executed before January 1, 1979, or if an inter vivos trust was created before that date, a Category Two trust does not have to comply with the 90-day rule. IRC §2055(e)(3)(C)(iv). Thus, a Category Two trust created before January 1, 1979, can be reformed at any time. Under Prob C §§16105 and 17200, the court is authorized to reform a trust to comply with the post-TRA 1969 rules. Therefore, a reformation proceeding apparently can be brought under Prob C §17200(b)(15) to reform a trust to comply with the new rules.

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§18.105 C. Requirements of Reformation Rules

One requirement of the reformation rules is that the actuarial value of the reformed charitable interest cannot vary from the actuarial value of the reformable charitable interest by more than 5 percent. IRC §2055(e)(3)(B)(i). Therefore, the actuarial value of the charitable interest must be determined before reformation and again after reformation. If the difference is less than 5 percent, the test has been met. Although the actuarial value of the reformed interest may be greater than the actuarial value of the interest before reformation, the deduction that will be allowed cannot exceed the value of the charitable interest before reformation. IRC §2055(e)(3)(E). In IRS Letter Ruling 200232105, for example, the IRS ruled that there was less than a 5-percent difference between the actuarial value of the remainder interest in a unitrust with a unitrust amount of 6.625 percent and the actuarial value of the remainder interest in a trust in which the grantor retained a life income interest. In IRS Letter Ruling 200622005, the IRS approved a reformation of a testamentary trust that was defective because the unitrust amount was only 4 percent. As reformed, the unitrust amount was 5 percent, with that amount being split between the charity and the individual beneficiary. The favorable ruling suggests that a qualified interest may comprise two separate interests—a lead interest and a remainder interest—under IRC §2055(e)(3)(D), because increasing the unitrust amount from 4 percent to 5 percent almost certainly results in a change in the value of the charitable remainder interest that exceeds 5 percent.

WARNING: The IRS may disregard an uncontested court order that it determines is inconsistent with applicable state law after giving "proper regard" to relevant court rulings under *Commissioner v Estate of Bosch* (1967) 387 US 456, 465, 18 L Ed 2d 886, 894, 87 S Ct 1776, even if the reformation proceeding was initiated before the 90-day deadline in IRC §2055(e)(3)(C). See §18.104. The reformation order also must satisfy all applicable federal law requirements. In IRS Legal Memorandum 200848020, the IRS ruled that no income tax deduction was allowable for accelerated charitable payments made pursuant to the reformation of a charitable lead trust funded with retirement benefits to permit noncharitable beneficiaries to be treated as "designated beneficiaries" of the trust for minimum distribution purposes, because the modification was not made in settlement of a dispute concerning the interests in the trust and accordingly the charitable payments were not made "pursuant to the governing instrument" as required by IRC §642(c). See §18A.6.

Another requirement is that the noncharitable-recipient interest must terminate at the same time after reformation as it did before reformation. For example, if a trust provides for the termination of a recipient's interest on his or her death, the trust as reformed must provide for termination of the recipient's interest on his or her death. One exception to this rule is that a trust that continued for the recipient for more than 20 years can (and must) be cut back to terminate at the end of 20 years (but not less than 20 years). IRC §§2055(e)(3)(B)(ii), 2522(c)(4).

NOTE: Before reforming an inter vivos charitable remainder unitrust providing for unitrust payments for one and two lives or for a term of years, the practitioner should review the sample documents contained in Rev Proc 2005-52—2005-55, 2005-2 Cum Bull 326. Before reforming an inter vivos charitable remainder annuity trust providing for annuity payments for one and two lives or for a term of years, the practitioner should review the sample documents contained in Rev Proc 2003-53—2003-56, 2003-2 Cum Bull 230.

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VII. ALTERNATIVES TO CHARITABLE REMAINDER TRUST

§18.106 A. Pooled Income Fund

A pooled income fund is a trust formed and managed by the charity for the benefit of multiple donors. The fund is generally made up of property contributed by many donors. Each donor reserves a life income interest in the total fund and shares in the income production of the fund in proportion to his or her share of assets contributed to the fund. A deduction against income taxes is allowed for the value of the donor's remainder interest, which is based on the value of the donor's contribution, the rate of return of the fund, and the income beneficiary's life expectancy. IRC §642(c)(5). Similar deductions are allowable against the gift or estate tax.

The pooled income fund is created and usually administered by a charitable organization, although many banks serve as trustee of pooled income funds as well. Donors and beneficiaries must be prohibited from serving as trustee of the pooled income fund. It is a very practical alternative for donors desiring to transfer a remainder interest to charity in an amount not large enough to justify the cost of maintaining a separate charitable remainder trust. By transferring assets to a pooled income fund, the donor can obtain an income, gift, or estate tax charitable deduction but can avoid the expense of creating a charitable remainder trust, the ongoing reporting requirements, record keeping, and investment decisions associated with a separate trust. In addition, an organization with a successful pooled income fund can diversify its investment portfolio because of its size—an advantage that may not be available to a charitable remainder trust unless the trust is substantial or elects to invest in mutual funds.

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§18.107 1. Comparison With Charitable Remainder Trusts

There are both substantial similarities and differences between charitable remainder trusts and pooled income funds, some of which are:

- The income interest in a pooled income fund must be created for the life or lives of one or more individuals; the life interest may not be measured by a term of years. In addition, the measuring lives must be beneficiaries of the fund, as is the case with charitable remainder trusts. Rev Rul 79-61, 1979-1 Cum Bull 220.
- Additions may be made to a pooled income fund; in that respect, it resembles a charitable remainder unitrust but differs from a charitable remainder annuity trust. In fact, most pooled income funds are designed to accept gifts from the same donors over a period of years, so that the donors may continue their charitable giving patterns.
- Unlike the two forms of charitable remainder trusts, a pooled income fund may not invest in tax-exempt securities. IRC §642(c)(5)(C). See Treas Reg §1.664-1(a)(3). Thus, if the donor intends that the recipient receive tax-exempt income, the pooled income fund is not the appropriate form of gift.
- The charitable organization to which the remainder interest in a pooled income fund is transferred must be a charity qualifying for the 50 percent of the adjusted gross income charitable contribution deduction. IRC §§170(b)(1)(A), 642(c)(5)(A). By comparison, a private grant-making foundation that qualifies only for the 30-percent charitable contribution deduction may be the charitable remainder beneficiary of a charitable remainder trust.
- A charitable remainder trust must file information income tax returns, may also be required to file the information returns required of private foundations, and may incur other expenses (*e.g.,* trustee's fees and investment management fees). A donor who transfers property to a pooled income fund need not worry about these details, because the charity maintaining the fund will generally provide all the needed services and will furnish the donor with the amount and character of income paid to him or her each year.
- Distributions from a charitable remainder trust are governed by the special rules in IRC §664 relating to the character of income earned by the trust, which passes through to the beneficiary based on the "four-tier" system. See §18.31. Distributions from pooled income funds are governed by the normal subchapter J trust distribution rules contained in IRC §§651-663. The pooled income fund is a simple trust in that it distributes all its income each year. Therefore, a life income beneficiary of a pooled income fund will receive a proportionate amount of the income as earned by the fund. Generally, the fund is drafted only to pay ordinary income. The rules of IRC §643(b) apply, however, permitting the drafter to define income according to local law and the trust document as long as the definition does not depart fundamentally from the concept of income under local law. A recipient of payments from a charitable remainder trust will receive income the character of which is determined by the rules of IRC §664.
- As with a spouse's interest in a charitable remainder trust that qualifies for the marital deduction, a life income interest in a pooled income fund will qualify for the estate and gift tax marital deduction. IRC §§2056(b)(7)(B), 2523(f)(2), 2523(g); Treas Reg §§20.2056(b)-7(d)(5), 25.2523(f)-1(c)(1)(iii). A spouse's interest in a charitable remainder trust qualifies automatically for the marital deduction, while the spouse's interest in a pooled income fund qualifies by election. See Treas Reg §20.2056(b)-6(g), Example (13).
- The value of the charitable contributions deduction for a gift of a remainder interest in a pooled income fund is the present value of the remainder interest determined by using Table S. IRS Pub 1457 contains current factors for pooled income fund remainder interests.
- The pooled income fund is a taxable trust under the rules of subchapter J as a simple trust that distributes all its income every year. IRC §651. Capital gain is usually set aside and considered to be for the charitable remainder beneficiary and deductible under IRC §642(c), while income distributions are distribution deductions under IRC §652(a). Under the applicable income tax rules, pooled income funds, like charitable remainder trusts, may accept appreciated property and sell it without incurring capital gains tax.

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§18.108 2. Drafting Requirements for Qualification

For the attorney who drafts the fund documentation for a charity, rather than the attorney who reviews the agreement for a donor joining such a fund, the requirements discussed in §§18.109-18.116 must be considered.

In addition, although the valuation of the property transferred and the assignment of units of participation to the income beneficiaries are not listed in the regulations as one of the eight requirements of the pooled income fund, drafters nevertheless include these clauses in the governing instrument. Every income interest is assigned a proportionate share of income based on a unit plan. The fair market value of the fund at the time of a transfer is divided by the number of then-outstanding units of the fund to determine a unit value. The value of the property is then divided by this unit value to determine the number of units assigned to the new transfer. The income is then divided among the units outstanding and prorated for the time they are outstanding during the year. For the assignment of units, the fund must be valued. Valuation is made on determination dates and must be at least quarterly. When contributions are made between valuation dates, the fund instrument may provide for averaging the values on the dates before and after each valuation.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.109 a. Contribution of Remainder Interest to Charity

§18.109 a. Contribution of Remainder Interest to Charity

Each donor must transfer property to the fund and contribute an irrevocable remainder in such property to or for the use of a public charity. The donor must retain for himself or herself, or create for another beneficiary, a life income interest in the transferred property. Treas Reg §1.642(c)-5(b)(1).

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§18.110 b. Creation of Life Income Interest

Each donor must retain for himself or herself an income interest in the property transferred or create an income interest for the life of one or more beneficiaries, each of whom must be living at the time of the transfer of the property to the fund by the donor. Members of a named class who are alive and can be ascertained at the time of the transfer of the property to the fund are acceptable. The instrument of transfer must specify the share of income of the named beneficiaries.

The donor may retain the power exercisable only by will to revoke or terminate the interest of any designated income beneficiary. The charity may be named as an income beneficiary of a portion of the income interest. The donor need not create an income interest in all the income from the transferred property as long as the remaining income is payable to the charity that owns the remainder interest in the fund. No charitable deduction is allowed to the donor for an income interest given to the charity.

The income interest must be paid for the life or lives of individuals, and such individuals may be named either concurrently or consecutively to receive income. Treas Reg §1.642(c)-5(b)(2).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.111 c. Commingling of Property

§18.111 c. Commingling of Property

Property transferred to the fund by each donor must be commingled with the property transferred to the fund by other donors for investment and reinvestment. Such transfers to the fund must meet the requirements of the creation of income interest and remainder interests. If multiple funds are created by the charity, each fund created by the charity must not be a device to permit a group of donors to manipulate the fund. The fund may be jointly invested (not commingled) with other funds of the charity, such as endowment funds. Treas Reg §1.642(c)-5(b)(3).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.112 d. Prohibition Against Exempt Securities

§18.112 d. Prohibition Against Exempt Securities

The property transferred to the fund may not include securities the income from which is exempt from any income tax, and the fund may not invest in such securities. This must be specifically prohibited in the trust instrument. Treas Reg §1.642(c)-5(b)(4).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.113 e. Maintenance by Charitable Organization

§18.113 e. Maintenance by Charitable Organization

The fund must be maintained by the charity owning the remainder interest. Maintenance means control whether direct or indirect and, at the very least, the charity must have the power to remove and replace the trustee of the fund. A national organization may hold a pooled income fund for its local affiliates or chapters as long as (Reg §1.642(c)-5(b)(5)):

- There is an "identity of aims and purposes" with the local chapters;
- The local organizations that can be named as recipients of the remainder interest have expressly consented to be included in the fund;
- The governing instrument provides that the designated local cannot sever its interest in the fund before the death of the beneficiary; and
- The governing instrument provides that if the local ceases to be affiliated with the national organization, the remainder will stay with the national organization or be transferred to another affiliated local.

See Rev Rul 92-107, 1992-2 Cum Bull 120.

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.114 f. Prohibition Against Donor or Beneficiary Serving as Trustee

§18.114 f. Prohibition Against Donor or Beneficiary Serving as Trustee

The governing instrument must prohibit the fund from having as a trustee any donor to the fund or a beneficiary (other than the charity owning the remainder interest). It is ordinarily acceptable for a trustee, an officer, or a director of the charity owning the remainder interest to contribute to the fund as long as the donor does not have general responsibilities over the fund. Treas Reg §1.642(c)-5(b)(6).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.115 g. Income of Beneficiaries Based on Rate of Return

§18.115 g. Income of Beneficiaries Based on Rate of Return

Each income beneficiary receives income in an amount determined by the rate of return earned by the fund for the taxable year. The governing instrument must direct the trustee to distribute income currently or within the first 65 days following the close of the taxable year in which the income is earned. Income paid within those 65 days is treated as paid on the last day of the taxable year. The income beneficiary includes in gross income all amounts properly paid, credited, or required to be distributed in that year. The income must either terminate with the last regular payment date before the death of the income beneficiary or be prorated to the date of death of the beneficiary. Treas Reg §1.642(c)-5(b)(7).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18 Charitable Remainder Trusts/§18.116 h. Termination of Life Income Interest

§18.116 h. Termination of Life Income Interest

At the termination of the income interest, the trustee must sever from the fund an amount equal to the value of the remainder interest in the property on which the income interest is based. The value of the interest may be either (1) the value as of the valuation date next succeeding the termination of the income interest or (2) the value as of the date on which the last regular payment was made, if that choice was made in drafting the governing instrument. Treas Reg §1.642(c)-5(b)(8).

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§18.117 3. Use of Sample Document

Revenue Procedure 88-53, 1988-2 Cum Bull 712, provides a sample document that will qualify as a pooled income fund. Certain choices have been made in the document, such as quarterly payments and severance on the last regular payment date. The document does not, however, have adequate trustee powers clauses or other clauses relating to trustees. As long as the drafter includes only items that affect the state law requirements of trusteeship and does not change any of the provisions relating to the federal tax law or regulatory requirements, the pooled income fund drafted based on the revenue procedure will meet the requirements of a pooled income fund within the "safe-harbor" provided by the revenue procedure.

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B. Charitable Gift Annuity

§18.118 1. Contractual Gift to Charity

For many decades charitable organizations have issued charitable gift annuities. The seemingly contradictory terms "gift" and "annuity" reflect the nature of the transaction: part gift to a charity and part purchase of an annuity from the charity. The donor transfers irrevocably to the charity money or other property in return for the charity's promise to pay an annuity or fixed amount to one or more designated annuitants for life. The amount transferred by the donor is in excess of what would be required to furnish a commercial annuity paying the same annuity rate. This excess amount is the gift element. A charitable gift annuity, being part sale or exchange of property and part gift, is subject to the bargain sale rules.

The residuum payable to the charity at the death of the annuitant can be used for general purposes by the charity or can be restricted to specific uses. Several states have passed laws requiring that the charity maintain a reserve of a certain portion, sometimes as much as 100 percent, until the annuitant's death. This, of course, locks up the money, permitting less liquidity for the charity at present. A reinsurance program can release locked-in funds, but the reinsurer must be chosen carefully to preserve the greatest amount of residuum for the charity.

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§18.119 2. Comparison with Charitable Remainder Trust

The charitable remainder annuity trust differs from the charitable gift annuity in several respects:

- The transfer of funds into a charitable remainder annuity trust provides the corpus from which payments are made. If in the course of payment the funds are exhausted, the trust ceases to exist. In contrast, a gift annuity agreement is a contractual obligation undertaken by a charity to pay the annuity amount for the life of the annuitants notwithstanding the fact that the payments might exceed the amount transferred. The contractual obligation is backed by the charity's assets.
- The donor to a charitable remainder annuity trust has the flexibility to set his or her own rate within certain guidelines. If the charity issuing gift annuities sponsors the American Council, it may choose to employ the suggested uniform rates, which are based on age at the time of the gift.
- The charitable deduction is allowed for both trusts. For the charitable remainder annuity trust, the deduction is calculated actuarially based on the full fair market value of the property transferred. The gift annuity, however, is treated as part sale and part gift, with the deduction for the gift portion being determined as the excess of the sale portion. The sale portion is the "investment in the contract" or roughly what it would cost to purchase an equivalent commercial annuity contract. Both annuity gifts use the same IRS actuarial tables, however, to calculate the present value of the annuity payments. The dollar amount will thus be identical even though the theoretical basis on which the deduction is calculated differs.
- Because the gift annuity is part sale, capital gain may be recognized to some extent. A transfer to a charitable remainder annuity trust, however, avoids recognition of capital gain on the transfer into the trust. When appreciated property is transferred to fund a gift annuity, basis is allocated between the gift element and the sale element. Gain will be recognized and will be long term or short term depending on the donor's holding period. Ordinary income may also be assessed, based on the same rules that would apply if the entire property had been sold by the donor. The tax treatment of income payments to the donor differs with each vehicle. The charitable remainder annuity trust has a four-tiered tax structure. The payments from the gift annuity are taxed under IRC §72 just as are payments from any other annuity.
- Charitable remainder trusts are strictly regulated by the IRS, while charitable gift annuities are subject to far less regulation. For example, the private foundation rules that, under IRC §4947(a)(2), apply (with some exceptions) to split interest trusts, do not apply to charitable gift annuities. As mentioned above, however, some states regulate reserves and investments of gift annuities. Generally, gift annuities are exempted from federal securities laws under the Philanthropy Protection Act of 1995 (Pub L 104-62, 109 Stat 682 (15 USC §80a-3(c)(10)).

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§18.120 3. Income Tax Considerations

There are two elements of the tax treatment of the donor: the allowable income tax charitable contribution deduction and the income tax treatment of the annuity payments.

An income tax charitable contribution deduction is allowed for the difference between the amount transferred to the charity and the value of the "investment in the contract." The investment in the contract is the present value of the annuity payments determined by using the tables in Rev Rul 84-162, 1984-2 Cum Bull 200. When the annuity is for two lives, a special calculation of a joint life annuity rate must be determined to calculate the charitable deduction.

Once the transfer is made and the donor receives annuity payments, a portion will be excluded from income and a portion will be ordinary income. Each annuity payment reflects a partial return of principal and, therefore, a portion is excluded from income. The remaining portion is the equivalent of income earned on that principal and is taxable at ordinary income rates.

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§18.121 4. Estate and Gift Taxes

In at least three rulings, the IRS has agreed that estate tax and gift tax charitable deductions are permitted for the charitable gift element of a gift annuity. Specific provision is made in Treas Reg §1.170A-1(d) for an income tax deduction; however, no specific provision is made in the estate and gift tax regulations for such a deduction.

In IRS Letter Ruling 8045010 and Rev Rul 80-281, 1980-2 Cum Bull 282, the IRS has made it clear that estate and gift tax charitable deductions are permitted for the value of the gift to charity. The underlying premise of both rulings is that the transfer to the charity exceeds the value of the annuity that the charity must pay. Also important was the charity's general obligation to pay the annuity out of its general funds, as opposed to a split interest arrangement in which the donor retains an income interest in the property transferred. In IRS Letter Ruling 200152018, the IRS ruled that a noncharitable beneficiary of a charitable remainder unitrust could receive a gift tax deduction for assigning the unitrust interest to the charitable remainder beneficiary of the trust in exchange for the right to receive an annuity of lesser value paid by the charity.

If the donor and the donor's spouse are the beneficiaries of a joint and survivor annuity, the donee spouse's interest qualifies for the marital deduction unless the donor elects out. IRC §§2056(b)(7), 2523(f).

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§18.122 C. Qualified Terminable Interest Property Trust for Spouse With Charitable Remainder

An important alternative to an IRC §664 charitable remainder trust is a qualified terminable interest property (QTIP) trust that meets the requirements of IRC §2056(b)(7)(B). A QTIP trust provides for payment of the trust income to a spouse for the spouse's lifetime, with the remainder passing to another beneficiary. IRC §2056(b)(7). If the other beneficiary is a qualified charitable organization, an estate tax charitable deduction will be allowed when the surviving spouse dies. IRC §2055. Thus, no gift or estate tax is incurred at the creation of the trust because the trust qualifies under IRC §2056(b)(7) for the marital deduction; when the trust is included in the surviving spouse's estate under IRC §2044, the surviving spouse's estate is entitled to an estate tax charitable deduction under IRC §§2044 and 2055.

The characteristics of a charitable remainder QTIP trust differ from those of an IRC §664 charitable remainder trust in the following respects:

- The surviving spouse is entitled to all income from the trust during his or her lifetime, rather than to only a specified percentage of the annual fair market value of the trust assets (charitable remainder unitrust) or a specified annuity (charitable remainder annuity trust).
- The trustee may be given the power to invade principal for the surviving spouse's benefit; in contrast, the IRC §664 charitable remainder trust permits the recipient to receive nothing except the annuity or unitrust amount. Because the QTIP charitable remainder trust will be subject to estate tax in the surviving spouse's estate under IRC §2044, the power of invasion may be very broad, even if the surviving spouse is the sole trustee or a cotrustee. The settlor of the trust may wish to limit the scope of the power to ensure that some property will be left for charity after the surviving spouse dies, but there are no tax reasons for limiting the power.
- The surviving spouse may be given the power to appoint the property to appointees other than charitable organizations. To the extent that the appointments come within the surviving spouse's exemption equivalent (taking into account the survivor's own property), there still will be no estate tax on the surviving spouse's death, even though some of the property in the trust will pass to beneficiaries other than charitable organizations. See Drafting California Revocable Trusts §§9.40-9.41 (4th ed Cal CEB 2003).
- The QTIP trust with a charitable remainder is not subject to certain private-foundation prohibitions that apply to other charitable remainder trusts. See §§18.79-18.81. Therefore, the trustee has more flexibility than is permissible in an IRC §664 trust. For example, a QTIP trust enables the trustee and the surviving spouse to enter into transactions with each other, which may result in substantial savings or convenience for the family. Any such transactions between the surviving spouse-recipient and an IRC §664 charitable remainder trust are prohibited by IRC §4941 (self-dealing prohibitions).
- An IRC §664 charitable remainder trust may terminate on remarriage (with the charity receiving its interest early), while a QTIP charitable remainder trust must continue for the lifetime of the spouse.
- A significant disadvantage to using a QTIP charitable remainder trust instead of an IRC §664 charitable remainder trust is that the QTIP charitable remainder trust is subject to income tax on the sale of assets while an IRC §664 trust is not. In addition, under certain circumstances, the recipient of an IRC §664 trust will receive the annual payments as capital gain, rather than as ordinary income, which is not the case with a QTIP trust.

If the surviving spouse is not a United States citizen, the marital deduction will not be allowed unless the trust is a qualified domestic trust (QDOT). IRC §§2056(d), 2056A. If a QDOT is followed by a charitable distribution, however, the charitable deduction will be denied to the estates of both spouses. Under current law, there is no charitable deduction because the federal estate tax on the QDOT is treated as a tax on the decedent spouse's estate.

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§18.123 D. Remainder Interest in Personal Residence or Farm With Retained Estate

A donor who desires to give to charity a remainder interest in a residence or farm while reserving the right to live in the residence or to use and occupy the farm during his or her lifetime cannot use a charitable remainder trust for this purpose. Only the annuity or unitrust amount may be paid to the recipient from a charitable remainder trust. Use of property owned by the trust is not equivalent to the payment of this amount. Rev Rul 77-58, 1977-1 Cum Bull 175. In addition, the use or rental of the residence or farm by the settlor of the trust constitutes an act of self-dealing under IRC §4941 and therefore is impermissible.

Under IRC §§170(f)(3)(B)(i), 2055(e)(2), and 2522(c)(2), a donor or a decedent can accomplish the desired result by making a gift or bequest of a remainder interest in a personal residence or farm and obtain a charitable income, estate, and gift tax deduction for the present value of the remainder interest at the time of the gift or bequest. The residence must be used by the donor as a residence, but it need not be the donor's principal residence. Rev Rul 75-420, 1975-2 Cum Bull 78. A personal residence includes stock in a cooperative housing corporation (Treas Reg §1.170A-7(b)(3)) as well as all the land used in connection with the residence.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

When the donor contributes his or her residence to a charity and retains a life estate for the donor and the donor's spouse, in order to avoid a gift the donor should retain the right to revoke the spouse's interest. A QTIP election must be made to qualify the interest passing to the surviving spouse for the marital deduction. See Treas Reg §20.2056(b)-6(g).

A farm is the land and buildings used by the donor or by a tenant of the donor for the production of crops, fruits, agricultural products, or livestock; the term "farm" includes the farmhouse and other improvements that constitute fixtures. Treas Reg §1.170A-7(b)(4). Separate parcels may be conveyed at different times if all parcels constitute a portion of the farm. Rev Rul 78-303, 1978-2 Cum Bull 122. A remainder interest in furniture, furnishings, farm implements, and other tangible personal property is not deductible, because it is not real property. Rev Rul 76-165, 1976-1 Cum Bull 279. An interest in less than the entire remainder may be given to the charity. Rev Rul 87-37, 1987-1 Cum Bull 295.

The value of a remainder interest in a personal residence or farm is computed on the basis of the remainder factors and actuarial tables provided in Treas Reg §§20.2031-7(d)(7), 25.2512-5(d) and IRS Pub 1457. For income tax purposes, a gift of a remainder interest in a personal residence or farm must be discounted to reflect straight-line depreciation. IRC §170(f)(4). See also Temp Treas Reg §1.170A-12T for an example of the computation of depreciation. No depreciation is taken into account for gift and estate tax purposes. Rev Rul 76-473, 1976-2 Cum Bull 306.

There is no clear authority in the law as to whether the life tenant can reserve or be given the power to dispose of the residence or farm during his or her lifetime. See generally Rev Rul 84-97, 1984-2 Cum Bull 196; Rev Rul 83-158, 1983-2 Cum Bull 159; *Estate of Eliza W. Blackford* (1981) 77 TC 1246, acq in part in result 1983-2 Cum Bull 1. The IRS has ruled, however, that a life tenant's power to sell property disqualifies the testamentary gift of a farm for the charitable deduction. See IRS Letter Ruling 8810004. On the basis of this ruling, the author suggests caution: Such rights should not be reserved or given to the life tenant.

The gift can be accomplished by recording a grant deed that reserves the life estate. The laws governing the rights and obligations of the tenants are well settled under statute and common law. The author suggests, however, that when an operating farm is involved, a side agreement detailing management and operational aspects and costs may be appropriate.

For discussion of another alternative, the qualified personal residence trust, see chap 17.

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18A

Nongrantor Charitable Lead Annuity Trusts

Jeffrey A. Dennis-Strathmeyer

I. INTRODUCTION §18A.1

II. SCOPE OF CHAPTER: NONGRANTOR CLATS VERSUS ALTERNATIVES §18A.2

III. ASSESSING THE NONGRANTOR CLT
- A. Overview of Historical Evolution §18A.3
- B. Contemporary Tax Considerations §18A.4
  - 1. Grantor's Income Tax Deduction for Contribution §18A.5
  - 2. Trust's Income Tax Deduction §18A.6
  - 3. Estate Tax Deduction §18A.7
  - 4. Gift Tax Deduction §18A.8
  - 5. Generation-Skipping Transfer Tax
    - a. Normal Inclusion Ratio Calculation §18A.9
    - b. Special CLT Inclusion Ratio Rules §18A.10
      - (1) Example of Annuity Inclusion Rules §18A.11
      - (2) Implications of Annuity Inclusion Rules §18A.12

IV. WHEN TO USE NONGRANTOR CLAT
- A. In General §18A.13
- B. Example of Nongrantor CLAT §18A.14
  - 1. Benefits of Leverage §18A.15
  - 2. Benefits of a Low Present Value Remainder §18A.16
- C. Implicit Assumptions of Favorable Scenarios §18A.17

V. SELECTION OF TRUSTEE §18A.18

VI. CLAT DRAFTING REQUIREMENTS
- A. Overview §18A.19
- B. Required and Highly Desirable Provisions
  - 1. Guaranteed Annuity Interest §18A.20
  - 2. Form: Payment of Guaranteed Annuity §18A.21
  - 3. Private Foundation Prohibitions §18A.22
  - 4. Form: Annuity Trust or Unitrust Mandatory Clause (Private Foundation Prohibitions) §18A.23
  - 5. Charitable Deduction Savings Clause §18A.24
  - 6. Form: Charitable Deduction Savings Clause §18A.25
  - 7. Other Provisions §18A.26

VII. AVOIDING GRANTOR TRUST STATUS §18A.27

VIII. NONQUALIFIED CHARITABLE LEAD TRUSTS §18A.28

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Source: Estate Planning/Drafting California Irrevocable Trusts/18A Nongrantor Charitable Lead Annuity Trusts/§18A.1 I. INTRODUCTION

§18A.1 I. INTRODUCTION

A charitable lead trust (CLT) is a trust that initially makes all distributions to charity. To qualify for an income tax deduction under IRC §170, a gift tax deduction under IRC §2522, or an estate tax deduction under IRC §2055, the charitable interest must be in the form either of an annuity interest (a right to receive periodic payments of a specific amount of money at least annually) or a unitrust interest (a right to receive periodic payments of a fixed percentage of the net fair market value of the trust assets, determined annually). Treas Reg §1.170A-6(c)(2)(i), (ii). If the charitable interest is an annuity, the trust is referred to as a charitable lead annuity trust (CLAT). If the charitable interest is a unitrust interest, the trust is referred to as a charitable lead unitrust (CLUT).

Historically, as further discussed in §18A.3, CLTs provided a wide variety of tax planning opportunities. Today these opportunities are limited, and CLTs are suitable only in specialized situations. A primary limitation on the utility of CLTs is the rule that an income tax deduction is allowed only when the trust assets will remain taxed to the grantor under IRC §671 during the term of the charitable interest. IRC §170(f)(2)(B). This result is significantly inferior to the result that occurs in the case of an outright gift, because the future income from the outright gift property is no longer taxed to the grantor.

As a consequence, CLTs are most likely to be used in situations in which the donor is not interested in obtaining an income tax deduction. The most common of these situations involves transfers at death. There is no income tax deduction for transfers at death in any event, so nothing is lost. In the inter vivos context, the absence of an income tax deduction is most likely to be irrelevant in a case in which a wealthy individual is effectively not eligible for further income tax deductions because his or her charitable gifts already exceed the applicable percentage of income limitations under IRC §170(b) and will continue to exceed those limitations during the subsequent 5 years of the allowable carryover period. This is particularly likely to occur if the donor is making gifts of appreciated property to a private foundation, in which case the annual charitable deduction limitation is only 20 percent of the donor's contribution base (adjusted gross income without regard to any net operating loss carryback to the taxable year). IRC §170(b)(1)(D).

In such cases, the primary benefits of a CLT result from the fact that the estate or gift tax deduction for the transfer will be calculated under IRC §7520 using an assumed rate of return equal to 120 percent of the federal midterm interest rate for the month of the transfer (or, if desired, either of the two previous months). If the CLT is a CLAT and actual investment return during the charitable term exceeds the IRC §7520 rate of return, the excess amount will pass to the remaindermen without being subject to estate tax or gift tax. Special generation-skipping transfer (GST) tax rules applicable to CLATs reduce, but do not eliminate, CLAT benefits in GST tax situations. See §18A.10.

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§18A.2 II. SCOPE OF CHAPTER: NONGRANTOR CLATS VERSUS ALTERNATIVES

Frequently, discussions of charitable lead trusts (CLTs) include discussions of both CLTs that are intentionally designed as grantor trusts (*i.e.,* the trust income is taxed to the grantor under IRC §671) and nongrantor trusts (*i.e.,* the trust income is taxed to the trust or its beneficiaries). Although only a grantor trust qualifies the contribution to the trust for an income tax deduction, the disadvantage of having the trust income taxed to the grantor (see §18A.1) is so great that most individuals should use other forms of charitable gifts to the extent income tax deductions are available. Accordingly, this chapter is devoted to nongrantor CLTs.

Similarly, for historical reasons, discussions of CLTs often include descriptions of trusts that provide that the remaining assets revert to the grantor at the end of the term. This could be useful in the days when the income tax advantages of CLTs were greater, but it makes little sense in an age when the primary benefit of a CLT is the ability to gift and devise property to others at a reduced transfer tax cost. The discussion in this chapter assumes that the noncharitable beneficiaries of the trust will not include the grantor or the grantor's spouse.

Because of the emphasis on transfer tax savings, this chapter devotes relatively little attention to charitable lead unitrusts (CLUTs), although the text refers to CLTs rather than CLATs when the statements are also applicable to CLUTs. CLATs produce better transfer tax results than CLUTs. This is the case even in generation-skipping transfer situations, notwithstanding the fact that CLATs, but not CLUTs, are burdened with the provisions of IRC §2642(e), which delay the determination of a CLAT's inclusion ratio until the end of the term of the charitable interest. See §18A.10.

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III. ASSESSING THE NONGRANTOR CLT

§18A.3 A. Overview of Historical Evolution

Before the Tax Reform Act of 1969 (Pub L 91-172, 83 Stat 487), the CLT was a highly flexible planning device. It was not necessary that the lead interest be in the form of a guaranteed annuity or unitrust interest. Further, entitlement to an income tax deduction did not require that the grantor be taxable on the trust income during the term of the charitable interest. These benefits were eliminated by that Act.

The Tax Reform Act of 1986 (TRA 1986) (Pub L 99-514, 100 Stat 2085) further limited the utility of CLTs. First, it eliminated rules that permitted shifting income tax liability to trust beneficiaries by creating a "Clifford" trust that provided no benefits to the grantor for ten years. Today, this can only be done by creating a trust in which the value of the reversionary interest is less than 5 percent. IRC §673(a). Second, TRA 1986 imposed a generation-skipping transfer (GST) tax. This tax contains an express provision intended to prevent taxpayers from using CLTs for the purpose of evading the GST tax. IRC §2642(e).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18A Nongrantor Charitable Lead Annuity Trusts/§18A.4 B. Contemporary Tax Considerations

§18A.4 B. Contemporary Tax Considerations

The following is a summary of the basic tax rules that most directly effect the usefulness of charitable lead trusts.

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§18A.5 1. Grantor's Income Tax Deduction for Contribution

Entitlement to income tax deductions for transfers to a qualifying charitable lead trust is subject to the percentage of contribution base limitations of IRC §170(b). Entitlement is further restricted by IRC §170(f)(2)(B), which provides:

> No deduction shall be allowed under this section for the value of any interest in property (other than a remainder interest) transferred in trust unless the interest is in the form of a guaranteed annuity or the trust instrument specifies that the interest is a fixed percentage distributed yearly of the fair market value of the trust property (to be determined yearly) *and the grantor is treated as the owner of such interest for purposes of applying section 671*. [Emphasis added.]

Under this provision and Treas Reg §1.170A-6(c)(4), the price of obtaining an income tax deduction in the current year for the present value of the lead interest will be the inclusion of the trust income in the income of the grantor for the charitable term. If the deduction is initially claimed and the donor later dies or otherwise avoids the impact of IRC §671, a portion of the original deduction will be recaptured by then including in the grantor's income the present value of the remaining charitable interest. Although it is sometimes suggested that the impact of subsequent inclusion of trust income in the donor's taxable income can be mitigated by having the trust invest in municipal bonds, a donor could still obtain greater tax benefits by making an outright gift to charity and shifting other investments to municipal bonds. Even if this were not the case, investing exclusively in municipal bonds would likely violate the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) because of the lack of diversity and expected low rate of total return. Finally, and perhaps most importantly, it is extremely unlikely that municipal bonds will outperform the IRC §7520 rate that is used to value the charitable interest in the first place, with the result that the remaindermen will end up worse off than if the donor had simply made outright gifts to the charity and the remaindermen of amounts equal to the IRC §7520 present values of the respective interests each would have received in a CLT if a CLT had been created.

The income tax detriment of grantor trust status also may be less than the benefit of the initial deduction if trust income is primarily capital gains, but the grantor would still be better off making an outright gift to the charity, thereby completely avoiding tax liability on future income from the transferred property.

If a CLT is not a grantor trust, trust income will be taxed to the trust, but the trust will be entitled to an IRC §642(c)(1) unlimited deduction for amounts of income distributed to the charity.

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§18A.6 2. Trust's Income Tax Deduction

A CLT is not exempt from income taxes. It is generally taxed as a complex trust and is entitled to a deduction for amounts distributed to charity under IRC §642(c). There are no percentage limitations, but the deduction cannot exceed the trust's gross income for the year of the deduction. The trustee may elect to treat amounts paid in one calendar year as if made in the preceding calendar year. In most cases, a properly drafted CLT will not have a significant income tax liability because of the IRC §642(c) deduction.

The governing instrument generally can affect the income tax characterizations of the distributions to the charity. IRC §662(b); Treas Reg §1.643(a)-5(b). To maximize the benefit of the deduction and reduce the taxes imposed on the trust's accumulated income (or the income distributed to the remaindermen in the final year of the trust), at least one commentator has suggested that the trust instrument should provide that the charitable distributions are to be paid first from ordinary income, followed in order of priority by short-term capital gain income, long-term capital gain income, unrelated business income (or perhaps that distributions should be made from 50 percent of unrelated business income before long-term capital gains), tax-exempt income, and finally principal. See Teitell, Charitable Lead Trusts §1.05 (1986). The order of payment is significant because no deduction is allowed under IRC §642(c) for any amount allocable to the trust's unrelated business income for the taxable year. IRC §681(a). However, the IRS has issued proposed regulations that would disregard provisions specifying the types of income to be used for payments to charity if the provisions have no economic effect independent of income tax consequences. Prop Treas Reg §§1.642(c)-3(b)(2), 1.643(a)-5(b).

In IRS Letter Ruling 200648025, the IRS ruled that a similar ordering rule in a proposed CLAT will not be given effect for income tax purposes under Treas Reg §1.642(c)-3(b)(2). See also IRS Letter Rulings 200108032, 199917068, 199915058, 199908002, 9808035, 8819020. The cited regulation authorizes an ordering rule providing that payments are made first from taxable income and then from nontaxable income, but the IRS has ruled that the ordering rule still must have economic effect. IRS Letter Ruling 8727072. For further discussion, see Casner & Pennell, Estate Planning §5.9 at 5.114 n22 (6th ed 1995). See also Ferguson, Freeland & Ascher, Federal Income Taxation of Estates, Trusts & Beneficiaries §6.09 (3d ed 1998).

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§18A.7 3. Estate Tax Deduction

If a qualifying CLT is established at death, the settlor's estate is entitled to an unlimited estate tax deduction for the value of the charitable annuity. IRC §2055. The deduction is also allowable to a surviving spouse's estate when a qualified terminable interest property (QTIP) trust, includable in the survivor's estate under IRC §2044, provides for establishing a CLT on the death of the surviving spouse. An estate tax deduction also will be allowed when a qualifying inter vivos CLT is includable in the estate of the donor under IRC §2036 or §2038, but the value of the deduction will be limited to the value of the charitable interest at that time.

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§18A.8 4. Gift Tax Deduction

A gift tax deduction is allowed for the gift of the qualifying charitable annuity or unitrust lead interest when the gift is complete for gift tax purposes. IRC §2522. Assuming the trust is intended to be a nongrantor CLT with the value of the gift of the remainder being determined based on the IRC §7520 rate at the time of the transfer (or either of the previous two months), the donor cannot retain a power to designate or change the charitable beneficiary. A gift tax return is required for the year the gift becomes complete. No annual gift tax exclusions are allowable for the gifts to the remaindermen, because these are gifts of future interests. IRC §2503(b).

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5. Generation-Skipping Transfer Tax

§18A.9 a. Normal Inclusion Ratio Calculation

The generation-skipping transfer (GST) tax makes specific provisions with respect to CLATs and CLUTs and treats them differently. For purposes of the GST tax, charities are not skip persons. IRC §2613(b). Accordingly, a transfer to a CLT is never a "direct skip." If the trust will benefit skip persons (persons assigned two or more generations below the grantor), there will eventually be one or more generation-skipping transfers. These may be taxable terminations (when all remaining beneficiaries are nonskip persons) or taxable distributions (whenever a distribution is made to a skip person) or both. IRC §2612. The tax is computed by multiplying the value of the property subject to the transfer by the maximum estate tax rate (45 percent in 2007-2009). IRC §§2001, 2641. This amount is then further multiplied by the inclusion ratio. The GST tax treatment of CLTs is strongly influenced by the rules for computing the inclusion ratio.

In simpler situations, the inclusion ratio is equal to one minus the "applicable fraction." The denominator of the applicable fraction is generally the value of the transferred property at the time of the transfer, and the numerator is the amount of the donor's IRC §2631 GST tax exemption that the donor chooses to allocate to the particular transfer. IRC §2642. Without special provisions, these rules would make it virtually impossible to create CLTs that would benefit skip persons. It would be foolish, for example, to allocate $1 million of GST exemption to a $1 million trust (thereby producing a fully exempt trust with an applicable fraction of one and, therefore, an inclusion ratio of zero) if the primary trust beneficiary was a charity.

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§18A.10 b. Special CLT Inclusion Ratio Rules

Because of the problem described in §18A.9, the GST tax contains one special rule applicable to all generation-skipping CLTs, plus two additional rules applicable to charitable lead annuity trusts but not to charitable lead unitrusts. The rule applicable to all CLTs provides that, for purposes of determining the applicable fraction, the value of the denominator is the value of the property in the trust *reduced by* any gift tax or estate tax charitable deduction allowed for the transfer to the trust. IRC §2642(a)(2)(B)(ii)(II).

Thus, if the donor gives $1 million to a CLUT and the present value of the remainder interest under IRC §7520 is $200,000, the donor need allocate only $200,000 of GST exemption to the trust to create a fully exempt (applicable fraction of one and inclusion ratio of zero) trust. No matter what the value of the trust assets at the end of the charitable lead term, the inclusion ratio will remain zero because that ratio is already determined.

Two additional rules produce very different results in the case of CLATs. First, the applicable fraction is not determined at the beginning of the trust, but instead is determined immediately after the end of the term of the charitable lead interest. IRC §2642(e)(1)(B). The clear purpose of this rule is to prevent excessive leveraging of the GST exemption in the case of annuity trusts. If investment results are good, it would otherwise be possible to create a CLAT that initially has a value of near zero, make the trust fully GST tax exempt with an allocation of very little GST tax exemption, and then end up with a very large GST tax-exempt trust at the end of the charitable term. Such excessive leveraging is less of an issue with a unitrust because unexpectedly high investment performance benefits *both* the charity and the remaindermen, inasmuch as the annual unitrust payment fluctuates with the value of the trust assets.

The second rule applicable only to annuity trusts provides that the numerator of the applicable fraction is the "adjusted" GST exemption allocated to the trust. IRC §2642(e)(1)(A). The adjusted GST exemption is the actual exemption allocated to the trust increased by interest at the IRC §7520 rate used to calculate the amount of the gift or estate tax deduction for the charitable lead annuity interest. IRC §2642(e)(2). In IRS Letter Ruling 200107015, the IRS ruled that the assignment of a CLAT remainder interest by the donor's child to the child's own children might circumvent the purpose of IRC §2642(e) and attempted to treat the child as GST transferor of only the "present value" of the interest. See 22 CEB Est Plan Rep 146 (Apr. 2001).

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§18A.11 (1) Example of Annuity Inclusion Rules

The annuity inclusion ratio rules work well when the actual investment rate of return is identical to the rate assumed under IRC §7520. Suppose, for example, that a $1 million CLT is established in a month when the IRC §7520 rate is 5 percent. The trust pays an annuity of $200,000 at the end of each year for 5 years. Based on the assumed rate of investment return of 5 percent, the annuity has a present value of $865,900 and the remainder has a *present* value of $134,100, a value that assumes that the actual *future* value of the property left in the trust at the end of the charitable term will be $171,149. If the donor allocates $134,100 of GST tax exemption to the trust at the beginning of the term, the adjusted GST tax exemption will be calculated by increasing this amount by the same 5 percent per annum. At the end of the ten years, the adjusted GST tax exemption will be exactly equal to the $171,149 remaining in the trust at that time, resulting in a GST tax inclusion ratio of zero. In terms of GST tax, the trust ends up in the same situation as would have occurred if the donor had made an outright gift to the charity of $865,900 together with an outright gift to a trust for issue of $134,100 that received an identical allocation of GST tax exemption.

However, donors establishing CLATs are gambling that the actual rate of return on trust investments will exceed the IRC §7520 rate. Suppose the actual rate of return for the trust is 7 percent rather than 5 percent. At the end of the term, the remaining balance in the trust will be $252,404, but the adjusted GST tax exemption is still $171,149. If the donor wants the trust to be fully exempt from GST tax, the donor must allocate an additional $81,255 of GST tax exemption to the trust. Alternatively, the donor could and should have been adding GST tax exemption to the trust at earlier dates inasmuch as "the adjusted GST tax exemption" rule allows exemption to "grow" once it is allocated. In any event, from a GST tax perspective, a CLAT does not produce any special benefits for a trust that will be protected by GST tax exemption.

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§18A.12 (2) Implications of Annuity Inclusion Rules

Two points should be made about the GST tax inclusion ratio rules for CLATs. First, a CLAT remains superior to a CLUT in generation-skipping situations even though the inclusion ratio for CLUTs is determined at the beginning of the term. It would not be necessary to add additional GST exemption to a CLUT, but under the best of normal circumstances the value of a CLUT remainder grows so slowly that the CLAT will produce better total results even if GST tax must be paid on the increased value. It is simply the price of success.

This leads to the second point, which involves the impact of the GST tax in situations in which the CLAT will distribute to skip persons but the donor has no remaining GST tax exemption. A CLAT will be useful in these situations, but only to the extent that the planner is able to overcome the fact that GST transfers to skip persons should normally be made in the form of a direct skip, because the GST tax on a direct skip is calculated on a tax-*exclusive* basis (the tax rate *is not* applied to the money to be used to pay the tax), whereas the GST tax on taxable terminations and taxable distributions is calculated on a tax-*inclusive* basis (the tax rate *is* applied to the money to be used to pay the tax). See §4.6.

To overcome the disadvantage of losing the opportunity to make a direct skip, it is simply necessary to make sure that the value of property transferred to the trust that otherwise would be available to make a comparable direct skip is negligible. If, for example, a proposed $1 million nonexempt generation-skipping CLAT produces a charitable lead interest with a present value of $900,000 and a remainder interest with a present value of $100,000, the transaction should be recast so that only $900,000 goes to the CLAT and the remaining $100,000 is used to make a separate direct skip transfer to a trust benefiting only skip persons. (There are other reasons for minimizing the present value of the CLAT remainder. See §18A.16.)

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IV. WHEN TO USE NONGRANTOR TRUST

§18A.13 A. In General

To assess the benefit of using a CLAT, it is helpful to compare the results of using such a device with the alternative of making two separate gifts: (1) an outright gift to charity of an amount equal to the present value of the charitable interest in the proposed CLAT (as determined by using the IRC §7520 interest rate) and (2) a gift to a trust for remaindermen of the present value of the remainder interest in the proposed CLAT. Assume the trust for the remaindermen will accumulate all income until the end of the charitable term for the proposed CLAT.

If, hypothetically, the selected trust investments for both the proposed CLAT and the alternative proposed trust for remaindermen have a total investment return for the term that is equal to the rate assumed under IRC §7520, the result is a wash. At the end of the proposed term the assets that will remain in the proposed CLAT will have the same value as the assets in the proposed alternative of a separate trust for the remaindermen.

If, however, the actual rate of investment return is higher or lower than the rate assumed under IRC §7520, the value of the remaining assets in the CLAT will similarly be higher or lower than under the proposed trust for remaindermen. Accordingly, the CLAT is desirable only when the §7520 rate is relatively low or there is some other reason to believe actual investment performance will exceed the assumed rate. For a discussion illustrating the benefits of a large CLAT when the rate of return exceeds the §7520 rate, see Babitz & Susano, *Charitable Lead Annuity Trust: A Useful, but Neglected, Planning Tool*, 34 Est Plan 21 (Aug. 2007).

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§18A.14 B. Example of Nongrantor CLAT

Suppose, to provide an extreme example, a donor might make a gift of $1 million to a CLAT with a 2-year term. The CLAT will pay $500,000 at the end of each year to the charity. The IRC §7520 rate for the year is 5 percent. Accordingly, the IRS will value the present value of the charitable interest at $929,700 and the present value of the remainder interest at $70,300. These figures assume that the future value of the remainder interest—the amount that will be left in the trust at the end of the term—will be $77,500, which is equal to $70,300 invested at 5 percent for 2 years compounded annually.

Now assume that the actual rate of investment return is 7 percent. At the end of the 2-year term, the amount in the trust will be $109,910. If, instead, the donor had made a $70,300 gift in trust for 2 years and that sum had grown at the 7-percent rate, that trust would have a value of only $80,486. As a result of using the CLAT, the remaindermen will receive an additional $29,424 without any increase in gift tax liability. Even if we appropriately discount this figure back to the time of the gift to determine the extra amount that the donor would have been required to invest at 7 percent for 2 years to generate the additional $29,424, the amount that has escaped the transfer tax system is $25,700.

Suppose instead that the donor makes a gift of $1 million to a CLUT with a 2-year term. The CLUT will pay 73.5 percent of the trust assets at the end of each year to the charity. The IRC §7520 rate for the year is 5 percent. Accordingly, the IRS will value the present value of the charitable interest at $929,774 and the present value of the remainder interest at $70,226—approximately the same values as in Example 1. Now assume that the actual rate of investment return is 7 percent as indicated in Example 2. In the first year, the charity receives $786,450 ($1,070,000 × 0.735), and $283,550 is left in the trust. In the second year, the trust grows to $303,400 ($283,550 × 1.07) and the charity receives $223,000 ($303,400 × 0.735). At the end of the 2-year term, the amount in the trust will be $80,400—the same amount as would be left in a separate trust funded with an initial gift of $70,226. This is because a proportionate share of the growth of trust assets goes to the charity. The CLAT produces better results in Example 2 because the remainder beneficiaries of the CLAT receive the benefit of the improved investment performance of the entire trust—not just the share of the trust representing the value of the remainder interest.

The reason the CLAT produces better results is that the remaindermen are receiving the benefit of improved investment performance on a much larger fund than would be the case if they had been the beneficiaries of a much smaller separate trust benefiting only themselves.

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§18A.15 1. Benefits of Leverage

When compared to the alternative of making outright gifts to both charities and family members, it becomes clear that the primary advantage of the CLAT is that the benefits to the remaindermen are "leveraged" in that they benefit not only from higher than assumed investment performance on assets having a value equal to the present value of the noncharitable gift, but also from the same higher performance on the assets initially equal in value to the present value of the charitable interest.

The amount of leverage depends on the relative sizes of the initial present values of the charitable and noncharitable gifts. Higher ratios produce higher leverage. Suppose, for example, that the donor established a 5-year, $1-million CLAT making annual payments of $230,000. The present value of the remainder interest under IRC §7520 will be a mere $3303. The future value of the remainder interest is assumed to be $4215. However, if the actual investment rate of return is 7 percent, the value of the property passing to the noncharitable beneficiaries after 5 years will be $79,881, more than 15 times the amount projected by the IRS.

The benefits of leverage also depend on the length of the term. If it is assumed that the CLAT assets will continue to produce a high rate of return, a longer term will produce better results if the assumption is correct. However, leverage is reduced as time passes, because the present value of the charitable interest keeps getting smaller and the present value of the remainder interest keeps getting larger.

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§18A.16 2. Benefits of a Low Present Value Remainder

For several reasons, CLATs should be designed so that the present value of the remainder is negligible when the trust is established. If the present value of the remainder is more than negligible, there are excess funds in the trust that are not producing any of the special benefits associated with the use of a CLAT.

First, the present value of the remainder is the value of the gift for transfer tax purposes. If the trust investment return is unexpectedly lower than the IRC §7520 rate used to value the gift, the gift will have been overvalued. However, this risk is minimized if the gift had little value in the first place. As with so-called zeroed-out GRATs (see §15.15), it is best to create a situation in which there is a lot to gain if investment performance is good and very little to lose if performance is bad.

Second, as noted in §18A.15, the greater the ratio between the size of the present value of the charitable interest and the size of the present value of the remainder interest, the greater the benefits of "leverage."

Finally, as noted in §18A.12, in situations involving nonexempt generation-skipping CLATs, a large present value for the remainder interest indicates that there are excess funds in the CLAT that should instead be transferred to a trust having only skip-person beneficiaries. This results in a "direct skip" transfer and therefore a lower effective rate of tax than will occur on the taxable termination that occurs at the end of the charitable term.

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§18A.17 C. Implicit Assumptions of Favorable Scenarios

In assessing nongrantor CLAT projected results, it is necessary to keep in mind a variety of factors. First, the results are unlikely to be favorable unless it is assumed that the grantor would have made the large gift to charity in any event and that no charitable income tax deduction would have been allowed for the gift.

Second, projections should take into account the fact that no IRC §2503 annual gift tax exclusions are allowed for gifts of the remainder interest because these are gifts of future interests. (This problem cannot be solved with *Crummey* withdrawal powers because the trust cannot make distributions to noncharitable beneficiaries until expiration of the charitable term. Besides, it would be poor strategy to waste annual exclusions on transfers that will primarily benefit charity.) This point will be irrelevant if the donor has already exhausted the current year's annual exclusions for transfers to the trust remaindermen.

It is also extremely important to keep in mind that leverage is a double-edged sword. If the trust's actual investment performance is worse than assumed under IRC §7520, the remaindermen end up substantially worse off than if the donor had made a separate gift to a trust for their benefit. In this respect, it is important to take administration costs into consideration. Unless these costs are kept to a minimum, it may be exceptionally difficult to achieve favorable results.

Income taxes are also a consideration, but in most cases tax considerations should be modest because of the deductions for the distributions to charity. See §18A.6.

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§18A.18 V. SELECTION OF TRUSTEE

No special trustee selection issues are imposed by the rules for obtaining a charitable deduction for a CLAT. However, trustee selection still presents the usual issues involved in designing an irrevocable trust that is intended to avoid estate tax inclusion as well as grantor trust status. Because the trustee typically has no distribution discretion during the charitable term, it may sometimes be feasible to permit the donor or the donor's spouse to be the trustee during that period, with a successor taking over before discretionary distributions can be made to other beneficiaries.

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VI. CLAT DRAFTING REQUIREMENTS

§18A.19 A. Overview

Generally, the requirements for drafting a CLAT are somewhat simpler than for a CRAT. The fundamental requirements are that the charitable interests must be annuity or unitrust interests and that all of these payments must be made before payments can be made to noncharitable beneficiaries. (It is permissible to establish a completely separate share of the trust to make earlier distributions to noncharitable beneficiaries, but it is simpler to accomplish this with a separate trust.) Depending on the size of the charitable interest, most or all of the private foundation excise tax rules will apply to the trust, resulting in modest governing instrument requirements. See §18A.20. Because of the limited tax benefits for CLATs, the remaining restrictions are relatively modest. In contrast to a charitable remainder trust (CRT), there are no minimum or maximum term requirements, except for the applicable rule against perpetuities, nor is there a minimum charitable benefit requirement.

In the context of inter vivos trusts, the more complicated drafting problems are likely to involve the usual desirability of ensuring that the trust is not a grantor trust for income tax purposes (see §18A.27) and that the donor does not retain any powers that could result in the trust being included in the grantor's estate. The IRS has issued sample forms for inter vivos CLATs in Rev Proc 2007-45, 2007-29 Int Rev Bull 89. The IRS has also issued sample forms for testamentary CLATs in Rev Proc 2007-46, 2007-29 Int Rev Bull 102.

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B. Required and Highly Desirable Provisions

§18A.20 1. Guaranteed Annuity Interest

The CLAT must provide the charity with a "Guaranteed annuity interest." Under Treas Reg §1.170A-6(c)(2)(i):

> (A) An income interest is a "guaranteed annuity interest" only if it is an irrevocable right pursuant to the governing instrument of the trust to receive a guaranteed annuity. A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term or for the life or lives of an individual or individuals, each of whom must be living at the date of transfer and can be ascertained at such date. * * * An amount is determinable if the exact amount which must be paid under the conditions specified in the governing instrument of the trust can be ascertained as of the date of transfer. * * *
>
> (E) Where a charitable interest in the form of a guaranteed annuity interest is transferred after May 21, 1972, the charitable interest generally is not considered a guaranteed annuity interest if any amount may be paid by the trust for a private purpose before the expiration of all the charitable annuity interests. * * *

For the most part, these requirements are straightforward as long as the drafter is not attempting to do something unusual. The trust must be irrevocable, and the payments to charity cannot be subject to conditions. The amount of the payments can be stated in terms of a fixed dollar amount or as a percentage of the value of the trust assets on the date of the transfer. In contrast to requirements for charitable remainder trusts, there are no minimum or maximum distribution requirements. The annuity amount can be described as a formula that will produce a charitable deduction equal to a specified percentage of the value of the trust. This is primarily useful in the context of a testamentary CLAT, because the drafter will not know what the IRC §7520 rate will be at the settlor's death.

There is also no limitation on the term of the trust, although the term should be less than the period allowed under the Rule Against Perpetuities. Because it is rarely appropriate for a CLAT to define the lead interest with reference to lives in being, the term will usually be stated as a specific number of years. If so, for a trust created in California, the Rule Against Perpetuities will not be violated as long as the trust will terminate in 90 years. Prob C §21205(b).

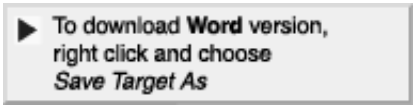
The regulations limit the class of persons whose lives can be the measuring lives for the charitable lead interest. Permissible measuring lives include the settlor, the settlor's spouse, and any individual who, with respect to all noncharitable remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor. The regulations permit the naming of unrelated contingent remainder beneficiaries if there is less than a 15-percent probability that the remainder will pass to a person who does not have a permitted relationship to the measuring-life individual. Treas Reg §1.170A-6(c)(2)(i)(A).

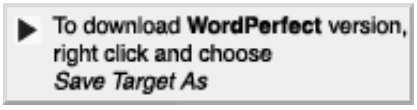
Because the interest of the charity must be determinable at the outset, the IRS contends that the trust must prohibit commutation during the trust term. Rev Rul 88-27, 1988-1 Cum Bull 331.

It might be noted that there are exceptions to the general rule that a CLAT cannot permit distributions for private purposes during the term of the charitable annuity. The regulations allow a deduction for a charitable interest in a CLAT even though a private interest begins before the expiration of the charitable interest if the private interest is in the form of a guaranteed annuity interest and the trust instrument does not provide any preference or priority in payment of the private annuity as opposed to the charitable annuity, or the private annuity is payable only from a group of assets devoted exclusively to private purposes. Treas Reg §1.170A-6(c)(2)(i)(E). It is difficult to conceive of a situation in which it would be desirable to draft a trust that would make use of these exceptions.

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§18A.21 2. Form: Payment of Guaranteed Annuity





18A.21-1 Payment of guaranteed annuity

***Payment of Guaranteed Annuity*. The "charitable beneficiary" of the trust is _ _[*name of charity*]_ _. The "charitable term" of this trust begins immediately and terminates _ _[*number of years of the lead term*]_ _ hereafter. The "annual annuity amount" is _ _[_ _[*dollar amount*]_ _/_ _[*number*]_ _ *percent of the fair market value of the trust on* _ _[*date*]_ _]_ _. On the first December 31st during the charitable term, the trustee shall distribute to the charitable beneficiary the annual annuity amount multiplied by a fraction having a numerator of the number of days of the charitable term that fall within the current calendar year and a denominator of the number of all days in the current calendar year. On each subsequent December 31st during the charitable term, the trustee shall distribute to the charitable beneficiary the annual annuity amount. On the last day of the charitable term the trustee shall distribute to the charitable beneficiary the annual annuity amount multiplied by a fraction having a numerator of the number of days of the charitable term that fall within the calendar year in which the term expires and a denominator of the number of all days in that calendar year. All such payments shall be made first from ordinary income other than unrelated business income, then from short-term capital gains, then from long-term capital gains, then from unrelated business income, then from tax-exempt income, and then from principal. Undistributed income shall be added to principal. The trustee shall not make any other distributions until the charitable term has expired and all required distributions to the charitable beneficiary have been made. These distributions shall not be prepaid or commuted.**

[*Add if annuity amount is described as a percentage of fair market value*]

***Adjustment for Incorrect Valuation*. If the initial fair market value of the trust assets is incorrectly determined, then, within a reasonable period after the value is correctly determined, the trustee shall pay to the charitable beneficiary (in the case of an undervaluation) or shall receive from the charitable beneficiary (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.**

Comment: The trust should then provide for the disposition of the trust estate following conclusion of the charitable term. These may include retention of the assets in trust. Because no charitable deductions are allowed for subsequent transfers to the trust, the trust instrument should describe all the assets of the trust and further provide that the trust term begins immediately.

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§18A.22 3. Private Foundation Prohibitions

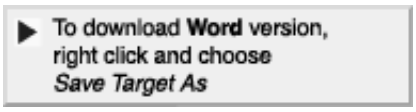
Generally, a CLT is subject to private foundation excise taxes imposed under IRC §§4941-4945. IRC §4947(a)(2). See §§18.79-18.80. Under IRC §§508(e) and 4947(a)(2) the governing instrument must contain the prohibitions stated in form 18A.23-1 except as stated in the form comment. In IRS Letter Ruling 200029033, the IRS ruled that noncharitable remaindermen of a 20-year CLAT could have the power to select charitable recipients of payments from the trust after the grantor's death and may select private foundations without violating the self-dealing rules, even if they are managers of the selected foundations, because any benefit to the manager will be "incidental or tenuous." Treas Reg §53.4941(d)-2(f)(2).

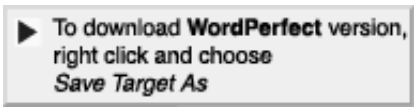
Private foundations are generally subject to a 2-percent excise tax on net investment income. IRC §4940(a). In Notice 2004-35, 2004-1 Cum Bull 889, the IRS stated that it will propose regulations clarifying that net investment income does not include distributions from trusts or estates, and that the distributions will not retain their character in the hands of the foundation for purposes of determining net investment income under IRC §4940(c). In Notice 2004-36, 2004-1 Cum Bull 889, the IRS stated that it will propose regulations consistent with *Ann Jackson Family Found.* (1991) 97 TC 534, aff'd (9th Cir 1994) 15 F3d 917. In that case, the Tax Court and the Ninth Circuit held that a private foundation need not include the income portion of trust distributions in "distributable amounts" for purposes of the IRC §4942 tax on undistributed income, as required by Treas Reg §53.4942(a)-2. These two notices greatly facilitate the use of charitable lead trusts. See 16 Prob Prac Rep 10 (June 2004).

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Source: Estate Planning/Drafting California Irrevocable Trusts/18A Nongrantor Charitable Lead Annuity Trusts/§18A.23 4. Form: Annuity Trust or Unitrust Mandatory Clause (Private Foundation Prohibitions)

§18A.23 4. Form: Annuity Trust or Unitrust Mandatory Clause (Private Foundation Prohibitions)





18A.23-1 Private foundation prohibitions

***Prohibited Transactions*. During the charitable term the trustee is prohibited from engaging in any act of self-dealing as defined in Internal Revenue Code §4941(d), from retaining any excess business holdings as defined in Internal Revenue Code §4943(c) that would subject the trust to tax under Internal Revenue Code §4943, from making any investments that would subject the trust to tax under Internal Revenue Code §4944, and from making any taxable expenditures as defined in Internal Revenue Code §4945(d). The trustee shall make distributions at such time and in such manner so as not to subject the trust to tax under Internal Revenue Code §4942.**

Comment: In the rare case that the present value of the lead interest at the inception of the trust is less than 60 percent of the total assets of the trust on that date, the trust will not be subject to IRC §§4943-4944, in which case the prohibitions concerning those sections may be deleted. IRC §4947(b)(3)(A); Treas Reg §1.170A-6(c)(2)(i)(D).

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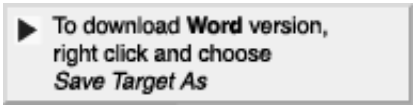
Source: Estate Planning/Drafting California Irrevocable Trusts/18A Nongrantor Charitable Lead Annuity Trusts/§18A.24 5. Charitable Deduction Savings Clause

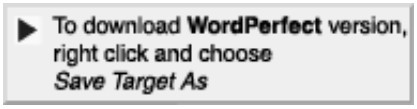
§18A.24 5. Charitable Deduction Savings Clause

Although not expressly required, it is good practice to provide a savings clause that clarifies the intended tax deductions and provides for selection of an alternate charitable recipient if the named charity later fails to qualify. If the CLAT is not intended to qualify for an income tax deduction, it is not necessary for the clause to refer to IRC §170. Indeed, this could be undesirable inasmuch as the estate and gift tax deduction provisions in IRC §§2055 and 2522 allow a broader group of recipients than the income tax provisions as a result of the absence of the IRC §170(c) requirement that the recipient be created under the laws of the United States, a State, the District of Columbia, or a possession of the United States. California has a savings statute for CLATs. Prob C §21541.

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§18A.25 6. Form: Charitable Deduction Savings Clause





18A.25-1 Savings clause

***Purpose of Trust*. The settlor(s) _ _[*intends/intend*]_ _ that the interest passing to _ _[*name of charity*]_ _ under this trust shall be a guaranteed annuity that qualifies for tax deductions under Internal Revenue Code §§2055 and 2522. All clauses of this instrument shall be interpreted according to this intention. The trustee shall have the power to amend the terms of this instrument in writing without application to any court to the extent permitted by the Internal Revenue Code and applicable Treasury Regulations to qualify and continue to qualify the trust for those deductions. If at any time a distribution is otherwise to be made to _ _[*name of charity*]_ _ and _ _[*name of charity*]_ _ is not an organization described in Internal Revenue Code §§2055(a) and 2522(a), the trustee shall make the distribution to one or more organizations selected by the trustee, at the trustee's discretion, which are then so described.**

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§18A.26 7. Other Provisions

A CLAT should include standard trust provisions for establishing and administering an irrevocable trust, including routine trustee power provisions. Although arguably not required, CLATs usually contain a provision prohibiting additional contributions to the trust as required for a charitable remainder annuity trust. See §18.74. In any event, no tax deduction is allowable for a transfer not made at the inception of the trust. The trust may provide that the remaining trust estate is retained in further trust following expiration of the charitable term.

A complete sample form is provided in App K.

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§18A.27 VII. AVOIDING GRANTOR TRUST STATUS

Merely stating that a CLAT is a "nongrantor" trust that is not taxed to the grantor under IRC §671 does not produce that result. The drafter of a nongrantor CLAT confronts the same issues that are confronted with any inter vivos irrevocable trust that is not to be taxed to the grantor and not to be included in the grantor's estate. In IRS Letter Ruling 200404009, the IRS issued extensive favorable rulings concerning CLATs that made most charitable distributions to a private foundation but allowed the noncharitable remainder beneficiaries to appoint some distributions to other charities. The IRS ruled that the powers to appoint among charities did not cause grantor trust status, because of the express terms of IRC §674(b)(4). While the trust document and ruling request may be more detailed than necessary, they provide something of a checklist that drafters may find helpful. For a general discussion of the grantor trust rules, see §§3.22-3.44A. See also the discussion of the "pipe dream" trust at §§5.13-5.31.

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§18A.28 VIII. NONQUALIFIED CHARITABLE LEAD TRUSTS

In rare cases, a gift tax deduction may be available for interests in a nongrantor CLT that is not a CLAT or CLUT. As with all nongrantor CLTs, the grantor does not receive an income tax deduction for the contribution to the trust. See §18A.5.

For example, if the grantor retains the right to designate the charities to receive the income each year, the gift of the income interest will be incomplete, but the grantor will treating as making a gift and receive an IRC §2522 gift tax deduction each year as the income is paid at the grantor's direction. The income interest will be disregarded in valuing the remainder interest under IRC §2702, however, if a spouse, sibling, ancestor, or descendant of the grantor, or spouse of a sibling, ancestor, or descendant has the remainder interest. As a result, this technique is effective only for transfers to non-family members or more distant relations, such as nieces and nephews.

If the income interest is divided among many charities so that the value of the interest of each charity on creation of the trust is less than $13,000, the gift of the income interest to each charity is a gift of a present interest that should be eligible for the IRC §2503(b) annual gift tax exclusion. If the trust is not a grantor trust, the grantor will not be taxed on the income. This exclusion from income has the same effect as an annual income tax deduction but is not subject to the percentage limitations of IRC §170.

Finally, if the grantor sells the remainder interest for its actuarial value as determined under IRC §7520 and makes a gift of the income interest to charity, the grantor may receive an IRC §2522 gift tax deduction for the income interest under an exception to the general rule of disallowance of the deduction for partial interests. See IRS Letter Ruling 8008105. The income interest will not be disregarded in valuing the remainder interest under IRC §2702, even if a spouse, sibling, ancestor, or descendant of the grantor, or spouse of a sibling, ancestor, or descendant has the remainder interest, because the grantor does not retain an interest in the trust.

For further discussion of these techniques, see McCaffrey, *Charitable Lead Trusts—Estate Planning for the Philanthropic Optimist*, Estate Planning 2003, chap 7 (Cal CEB 2003). See also Grumet, *Choosing the Best Charitable Lead Trust to Meet a Client's Needs*, 30 Est Plan 86 (2003).

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19

Issues Related to Nature of Trust Assets

Diana Hastings Temple
Sandra J. Chan

I. INTRODUCTION §19.1

II. REAL PROPERTY
- A. Creation and Validity of Trusts Containing Real Property §19.2
- B. Powers Relating to Real Property Discussed Elsewhere §19.3
- C. Power to Subdivide and Sell Real Property
  - 1. Trustees Have Specific Power to Subdivide, Develop, and Sell Land §19.4
  - 2. Form: Power to Subdivide and Sell Property §19.5
- D. Powers Related to Employment of Managers and Brokers
  - 1. Power to Employ Managers and Brokers §19.6
  - 2. Form: Power to Employ Property Managers to Assist Trustee §19.7
  - 3. Form: Power to Employ Real Estate Brokers §19.8
  - 4. Form: Payment of Managers' and Brokers' Compensation §19.9
  - 5. Form: Exonerating Trustee for Liability for Acts of Agents §19.10
- E. Allocation of Items Between Income and Principal
  - 1. Gains and Losses From Sale of Property §19.11
  - 2. Form: Allocation of Gains or Losses Differs From Statute §19.12
  - 3. Option Money
    - a. Allocation of Gains and Losses Is Similar to Sale of Real Property §19.13
    - b. Form: Allocation of Forfeited Option Money §19.14
  - 4. Taxes and Assessments
    - a. Allocation of Taxes and Assessments §19.15
    - b. Form: Allocation of Taxes and Assessments §19.16
  - 5. Expenses of Rental Property
    - a. Allocation of Expenses of Rental Property §19.17
    - b. Form: Creation of Depreciation Allowance to Allocate Extraordinary Repairs or Expenses to Income §19.18
  - 6. Allocation of Depreciation, Depletion, or Obsolescence §19.19
  - 7. Power to Address Environmental Cleanup Concerns
    - a. Fiduciary Liability Limited to Trust Assets §19.20
    - b. Form: Power to Monitor Property and Comply With Environmental Laws §19.21
    - c. Form: Special Trustee to Accept Real Property §19.22

III. PERSONAL PROPERTY
- A. Powers Relating to Personal Property Discussed Elsewhere §19.23
- B. Stocks in Publicly Traded Companies
  - 1. Powers to Deal With Stock §19.24
  - 2. Allocations of Corporate Distributions Between Income and Principal §19.25
  - 3. Form: Allocations to Income Consistent With Tax Treatment §19.26
- C. Bonds and Other Obligations for Payment of Money §19.27
  - 1. Form: Power to Purchase Bonds at Premium §19.28
  - 2. Form: Power to Purchase Bonds at Discount §19.29
- D. Puts, Calls, Margin Accounts, and Other Specialized Investments
  - 1. No Statutory Authority for Specialized Investments §19.30
  - 2. Form: Power to Make Specialized Investments §19.31
- E. Tangible Personal Property
  - 1. Difficulties of Holding in Trust §19.32
  - 2. Form: Power to Abandon Property §19.33

IV. UNDERPRODUCTIVE PROPERTY
- A. Duty to Make Property Productive

1. Trustee Has Duty to Make Property Productive, But Investment in Underproductive Property May Be Prudent §19.34
2. Form: Authorization to Acquire and Retain Underproductive Property §19.35
3. Form: Power to Permit Beneficiaries to Occupy Residential Real Estate §19.36
B. Allocations of Proceeds of Sale of Underproductive Property Between Income and Principal
1. Definition of "Underproductive Property" §19.37
2. Statutory Adjustment Power §19.37A
3. Form: Allocation of Proceeds of Sale §19.38
4. Form: No Special Adjustments for Underproductive Property §19.39
C. Allocation of Expenses Pertaining to Underproductive Property
1. Ordinary Expenses Allocated to Income §19.40
2. Form: Allocation of Ordinary Expenses to Principal §19.41
3. Form: Definition of "Ordinary Expenses" §19.42
D. Tax Considerations §19.43
1. Marital Deduction Trusts §19.44
2. Form: Full Beneficial Enjoyment Accorded to Spouse §19.45
3. Form: Spouse's Power to Compel Conversion to Productive Property §19.46
4. Estate and Income Tax Implications to Settlor-Trustee or Beneficiary-Trustee
a. Trust Taxable to Settlor-Trustee §19.47
b. Form: Powers Exercisable Only in Trustee's Fiduciary Capacity §19.48
5. Trusts Containing Charitable Interests §19.49

V. ENCUMBERED PROPERTY
A. Settlors Must Provide for Payments on Encumbrance §19.50
B. Allocations of Payments on Encumbrances
1. Payments Divided Between Income and Principal §19.51
2. Form: Allocation of Payments §19.52
C. Tax Considerations of Transfer of Encumbered Property
1. Income Tax Implications of Payment of Encumbrance
a. When Settlors Are Personally Liable on Encumbrance §19.53
b. When Settlors Are Not Personally Liable on Encumbrance §19.54
2. Capital Gains Tax Implications of Transfer §19.55
3. Gift Tax Implications of Transfer §19.56
4. Estate Tax Implications of Transfer §19.57

VI. TRANSFERS WITH LEASEBACKS §19.58
A. Income Tax Treatment of Lease Payments
1. Income to Nongrantor Trust §19.59
2. Deductibility of Lease Payments by Settlors §19.60
3. Treatment of Income for Grantor Trust §19.61
B. Sale of Property to Trust
1. Advantages and Disadvantages of Sale to Trust §19.62
2. Installment Sale Treatment §19.63
3. Realization of Capital Gain §19.64
4. Nonrecognition of Capital Loss §19.65
5. When Trust Is "Grantor Trust" §19.66

VII. MORTGAGES, DEEDS OF TRUST, AND OTHER SECURED INSTRUMENTS §19.67
A. Power to Subordinate
1. Need for Power to Subordinate §19.68
2. Form: Grant of Power to Subordinate §19.69
B. Investments in Default
1. Need for Power to Foreclose §19.70
2. Form: Authorization to Foreclose and Bid on Property §19.71
3. Allocation of Proceeds on Disposition of Property Acquired by Foreclosure §19.72
4. Form: Allocation of Sale Proceeds of Property Acquired by Foreclosure §19.73

VIII. BUSINESS INTERESTS
A. Chapter 14 §19.74
1. Transfers of Interests in Corporations and Partnerships §19.75
2. Buy-Sell and Other Restrictive Agreements §19.76
3. Family Partnership Income Tax Rules
a. Family Partnership Test §19.77
b. When Donor May Be Treated as Substantial Owner of Interest §19.78

4. Partnership Interests in General §19.79
B. Power to Retain or Acquire Business Interests §19.80
1. Form: Authority to Invest in Partnerships §19.81
2. Form: Authority to Incorporate, Continue to Operate Business in Corporate or Unincorporated Form, and Form Corporations §19.82
3. Form: Authority to Consent to Corporate Transactions §19.83
4. Form: Authority to Retain Specified Business Interest §19.84
C. Directions on Management of Business Enterprise §19.85
D. Exoneration of Trustee From Liability for Management of Business Interest §19.86
E. Trustee's Compensation in Connection With Management of Business §19.87
1. Form: Reasonable Compensation in Connection With Business Interest §19.88
2. Form: Compensation as Officer of Corporation Not to Interfere With Trustee's Compensation §19.89
F. Expenses of Ongoing Business
1. Reimbursement of Trustee §19.90
2. Form: Reimbursement of Trustee for Expenses Related to Business §19.91
3. Allocation of Net Receipts and Proceeds of Liquidation §19.92
a. Form: Definition of "Income" §19.93
b. Form: Allocation of Net Cash Receipts §19.94
c. Form: Allocation of Proceeds of Liquidation §19.95
G. Stock in S Corporations §19.96
1. Grantor Trusts §19.97
2. Marital Deduction Trusts §19.98
3. Qualified Subchapter S Trusts (QSSTs)
a. Requirements §19.99
b. Form: Qualification of Trust as QSST §19.100
4. Liquidating Distributions
a. Disparate Provisions in Internal Revenue Code and Regulations §19.101
b. Form: Power to Make Distributions to Pay Capital Gains Tax §19.102
5. Electing Small Business Trusts (ESBTs) §19.102A
H. Stock of "Controlled" Corporations
1. When Settlors May Retain Right to Vote §19.103
2. Form: Power to Vote Stock of "Controlled" Corporation §19.104
I. Stock Subject to Securities Acts Restrictions §19.105
1. Rule 10b-5 §19.106
2. Section 16 §19.107
3. Securities Act and Rule 144 §19.108

IX. ASSETS SUBJECT TO DEPLETION (WASTING ASSETS), INTELLECTUAL PROPERTY, AND RETIREMENT PLANS
A. Use of Wasting Assets to Fund Trust §19.109
B. Allocation of Expenses and Income
1. Rules for Allocation of Receipts §19.110
2. Form: Establishment of Reserve for Depreciation, Depletion, and Amortization §19.111
C. Natural Resources
1. Trust's Lease or Ownership of Property Containing Natural Resources §19.112
2. Form: Trustee to Allocate to Income Given Percentage of Receipts From Property Containing Natural Resources §19.113
D. Intellectual Property §19.114
1. Assignment and Licensing of Copyrights §19.115
2. Copyright Term and Renewal and Termination Rights §19.116
E. Retirement Plans §19.117

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§19.1 I. INTRODUCTION

Because of differences inherent in the nature of the type of assets, the trustee's discharge of the responsibility to preserve and administer the trust's property may vary accordingly. For this reason, the administration of a trust may run much more smoothly if the drafter of the trust instrument considers the assets that will comprise the trust estate. This chapter examines some of the issues posed by the character of various assets and suggests drafting techniques to meet these situations.

Before executing the trust instrument and any transfer documents, the drafter and the settlors might consider a pretransfer review of the documents by the transfer agent for the assets. For example, if the proposed transfer concerns real estate, a review of the proposed documents with a title company may alert the drafter to particular clauses that should be included in or excluded from the trust instrument.

Issues unique to life insurance are discussed in chap 11. Issues unique to employee retirement plans are discussed in §19.117. If assets transferred to the trust are not likely to be sold (*e.g.,* because of a lack of marketability or the settlors' desire that an asset be retained), the trustee should be authorized to retain these assets and be protected from liability for doing so. A form for such authority may be found in §10.63.

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II. REAL PROPERTY

§19.2 A. Creation and Validity of Trusts Containing Real Property

California trust law contains its own specific Statute of Frauds for real property located in California and its own specific protection for bona fide purchasers for value. Under the statute, the trust relationship must be evidenced by an instrument in writing signed by the trustee, the trustee's agent if authorized in writing, the settlors or the settlors' agent if authorized in writing, or "by operation of law" (Prob C §15206). The rights of a person dealing with a trustee in good faith and for a valuable consideration are protected (Prob C §§18103-18104). For trusts that contain real property located in other jurisdictions, the law governing the creation and validity of trusts in that jurisdiction applies. See chap 20.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.3 B. Powers Relating to Real Property Discussed Elsewhere

§19.3 B. Powers Relating to Real Property Discussed Elsewhere

Several issues that relate to the administration of trusts containing real property are discussed in chap 10, which covers the trustee's general powers and administrative provisions. The following powers are discussed in the specified sections:

- Power to encumber property (see §§10.67-10.68);
- Power to compromise and release claims and debts (see §10.85);
- Power to carry insurance against contractual and tort liability (see §§10.86-10.87);
- Power to distribute real property in kind (see §§10.106-10.107); and
- Spendthrift provisions for real property trusts (see §§10.123-10.124).

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C. Power to Subdivide and Sell Real Property

§19.4 1. Trustees Have Specific Power to Subdivide, Develop, and Sell Land

California law provides trustees with the specific power to subdivide and develop land, dedicate land to public use, make or obtain the vacation of plats, adjust boundaries, adjust differences in valuation on exchange or partition, and dedicate easements to public use. Prob C §16230. Trustees also have the statutory power to grant options involving the disposition of property (see Prob C §16233) and to encumber property "in connection with the exercise of any power vested in the trustee" (see Prob C §16228). The settlors may prefer to provide such specific powers in the trust instrument, particularly if the settlors intend for the trust to engage in the active development of real property, because of questions that may arise regarding the trustee's power to dedicate trust property without consideration, to sign applications or other documents required in the establishment of a subdivision, and to place easements or restrictions on it for other than public use.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.5 2. Form: Power to Subdivide and Sell Property

§19.5 2. Form: Power to Subdivide and Sell Property

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19.5-1 Power to subdivide and sell property

***Power to Subdivide Property*. The trustee shall have the power, on terms and conditions that the trustee, at the trustee's discretion, determines, to:**

(1) Subdivide and resubdivide any real property of this trust;

(2) Sign any applications, maps, and other documents necessary to implement subdivision or resubdivision;

(3) Zone or rezone any trust property or secure any variance for the use of, or secure any permits for the nonconforming use of, any trust property;

(4) Grant and dedicate, without receipt of consideration, any part of the trust property for streets, alleys, parkways, parks, or other public purposes;

(5) Impose on such property easements, rights of way, conditions, covenants, restrictions, and other servitudes as the trustee, at the trustee's discretion, determines to be proper;

(6) Encumber the property to secure funds for its improvement, and

(7) Perform all other acts necessary or proper to effect subdivision or resubdivision of property.

As used in this clause, the term "subdivision" includes the subdivision of property for purposes of development as condominiums, planned unit developments, or other similar projects.

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D. Powers Related to Employment of Managers and Brokers

§19.6 1. Power to Employ Managers and Brokers

A trustee may delegate "investment and management" functions as prudent under the circumstances. Prob C §16052(a). The trustee may employ advisors, even if associated or affiliated with the trustee, "to advise or assist the trustee in the performance of administrative duties," unless the trust instrument forbids such employment. Prob C §§16046(b), 16247.

Particularly when the trustee will invest in real property development or management projects but has little or no experience with such matters, the settlors may prefer to state explicitly the trustee's power to hire real estate agents and brokers. If the trustee will be paid on a percentage basis, rather than on an hourly or "reasonable" basis, the settlors may also prefer a specific direction on whether the trustee must pay the compensation of such managers and agents from the trustee's own fees or whether the trust will pay for such compensation in addition to the trustee's fees.

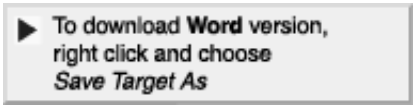
If the compensation of such agents is related to the administration, management, or preservation of trust property, it is to be charged to income. Prob C §16370(c). If, however, the compensation is related to the preparation of property for rental or sale, it is charged to principal. Prob C §16373(b). Thus, it may be difficult for the trustee to know how to allocate property management fees and other fees and costs. For this reason, the settlors may prefer to provide for the allocation of compensation in the trust instrument.

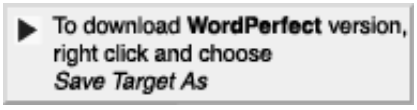
Moreover, the settlors may wish to absolve the trustee from liability for managers' and agents' acts and omissions, even if the settlors are relying on Prob C §16052 to permit the trustee to delegate investment or managerial functions to an agent. The settlors may particularly wish to absolve the trustee from liability when the trustee is inexperienced in the tasks for which the managers or agents are hired.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.7 2. Form: Power to Employ Property Managers to Assist Trustee

§19.7 2. Form: Power to Employ Property Managers to Assist Trustee





19.7-1 Power to employ property managers to assist trustee

***Power to Employ Property Managers*. The trustee shall have the power, on terms and conditions that the trustee, at the trustee's discretion, determines, to employ persons, including investment advisors, real property managers, or other agents _ _[*, but not if they are associated or affiliated with the trustee,*]_ _ to advise or assist the trustee in the performance of the trustee's duties.**

Comment: The bracketed clause might be used if the settlors do not wish the trustee to hire his or her own company to perform managerial functions.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.8 3. Form: Power to Employ Real Estate Brokers

§19.8 3. Form: Power to Employ Real Estate Brokers

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19.8-1 Power to employ real estate brokers

***Power to Employ Real Estate Brokers*. The trustee shall have the power, on terms and conditions that the trustee, at the trustee's discretion, determines, to:**

(1) Employ real estate agents and brokers to facilitate the sale or leasing of any property of the trust estate;

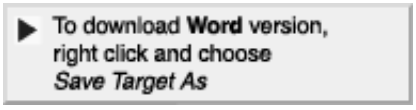
(2) List property for sale or lease; and

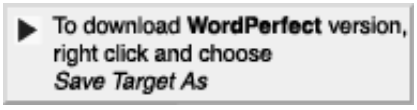
(3) Grant an exclusive right to sell or lease any property of the trust estate.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.9 4. Form: Payment of Managers' and Brokers' Compensation

§19.9 4. Form: Payment of Managers' and Brokers' Compensation





19.9-1 Payment of managers' and brokers' compensation

***Compensation of Managers and Brokers*. The trustee shall have the power, on terms and conditions that the trustee, at the trustee's discretion, determines, to pay the compensation of investment advisors, real property managers, real estate agents or brokers, or other agents involved in the management of real property as a proper expense of this trust and not of the trustee personally.**

[*Use one of the following alternatives*]

[*Alternative 1: Trust to bear expense of agents*]

The expense of compensation of investment advisors, real property managers, real estate agents or brokers, or other agents involved in the management of real property shall be allocated _ _[*one half to income and one half to principal/all to income/all to principal/to income or to principal, or to both, as the trustee, at the trustee's discretion, determines*]**_ _.**

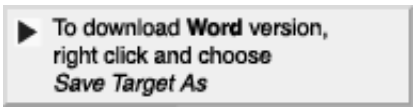
[*Alternative 2: Trustee to bear expense of agents*]

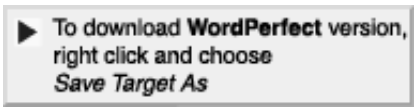
The expense of compensation of investment advisors, real property managers, real estate agents or brokers, or other agents involved in the management of real property shall be borne by the trustee personally and shall not be charged as an expense of this trust.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.10 5. Form: Exonerating Trustee for Liability for Acts of Agents

§19.10 5. Form: Exonerating Trustee for Liability for Acts of Agents





19.10-1 Trustee not liable for acts of agents

***Nonliability of Trustee for Acts of Agents*. The trustee shall not be responsible for any act, omission, or wrongdoing of any investment advisor, real property manager, real estate agent or broker, or other agent involved in the management of real property unless the trustee fails to use _ _[*reasonable care/good faith*]_ _ in the selection or supervision of such agents.**

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E. Allocation of Items Between Income and Principal

§19.11 1. Gains and Losses From Sale of Property

In the most ordinary situation, real property is leased or rented, and the rent is allocated to income while any capital gain or loss on the sale of the real property is allocated to principal. See Prob C §§16355(b), 16356. The real property held by the trust, however, might be held specifically for the purpose of making a profit on the sale of the real property. This situation most commonly occurs when the trust is involved in the business of developing real property.

In such a situation, it makes little economic sense to allocate all the profit to principal with no current income for an income beneficiary. In some situations, the settlors may wish to allocate at least a portion of the profits to income. For more complete discussion of underproductive property, see §§19.34-19.49.

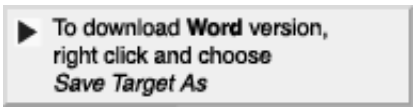
As an alternative, the settlors may wish to use a unitrust interest or to give the trustee liberal powers of invasion. See Halbach, *Planning and Drafting To Solve Principal and Income Problems*, 21 USC Tax Inst 541 (1969). Some of these options may not be available, however. If, for example, the drafter intends that transfers to the trust will qualify for the federal gift tax marital deduction, it will be necessary to provide the spouse with a standard income interest (which may be converted to a unitrust interest under Prob C §§16336.4-16336.7) or a unitrust interest with a payout percentage no less than 3 percent and no more than 5 percent that satisfies the definition of income in Prob C §16328 and Treas Reg §1.643(b)-1 (incorporated by reference in Treas Reg §25.2523(e)-1(f)(1)) to meet the statutory requirements for the deduction. IRC §2523.

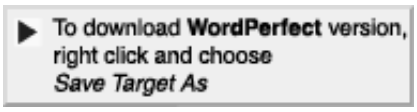
The settlors might consider including a clause that provides for the allocation of gain or loss in this situation. If the settlors are unsure how the situation should be handled, but want the trustee to avoid the need to seek a court order for instructions, the settlors may provide that the allocation is left to the trustee's discretion. Some guidelines to the trustee or some examples of allocations would be helpful to the trustee. Because they are not binding on the trustee, they may be contained in a separate letter to the trustee. Generally, an independent trustee can be given broad discretion to determine principal and income or even to make adjustments between them to take into account investment decisions. See Prob C §16336. However, such discretion should not be given to a beneficiary who might benefit from an exercise of the power because this might be deemed to give the beneficiary a general power of appointment with respect to that portion of the trust that the beneficiary could distribute to himself by exercising an overly broad power. IRC §2041. This restriction does not apply to the unitrust conversion power. See Prob C §16336.4.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.12 2. Form: Allocation of Gains or Losses Differs From Statute

§19.12 2. Form: Allocation of Gains or Losses Differs From Statute





19.12-1 Allocation of gains or losses differs from statute

***Allocation of Gain or Loss*. The trustee shall allocate any gain or loss resulting from the sale, exchange or other taxable transfer of real property to _ _**[*income/income or principal, as the trustee, at the trustee's discretion, determines*]**_ _.**

Comment: If the trustee is or may be a "tax-sensitive" trustee (*e.g.*, the settlor, a beneficiary, or a nonadverse, nonindependent party), the use of such a discretionary power might be construed as a power to control beneficial enjoyment under IRC §674 unless the trustee's power may only be exercised in a fiduciary capacity. See *Old Colony Trust Co. v U.S.* (1st Cir 1970) 423 F2d 601.

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3. Option Money

§19.13 a. Allocation of Gains and Losses Is Similar to Sale of Real Property

The active trading or development of real property necessarily involves options to purchase. In this area, the logic of allocating the gains and losses from the sale of the real property should govern. For example, if the trustee sells an option to a potential purchaser and the option is exercised, the option money should be accounted for as a part of the sales proceeds. If the underlying property of the option is ordinarily held for the production of income (*e.g.,* a rental building), the option should be accounted for as principal. If, however, the sales of the underlying property are to produce current income (*e.g.,* the sale of real property lots), the option money should probably be accounted for as income.

If the trustee sells an option but the option is unexercised, the amount paid for an unexercised option is taxable as ordinary income (Treas Reg §1.1234-1(b)), but the amount paid for an exercised option is taxable as capital gain. The rationale behind characterizing income as ordinary or capital gain for income tax purposes, however, is different from the rationale behind the allocation between principal and income for fiduciary and accounting purposes. If the option relates to a principal asset and would be allocated to principal if the option had been exercised, it is logical for trust accounting to allocate unexercised option money to principal.

Naturally, the settlors may prefer to designate the allocation in the trust instrument, especially when the settlors will transfer an asset the sale proceeds of which will be used to generate current income. Alternatively, the settlors may prefer to leave the allocation up to the trustee.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.14 b. Form: Allocation of Forfeited Option Money

§19.14 b. Form: Allocation of Forfeited Option Money

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19.14-1 Allocation of forfeited option money

[*Use one of the following alternatives*]

[*Alternative 1: As provided in trust instrument*]

***Allocation of Option Money*. The trustee shall credit any option money received on the sale of real property and not applied as a credit against the purchase price of such property to trust _ _[*income/principal*]_ _.**

[*Alternative 2: In trustee's discretion*]

***Allocation of Option Money*. The trustee shall credit any option money received on the sale of real property and not applied as a credit against the sales price of such property to trust income or trust principal, or partly to each, as the trustee, at the trustee's discretion, determines.**

Comment: If a settlor or a beneficiary is the trustee, the drafter must be sure that any power to allocate the economic benefits of the trust as provided in Alternative 2 are held only in a fiduciary capacity. See IRC §§674(a), 2036(a), 2038(a)(1).

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4. Taxes and Assessments

§19.15 a. Allocation of Taxes and Assessments

Despite the characterization of capital gains tax as an income tax, it is, for trust accounting purposes, usually charged to principal unless the sale of the property is designed to produce current income. Prob C §16374(b). Like option money and other items perhaps unique to real estate management and development, the settlors may wish to provide for the allocation of capital gains tax in the same way that the capital gains and losses are allocated.

Recurring property taxes on real property are allocated to income, and special assessments are charged to principal. Prob C §§16370(c), 16373(b)(2). Because special assessments are considered to be an extraordinary expense related to capital improvements, however, Prob C §16372(b) also permits the trustee to establish an allowance for depreciation out of income to cover such an item unless the real property in question is a beneficiary's residence.

The settlors may wish to allocate real property taxes or special assessments differently than the statute or may prefer to give the trustee discretion over the allocation of these items. A change from the statute may be warranted if the real property in question is a subdivision, with the sale of lots being used to generate current income.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.16 b. Form: Allocation of Taxes and Assessments

§19.16 b. Form: Allocation of Taxes and Assessments

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19.16-1 Allocation of taxes and assessments

***Allocation of Taxes and Assessments*. The trustee may pay from principal or income, or partially from each, as the trustee, at the trustee's discretion, determines, any property taxes and assessments levied against trust property. The trustee may elect to pay any assessment in a lump sum or in installments and, if the installment method is selected, may treat each installment as a separate levy for the purpose of charging the same to principal or income.**

Comment: If a settlor or a beneficiary is the trustee, any power to allocate the economic benefits of the trust may be held only in a fiduciary capacity. See IRC §§674(a), 2036(a), 2038(a)(1).

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5. Expenses of Rental Property

§19.17 a. Allocation of Expenses of Rental Property

Income is charged with the "ordinary expenses" incurred in the administration of trust property, including water rates, insurance premiums, mortgage interest, and "ordinary repairs." Prob C §16370(c). Other charges, including the expenses of preparing the property for rental, are charged to principal. Prob C §16373(b).

The trustee also has broad powers to set up reserves if charges against income are of "unusual amount" (Prob C §16373(b)) and to set up an allowance for depreciation out of income under generally accepted accounting principles for extraordinary repairs or expenses incurred in making capital improvements (Prob C §16372(b)). Particularly if the trust will own real property used to produce income (either through rentals or sales of lots), the settlors may wish to deviate from or clarify the statutory allocation rules.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.18 b. Form: Creation of Depreciation Allowance to Allocate Extraordinary Repairs or Expenses to Income

§19.18 b. Form: Creation of Depreciation Allowance to Allocate Extraordinary Repairs or Expenses to Income

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19.18-1 Creation of depreciation allowance to allocate extraordinary repairs or expenses to income

***Depreciation Allowance*. The trustee shall establish an allowance for depreciation out of income, according to generally accepted accounting principles, for repairs of and improvements to any real property of the trust estate. Any such depreciation shall be treated as an expense against gross income, regardless of whether such depreciation may be deductible for purposes of any income tax.**

Comment: If a settlor or a beneficiary (when the property in the trust is not intended to be part of the beneficiary's gross estate) is the trustee, the drafter must be sure that any power to allocate the economic benefits of the trust are held only in a fiduciary capacity. See IRC §§674(a), 2036(a), 2038(a)(1).

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§19.19 6. Allocation of Depreciation, Depletion, or Obsolescence

A trustee is not required to set aside a reserve (an allowance from income) for depreciation or depletion of trust property, or any amount to amortize trust property unless expressly required to do so by the trust instrument. Prob C §16372. The trustee has the discretion to establish or continue such a reserve or allowance. In addition, the trustee may, at the trustee's discretion, make a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles, except that no allowance for depreciation may be taken for any portion of real property used as a residence by a beneficiary of the trust. Prob C §16372(b). The court of appeal has held that a depreciation reserve must be allocated to principal even if subsequent events establish that the property in question actually appreciated and the reserve was not necessary. *Stahl v Wells Fargo Bank* (1998) 63 CA4th 396, 73 CR2d 667.

Special rules cover the allocation of depreciation and depletion deductions between the trust and income beneficiaries for income tax purposes. See IRC §§167(d) (depreciation), 611(b) (depletion), 642(e) (depreciation and depletion deduction allowed to the trust to the extent not allowable to beneficiaries). See also Treas Reg §§1.167(h)-1(b) (rule applicable if depreciation deduction exceeds income set aside for reserve), 1.611-1(c)(4) (rule applicable if depletion deduction exceeds income set aside for reserve). Note that the available deduction for amounts paid or permanently set aside for a charitable purpose pursuant to the terms of the trust instrument under IRC §642(c) will be reduced if the trustee sets aside a reserve for depreciation or depletion because the deduction is limited to trust income. See §3.5.

Probate Code §16363 provides that receipts from royalties and other production interests in minerals, water, and other natural resources (other than timber) are allocated 90 percent to principal and the balance to income. The allocation of receipts from timber is provided in Prob C §16364. For other property subject to depletion, the trustee has discretion to set up a reasonable allowance for depletion or amortization. Prob C §16372. When a marital deduction power of appointment trust is used, the trustee's discretion over the trust may be limited. See Treas Reg §20.2056(b)-5(f)(3) (permitting reserve if spouse not deprived of "requisite beneficial enjoyment"). Most practitioners believe that the rules applying to power of appointment trusts also apply to qualified terminable interest property (QTIP) trusts.

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7. Power to Address Environmental Cleanup Concerns

§19.20 a. Fiduciary Liability Limited to Trust Assets

The Resource Conservation and Recovery Act of 1976 (RCRA) (42 USC §§6901-6992k), and the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 USC §§9601-9675) were enacted to deal with the problems of hazardous waste contamination. Under these statutes, certain parties (primarily titleholders) may be personally liable to the United States government or private parties for "response costs" (costs to investigate, monitor, clean up, and otherwise deal with hazardous waste). California imposes similar liability under the Carpenter-Presley-Tanner Hazardous Substances Account Act (Health & S C §§25300-25395.15). Liability under these Acts for titleholders is usually strict, joint, and several, but they limit fiduciary liability to the value of the trust's assets in certain situations. 42 USC §6907(n)(1); 42 USC §6991b(h)(9); Health & S C §25548.3. See *Canadyne-Georgia Corp. v NationsBank* (11th Cir 1999) 183 F3d 1269. A fiduciary is not exempt from liability, however, if:

- The hazardous situation resulted from the fiduciary's own negligent, intentional, or reckless conduct;
- The fiduciary relationship was created to evade such liability; or
- The fiduciary is a beneficiary of the trust.

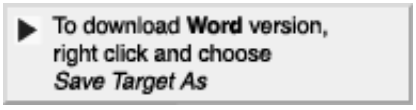
Thus, although the fiduciary who merely holds title to environmentally contaminated real property may be protected from personal liability, the fiduciary who actually operates contaminated property may be exposed to personal liability for cleanup costs as well as civil and criminal penalties. See *U.S. v Petersen Sand & Gravel, Inc.* (ND Ill 1992) 806 F Supp 1346. Acceptance of the property by the trustee is therefore crucial to its own personal liability. Most corporate trustees already require that real property be subjected to an environmental review before its acceptance by that trustee. The settlors may wish to provide a similar ability in an individual trustee as well as indemnification from the settlors' own assets for any personal liability of the trustee. For further discussion, see California Trust Administration, chap 6 (2d ed Cal CEB 2001).

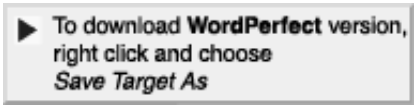
Form 19.21-1 allows the trustee, at the expense of the trust, to conduct an environmental investigation of the trust's property and to use trust assets (including those other than the contaminated property) to comply with environmental cleanup legislation. Form 19.22-1 provides for a special trustee to take control of any real property not specifically accepted by the trustee.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.21 b. Form: Power to Monitor Property and Comply With Environmental Laws

§19.21 b. Form: Power to Monitor Property and Comply With Environmental Laws





19.21-1 Power to monitor property and comply with environmental laws

***Power to Monitor Property*. The trustee may, at the trustee's discretion:**

(1) Inspect from time to time or monitor any property held as part of the trust estate to determine compliance with any law, regulation, or ordinance that may or does affect the property. This power specifically includes the power to inspect assets controlled by any business enterprise held by the trustee.

(2) Take any action to prevent, abate, clean up, or otherwise remedy any actual or threatened violation of any environmental law arising from the existence, condition, maintenance, or use of any property held in any trust created under this instrument.

Action may be taken before or after the initiation of enforcement action by any government agency. The trustee may, at the trustee's discretion, charge the cost of any inspection, monitoring, reporting, preventive activity, abatement, cleanup, or other remedial action against trust income or principal.

(3) Settle or compromise any claim against the trust asserted by any government body or private party involving the violation of any environmental law alleged to result from the existence, condition, maintenance, or use of any trust property.

(4) Decline to accept any property in trust if the trustee determines, at the trustee's discretion, that the property's existence, condition, maintenance, or use (before or after its acceptance into the trust) does or could violate any environmental law, resulting in liability to the trustee or detriment to the value of other trust assets. Acceptance of any property into the trust shall not create any inference regarding the existence of any liability under any environmental law affecting the property.

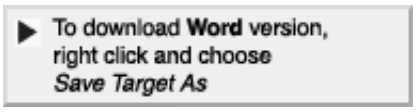
(5) Decline to serve as trustee or resign as trustee if the trustee determines, at the trustee's discretion, that there may be or is a conflict of interest between the trustee in a fiduciary capacity and as an individual because of environmental claims or liabilities that could be asserted against the trustee arising from the existence, condition, maintenance, or use of any trust property.

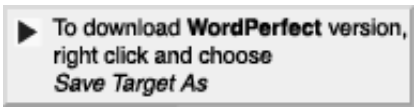
As used in this trust, "environmental law" means any federal, state, or local law, regulation, rule, or ordinance relating to the protection of the environment or human health. The trustee shall not be liable to any beneficiary for any detriment to trust property values due to the trustee's compliance with any environmental law.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.22 c. Form: Special Trustee to Accept Real Property

§19.22 c. Form: Special Trustee to Accept Real Property





19.22-1 Special trustee to accept real property

***Special Trustee for Real Property*. The following persons, in the order of priority indicated, shall act as the initial _ _[*and/or*]_ _ successor special trustee with respect to any real property not specifically accepted by the trustee by a separate writing delivered to the settlors or, if the settlors are not then living, to the beneficiaries of this trust or their legal representatives: _ _[*Names of special trustees*]_ _. The special trustee shall act as trustee with respect to any real property not accepted by the trustee as indicated above, and, in particular, shall act as trustee with respect to all real property other than any residential real property located in California. The special trustee shall hold title to this property and have all the powers granted to the trustee under this instrument with respect to such property. The net income and proceeds of sale of all or any part of this property shall be remitted to the trustee to be administered by the trustee. The trustee shall not, however, be required to obtain an accounting of the acts of the special trustee. The trustee shall not be liable to the settlors, any beneficiary, or any other person for any loss or diminution in the value of the trust resulting from any act or omission to act by the special trustee. Unless the special trustee then in office is also acting as the trustee, the sole duty and responsibility of the special trustee shall be to exercise those rights and powers that are specifically given to the special trustee by the express terms of this instrument.**

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III. PERSONAL PROPERTY

§19.23 A. Powers Relating to Personal Property Discussed Elsewhere

A trustee may invest in any kind of property or type of investment that is consistent with the trustee's duties and standard of care. Prob C §16047(e). Issues unique to certain kinds of personal property are discussed in this chapter. Many issues are also discussed elsewhere, such as the following powers:

- Power to commingle assets or hold undivided interests (see §§10.42-10.43);
- Power to hold or invest in personal property (see §§10.60-10.61);
- Power to carry insurance (see §§10.86-10.87); and
- Spendthrift provisions (see §§10.123-10.124).

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B. Stocks in Publicly Traded Companies

§19.24 1. Powers to Deal With Stock

A trustee has the power to invest in "any kind of property or type of investment … consistent with the standards of" Prob C §§16000-16105. Prob C §16047(e). More specifically, trustees have the power:

- To exercise, and give proxies to exercise, any voting rights with respect to corporate shares (Prob C §16234(a));
- To waive notices of shareholder meetings (Prob C §16234(b));
- To ratify any action that could be taken by shareholders (Prob C §16234(c));
- To pay calls and assessments (Prob C §16235);
- To sell or to exercise stock subscription or conversion rights (Prob C §16236);
- To consent to changes in the form of business (Prob C §16237);
- To hold securities in the name of a nominee without disclosure of the trust (Prob C §16238); and
- To deposit securities in a securities depository (Prob C §16239).

Although these powers are provided by statute, some settlors prefer to expressly provide such powers in the trust instrument, either explicitly or by means of more general language. For such a form, see §10.60.

For discussion of underproductive property, see §§19.34-19.49.

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§19.25 2. Allocations of Corporate Distributions Between Income and Principal

Corporate distributions of property other than money and distributions of money in total or partial liquidation of the corporation (*i.e.*, the total amount of money and property received by all owners is greater than 20 percent of the entity's gross assets or the entity indicates that it is a distribution in partial liquidation) or in exchange for all or part of the trust's interest in the corporation are allocated to principal. Prob C §16350(c)(1)-(3), (d)(1). See *Hasso v Hasso* (2007) 148 CA4th 329, 55 CR3d 667 (corporate statement that an asset had been converted into cash for distribution was not sufficient to indicate that the distribution was made in partial liquidation of the entity).

Distributions of money made from ordinary income by a regulated investment company or by a qualified real estate investment trust (REIT) are allocated to trust accounting income; all other distributions of money by such a company or trust are allocated to principal. Prob C §16350(b), (c)(4). All other corporate distributions of money are allocated to income. Prob C §16350(b).

The settlors may prefer to use a variable annuity interest (unitrust) for the "income" (*i.e.,* lead) beneficiary. Alternatively, the settlors may prefer to provide a characterization different from the above, particularly if the "income" to be paid to the income beneficiary of the trust is to be made from the buying and selling of securities rather than from the payment of dividends. Such a form can be generated by modifying the form for real property found in §19.12. Nevertheless, simply because the trust invests in growth stocks does not necessarily mean that the settlors intend to change the statutory allocation rules. Such investments may be made because the real intent of the settlors is to transfer as much of the return of the portfolio as far down the beneficial interest "chain" as possible, or to protect against inflation.

Of course, the characterizations provided by Prob C §16350 or by the settlors in the trust instrument do not control for purposes of income taxation. If the trust's allocations to income differ substantially, the settlors may wish to provide that at least the amount necessary to pay the income taxes be allocated to income. See §19.26.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.26 3. Form: Allocations to Income Consistent With Tax Treatment

§19.26 3. Form: Allocations to Income Consistent With Tax Treatment

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19.26-1 Allocations to income consistent with tax treatment

***Allocations to Pay Income Taxes*. For distributions made with respect to stocks, bonds, obligations for the payment of money, or other securities, the trustee shall allocate to income such portions as shall be equal to the federal or state income tax payable by the income beneficiary. The remainder of these distributions shall be allocated to principal or income as provided in the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375).**

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.27 C. Bonds and Other Obligations for Payment of Money

§19.27 C. Bonds and Other Obligations for Payment of Money

The general investment power and authority of the trustee is probably sufficient to provide the trustee with the power to invest in corporate or municipal bonds or other obligations for the payment of money, including debentures. Under Prob C §16224, a trust that permits investment in obligations of the United States is deemed to permit investment in mutual funds and common trusts funds

> the portfolios of which are limited to United States government obligations maturing not later than five years from the date of investment or reinvestment and to repurchase agreements fully collateralized by United States government obligations.

Although this provision does not literally prevent investment in mutual funds investing in longer-term government bonds, it can be argued that it implies such a prohibition. As such, the provision seems to conflict with the later-enacted trustee power to invest in any kind of asset under Prob C §16047(e).

Statutory law provides that all bonds or other obligations for the payment of money, and the proceeds received from their sale, redemption, or other disposition, are principal, except that amounts received in excess of purchase price (or value if otherwise acquired) on bonds maturing within 1 year after purchased or acquired by the trustee are allocated to income. Prob C §16357(b). Premiums and discounts on bonds and other obligations for the payment of money also belong to principal. The purchase price or sales proceeds are credited to principal at their inventory value. No portion of these items belongs to income. This rule makes sense in that premiums and discounts are generally attributable to market fluctuations in interest rates: Bonds trade at a premium or discount to adjust the stated coupon rate to the current market rate of interest.

Like the statutory or settlor-imposed rules applicable to corporate stock, however, neither these rules nor any allocation prescriptions imposed by the settlor need to be consistent with the rules applicable to the determination of bond proceeds as principal or income for income tax purposes. See IRC §§454, 1271-1275. Form 19.26-1 includes an allocation to income for the income tax attributable to bonds and other obligations for the payment of money.

A trustee who invests too heavily in bonds at a premium may violate the fiduciary duty to the remainder beneficiaries. Therefore, a settlor who wants to authorize the purchase should include a specific clause in the trust instrument permitting the purchase of bonds at a premium and provide for amortization of the premium. Alternatively, the settlor may authorize purchase of premium bonds without any amortization requirement, despite the inequity.

A tax-sensitive trustee should be required to amortize premiums to avoid the assertion that the trustee has the power to invade principal for the benefit of the income beneficiary without an ascertainable standard.

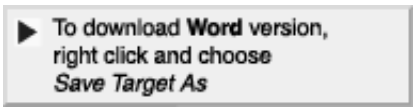
The form in §19.29 is the counterpart of the form in §19.28, with the position of the remainder and income beneficiaries reversed. Part of the interest received from bonds purchased at a premium represents amortization of the premium; for bonds purchased at a discount, part of the proceeds on the sale or other disposition of the bonds represents accumulation of the discount, which may be treated as income or principal (form 19.29-1).

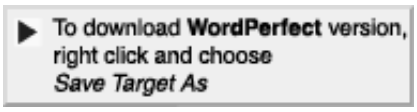
Some corporate trustees may object to provisions for the amortization of premium or the accumulation of discount because of bookkeeping expenses. If the provisions are omitted to meet the objection, extremely heavy investment in premium or discount bonds should be avoided.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.28 1. Form: Power to Purchase Bonds at Premium

§19.28 1. Form: Power to Purchase Bonds at Premium





19.28-1 Power to purchase bonds at premium

***Power to Purchase Bonds at Premium*. The trustee may purchase bonds and pay any premiums connected with the purchase that the trustee at the trustee's discretion considers advisable,**

[*Use one of the following alternatives*]

[*Alternative 1: Premiums to be amortized*]

provided, however, each premium is repaid periodically to principal from the interest on the bond in a reasonable manner as the trustee determines and, to the extent necessary, from the proceeds on the sale or other disposition of the bond.

[*If appropriate, add the following option*]

[*Option: Trustee need not repay premium within specified percent of par value*]

The trustee need not repay any portion of the premium on bonds purchased at not more than _ _[*specify, e.g., 103*]**_ _ percent of their par value.**

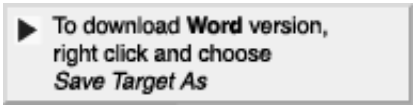
[*Alternative 2: No amortization of premiums*]

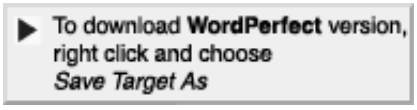
despite any loss or gain on the bonds that falls on or inures to principal on their respective maturities or on their sale or other disposition.

Comment: Alternative 1 is unnecessary if prescribed distributions are independent of the distinction between income and principal. The optional addition to Alternative 1 should not be used when there is a tax-sensitive trustee.

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§19.29 2. Form: Power to Purchase Bonds at Discount





19.29-1 Power to purchase bonds at discount

***Power to Purchase Bonds at Discount*. The trustee may purchase bonds at such discount as the trustee at the trustee's discretion considers advisable.**

[*If appropriate, add the following option*]

[*Option 1: Discount to be accumulated to income*]

If, however, the trustee determines, at the trustee's discretion, that the current yield on the bonds is materially less than the rate of return that the trust could otherwise obtain with equivalent safety, all or a portion of the discount shall be credited periodically to income of the trust in a reasonable manner as the trustee determines and, to the extent necessary, paid from the proceeds on the sale or other disposition of the bond or from principal.

[*If appropriate, add the following option to Option 1*]

[*Option 2: Trustee need not accumulate bond discount within specified percentage of par value*]

The trustee need not accumulate discount of bonds purchased at not less than _ _[*specify, e.g., 97*]_ _ percent of their par value, and any loss or gain on the sale or other disposition of the bonds shall fall on or inure to principal.

Comment: Option 1 is unnecessary if prescribed distributions are independent of the distinction between income and principal. Option 2 should not be used when there is a tax-sensitive trustee.

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D. Puts, Calls, Margin Accounts, and Other Specialized Investments

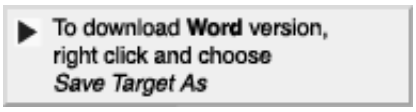
§19.30 1. No Statutory Authority for Specialized Investments

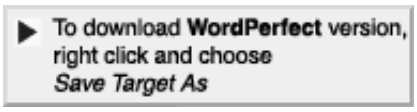
No express statutory authority exists to allow a trustee to invest in puts, calls, future contracts, or other such specialized types of investments. Although Prob C §16047(e) allows a trustee to invest in "any kind of property," some people believe that the statute does not cover futures contracts—the basis of many specialized investments. In addition, no express statutory authority exists for a trustee to trade on margin, although the trustee has the specific power to encumber trust property for a term within or extending beyond the term of the trust (Prob C §16228) as well as the power simply to borrow money (Prob C §16241). With these and other more atypical or risky investments, most securities companies (and, possibly, trustees) are more comfortable with a specific power contained in the trust instrument before they will allow a fiduciary to invest in such items or to trade on margin.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.31 2. Form: Power to Make Specialized Investments

§19.31 2. Form: Power to Make Specialized Investments





19.31-1 Power to make specialized investments

***Power to Make Specialized Investments*. The trustee may, without the order of any court, invest trust property in options (including, without limitation, options to purchase real property), financial futures contracts, commodities, commodities futures contracts, and forward and leverage contracts. The trustee may also, without the order of any court, enter into contracts providing for puts and covered calls and establish and maintain margin accounts with securities dealers or brokers (including, without limitation, discretionary accounts and joint or general partnership accounts).**

Comment: If the specialized investments are for the primary purpose of generating current income, the settlors may prefer to allocate any gains or losses to income. If the primary purpose is to hedge against a possible downturn in the value of stock (*e.g.,* a put), the settlors may prefer to allocate gains or losses to principal. Form 19.26-1 may be adapted for these purposes.

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E. Tangible Personal Property

§19.32 1. Difficulties of Holding in Trust

Because tangible personal property depreciates and is difficult to account for, it is not ordinarily held in trust. Sometimes, however, tangible personal property is held for investment (*e.g.*, a valuable painting) and might be a suitable investment for the trust.

Retaining tangible personal property may not be in the best interests of the trust or its beneficiaries, particularly if such property is not held for investment. California statutory law provides the trustee with the power to abandon trust property. Prob C §16227. The trustee might consider using such power when the cost of maintaining such property exceeds its fair market value. The settlors may wish to provide a specific power to the trustee to abandon trust property. Form 19.33-1 may be used.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.33 2. Form: Power to Abandon Property

§19.33 2. Form: Power to Abandon Property

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19.33-1 Power to abandon property

***Power to Abandon Property*. The trustee may, without the order of any court, abandon any _ _[*trust property/tangible personal property of the trust not held for investment*]_ _ if the trustee determines, at the trustee's discretion, that such abandonment is in the best interests of the trust and its beneficiaries.**

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IV. UNDERPRODUCTIVE PROPERTY

A. Duty to Make Property Productive

§19.34 1. Trustee Has Duty to Make Property Productive, But Investment in Underproductive Property May Be Prudent

Generally, a trustee has the duty to make trust property productive. Prob C §16007. In a broad sense, this merely requires that the trustee not be wasteful. For example, it would typically be imprudent to fail to rent farm land during a prime growing season. The value of the land for that period would be lost. Similarly, it would likely be imprudent to hold excess cash in a bank account that did not bear interest.

However, the duty to make trust property productive is often discussed in the more narrow context of a duty to make the trust property produce "trust income" in those situations in which the distribution rights of beneficiaries depend on whether additions to the value of the trust estate are classified as trust income or trust principal. Suppose, for example, that a trust instrument provides for distributing income to X for life with remainder to Y. The settlor certainly intended that X benefit from the trust. In the absence of some sort of trustee adjustment power, it would be a breach of the trust for the settlor to invest the trust estate exclusively in investments producing little trust income, no matter how wonderful the trust's total investment return after taking into account capital appreciation. In contrast, capital appreciation investments might be quite appropriate for a trust that provided that all income was to be added to principal and the trustee was then to make distributions of specified amounts or according to a discretionary formula. The following discussion is concerned with situations in which distribution rights depend on whether investment return takes the form of trust income or principal.

When it exists, the duty to make a trust property productive of income is to be judged on a portfolio basis. The income beneficiary typically does not have the right to compel that each and every asset produce a significant rate of trust income. See Prob C §16047. See also Comment to Prob C §16336 in 29 Cal L Rev'n Comm'n Reports 273, 275 (1999).

In some cases, a settlor will intentionally fund an inter vivos irrevocable trust with significant amounts of unproductive property. For example, a trust might be funded with interests in a family-controlled business entity that makes few distributions, or a trust might be funded with unimproved real property with no short-term income potential, but long-term subdivision prospects. In such cases, unless precluded by the need to avoid restrictions on a spouse's income interest that could result in loss of a desired marital deduction, it will often be appropriate for the trust instrument to provide express guidance as to the trustee's duty to make the property productive. For example, the settlor may wish to provide the trustee with the specific power to acquire or retain underproductive property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.35 2. Form: Authorization to Acquire and Retain Underproductive Property

§19.35 2. Form: Authorization to Acquire and Retain Underproductive Property

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19.35-1 Authorization to acquire and retain underproductive property

[*Use one of the following alternatives*]

[*Alternative 1: Trustee authorized to acquire and retain underproductive property*]

***Power to Acquire and Retain Underproductive Property*. The trustee shall have no liability to any beneficiary for any decision of the trustee to accept or to acquire for, or retain in, such trust any asset or combination of assets, regardless of whether any such asset or combination of assets is income producing and constitutes all or most of the trust property** _ _[*, particularly any interests in* _ _[*name of company*]_ _]_ _**.**

[*Alternative 2: Trustee authorized only to retain underproductive property*]

***Power to Retain Underproductive Property*. The trustee shall have no liability to any beneficiary for any decision of the trustee to retain in such trust any asset or combination of assets of the class, kind, or character transferred to such trust by the settlors, regardless of whether any such asset or combination of assets is income producing** _ _[*, particularly any interests in* _ _[*name of company*]_ _]_ _**.**

Comment: The settlors may wish to limit either alternative to a particular form of underproductive property, *e.g.,* the residence of a beneficiary or interests in a closely held company.

The settlors may also wish to provide the trustee with directions on the acceptance or retention of underproductive property, *e.g.,* that the needs of the remainder beneficiaries are to be given first consideration or that continued losses are to be a factor in determining whether to retain business interests.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.36 3. Form: Power to Permit Beneficiaries to Occupy Residential Real Estate

§19.36 3. Form: Power to Permit Beneficiaries to Occupy Residential Real Estate

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19.36-1 Power to permit beneficiaries to occupy residential real estate

***Power to Permit Beneficiaries to Occupy Residence*. The trustee may permit any beneficiary to reside rent free in any residence forming part of the assets of a trust created for the benefit of that beneficiary and to pay any real estate taxes, expenses of maintaining the residence in suitable repair and condition, and hazard insurance premiums on the residence. The trustee may not, however, do anything that would deprive the beneficiary of the beneficial enjoyment of the trust. If this power interferes with the beneficiary's beneficial enjoyment, the beneficiary or the beneficiary's legal representative shall have the right to limit, restrict, or terminate the trustee's exercise of this power. The trustee shall not be liable to any person, including a trust beneficiary, for retaining a residence under this clause or for any loss or damage to the residence, whether or not the loss or damage results from a beneficiary's occupancy or use of the residence and whether or not the residence was insured adequately or at all against loss or damage.**

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B. Allocations of Proceeds of Sale of Underproductive Property Between Income and Principal

§19.37 1. Definition of "Underproductive Property"

"Underproductive property" is not defined in the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). Unless the instrument provides otherwise, proceeds of sale of trust property, including capital gains, are allocated to principal under Prob C §16355 subject to the trustee adjustment power in Prob C §16336 or the trustee power to convert the trust to a unitrust under Prob C §§16336.4-16336.7. Under §16336, the trustee may make an adjustment between principal and income to compensate the income beneficiaries for holding underproductive property. However, the power may not be exercised if the trustee is a beneficiary of the trust. See §19.37A. This restriction does not apply to the power to convert the trust to a unitrust. See §10.116A.

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§19.37A 2. Statutory Adjustment Power

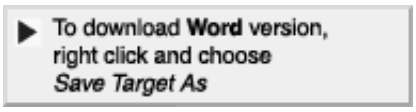
The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) allows a trustee to make adjustments between the principal and income accounts. Prob C §16336. The purpose of the adjustment power is to permit a trustee to invest trust property in a manner that is expected to produce the highest total investment return even though the selected investments do not produce the desired mix between principal appreciation and trust income that the trustee otherwise believes is consistent with the settlor's intentions. In particular, it is intended to permit heavy investment in publicly traded common stocks that produce very low dividends but have excellent appreciation potential. If the trustee chooses to follow that course, the trustee has discretion to make distributions to the income beneficiary that exceed the low dividends. This adjustment power differs from former statutory provisions that provided for payments of delayed income on the sale of unproductive property. The trustee is not required to delay adjustments until sales occur and the trustee should base the adjustment on the investment performance of the trusts as a whole, rather than on an item-by-item basis. In short, §16336 is a response to the conclusion that portfolio investment decisions should not be constrained by the limitations otherwise imposed by the need to make distributions to an income beneficiary in amounts the settlor likely intended.

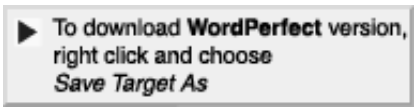
Unfortunately, §16336 contains many restrictions that are designed to prevent unintended tax consequences. As a result, the benefits of the statute are often unavailable unless the trust has an independent trustee. Accordingly, it remains the case that trust drafters should normally seek to draft distribution provisions that do not make distribution rights dependent on distinctions between income and principal in the first place. For example, the initial beneficiary might be given the right to annual payments of a specific sum of money, with or without cost-of-living adjustments, or a unitrust amount. For further discussion of such alternatives, see §§9.41-9.45.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.38 3. Form: Allocation of Proceeds of Sale

§19.38 3. Form: Allocation of Proceeds of Sale





19.38-1 Trustee given discretion to apportion sale proceeds

***Trustee Discretion to Allocate Proceeds of Sale*. A portion of the net proceeds of sale of any part of principal that has not produced an average net income** _ _[*of at least* _ _[*number*]_ _ *percent/at least equal to the prevailing rate paid on regular savings accounts by national banks located in the place of administration of the trust/at least equal to the prevailing rate paid on United States Savings Bonds, Series EE, or any successor series*]_ _ **per year of its** _ _[_ _[*inventory/average/fair market*]_ _ *value as of the* _ _[*beginning/end*]_ _ *of the year*]_ _ **for more than one year, including as income the value of any beneficial use of the property by the income beneficiary, may, at the trustee's discretion, be treated as delayed income to which the income beneficiary is entitled as provided in this instrument.**

Comment: This type of provision is not needed if the trust distribution provisions do not make distribution rights dependent on distinctions between principal and income or if the trustee has the power to make adjustments between principal and income under Prob C §16336. See §19.37A.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.39 4. Form: No Special Adjustments for Underproductive Property

§19.39 4. Form: No Special Adjustments for Underproductive Property

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19.39-1 No special adjustments for underproductive property

***No Special Adjustments for Underproductive Property*. The trustee shall make no special adjustments in the principal and income accounts by reason of the disposition of any property that was non-income-producing or low-income-producing property.**

Comment: This clause severely restricts trustee discretion and is not recommended. If the trust will hold a specific unproductive asset for a prolonged period, the trust should more specifically address the issues presented by that asset.

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C. Allocation of Expenses Pertaining to Underproductive Property

§19.40 1. Ordinary Expenses Allocated to Income

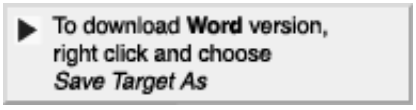
Unless there is an express direction in the trust instrument, all "ordinary" expenses incurred in the administration, management, and preservation of trust property are allocated to income, and the trustee is permitted to make an allowance against income for depreciation. Prob C §§16370(c), 16372(b). As applied to underproductive property, this rule may create a hardship for the income beneficiary while the property is underproductive: Such expenses may be paid out of the income from other assets that otherwise would go to the income beneficiary.

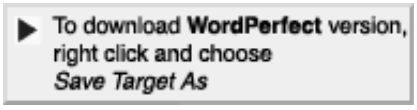
The settlors thus may wish to include specific direction about the allocation of expenses during any period in which the trust contains underproductive property. Particularly if the trust holds land that will be sold to produce income, the settlors may wish to include an allocation that matches the settlors' intended return to the lead beneficiary. Alternatively (and particularly if the settlors do not anticipate underproductive property but are not necessarily opposed to the trustee's investing in it), the settlors may provide the trustee with the discretion to allocate the expenses of underproductive property.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.41 2. Form: Allocation of Ordinary Expenses to Principal

§19.41 2. Form: Allocation of Ordinary Expenses to Principal





19.41-1 Allocation of ordinary expenses to principal

[*Use one of the following alternatives*]

[*Alternative 1: Payment of ordinary expenses from principal*]

***Allocation of Expenses*. Ordinary expenses incurred in connection with the administration, management, or preservation of underproductive property shall be made _ _[*one half against trust principal and one half against trust income/against trust principal*]_ _.**

[*Alternative 2: Allocation of expenses based on trust's total productivity*]

***Allocation of Expenses*. Ordinary expenses incurred in connection with the administration, management, or preservation of underproductive property shall be charged against trust principal to the extent that the expenses in any year reduce the net income of the trust for that year below a return equal to _ _[*number*]_ _ percent of the _ _[_ _[*inventory/average/fair market*]_ _ *value as of the* _ _[*beginning/end*]_ _ *of the year*]_ _ of the year concerned.**

[*Alternative 3: Trustee has discretion to allocate expenses*]

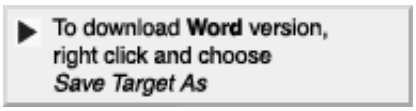
***Allocation of Expenses*. Ordinary expenses incurred in connection with the administration, management, or preservation of underproductive property shall be made against trust income or against trust principal, or partly against each, as the trustee, at the trustee's discretion, determines.**

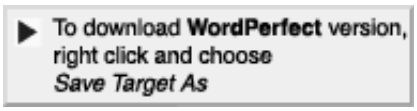
Comment: Alternative 1 favors the income beneficiary. Alternative 2 sets an allocation standard based on the economics of the situation and most closely resembles what would happen if the property were productive, *i.e.,* the income beneficiary would pay the current expenses and would not be reimbursed when the property is sold or otherwise disposed of. For discussion of the tax consequences arising from use of a discretionary clause, see §19.43.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.42 3. Form: Definition of 'Ordinary Expenses'

§19.42 3. Form: Definition of "Ordinary Expenses"





19.42-1 Definition of "ordinary expenses"

***Definition of "Ordinary Expenses*." For purposes of the clause above, "ordinary expenses" are limited to regularly recurring taxes assessed against any portion of the trust principal, water bills, premiums on insurance, interest paid by the trustee, and ordinary repairs.**

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§19.43 D. Tax Considerations

A trustee who may acquire and hold property that does not produce current trust accounting income has the power to shift the beneficial enjoyment of the trust property between the income beneficiary and the remainder beneficiary. Such a power deprives the income beneficiary of the current trust accounting income that could be earned on the trust assets. However, the lack of accounting income usually (but certainly not always) is made up in return to principal. In other words, return is converted from current income (or current income and capital appreciation) to capital appreciation. Modern investment theory does not distinguish between "income" and "appreciation," preferring instead to concentrate on total "return."

Without more, such a power could have adverse tax consequences in several different areas. For discussion of these consequences and a potential means of restoring the tax benefits, see §§19.44-19.49.

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§19.44 1. Marital Deduction Trusts

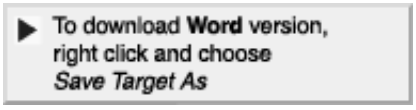
Transfers to a trust that otherwise qualifies for the marital deduction but that permits the trustee the unbridled power to acquire or retain unproductive property do not qualify for the federal gift tax marital deduction, because the income beneficiary-spouse is not entitled to receive all the income of the trust. On gift taxes, see Treas Reg §§25.2523(e)-1(f)(4)-(5), 25.2523(f)-1(f), Example (2). An exception to this rule exists for a power to retain a residence for a spouse or to retain "other property for the personal use" of the spouse. Treas Reg §25.2523(e)-1(f)(4). For additional restrictions for transfers to spouses who are not United States citizens, see §§2.81-2.83.

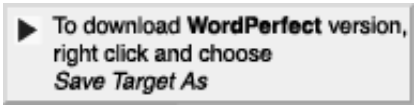
If, however, the applicable rules for the administration of trusts require the trustee to make the property productive within a reasonable time or require the trustee to provide the income beneficiary-spouse with "substantially that degree of beneficial enjoyment… accord[ed] to a person who is unqualifiedly designated as the life beneficiary of a trust," the transfer qualifies for the federal gift or estate tax marital deduction. Treas Reg §25.2523(e)-1(f)(1), (4)-(5). One way to satisfy this requirement is to give the spouse a unitrust interest with a payout percentage of no less than 3 percent and no more than 5 percent, as provided by the definition of trust income in Treas Reg §1.643(b)-1. The unitrust amount is based on the fair market value of trust property, regardless of income from the property. Alternatively, the income beneficiary-spouse may have the power to require that the trustee make the property productive or convert it to productive property within a reasonable time. See, *e.g.,* Treas Reg §25.2523(e)-1(f)(4).

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.45 2. Form: Full Beneficial Enjoyment Accorded to Spouse

§19.45 2. Form: Full Beneficial Enjoyment Accorded to Spouse





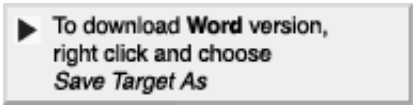
19.45-1 Full beneficial enjoyment accorded to spouse

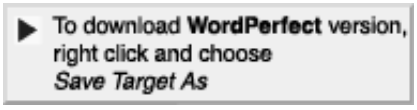
***Spouse's Right to Full Beneficial Enjoyment of Trust Property*. Any provision in this instrument affecting the interests of _ _[*name of beneficiary of marital deduction trust*]_ _ (called the spouse) in the trust that would operate to deny to the spouse during the spouse's lifetime that degree of beneficial enjoyment of the trust that the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust shall be of no force or effect.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.46 3. Form: Spouse's Power to Compel Conversion to Productive Property

§19.46 3. Form: Spouse's Power to Compel Conversion to Productive Property





19.46-1 Spouse's power to compel conversion to productive property

Spouse's Power to Compel Trustee to Make Trust Property Productive of Income. **_ _**[*Name of beneficiary of marital deduction trust*]**_ _ (called the spouse) may, by written instrument delivered to the trustee, direct the trustee to convert to income-producing property any non-income-producing property held as a part of this trust. The trustee shall comply with such a direction within a reasonable time after receiving it.**

Comment: The settlors may prefer the "belt-and-suspenders" approach of using both forms 19.45-1 and 19.46-1.

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4. Estate and Income Tax Implications to Settlor-Trustee or Beneficiary-Trustee

§19.47 a. Trust Taxable to Settlor-Trustee

If a settlor or beneficiary of the trust serves as the trustee, an unbridled power to acquire or retain underproductive property may be considered to be a power to shift the beneficial enjoyment of the property transferred to the trust within the ambit of IRC §§2036 and 2038. In that situation, the value of the trust estate would be included in the gross estate of the settlor or beneficiary, as the case may be, for estate tax purposes. If the trust was established to remove the assets from the settlor's estate or to prevent the assets from becoming a part of the beneficiary's estate, these purposes would be defeated.

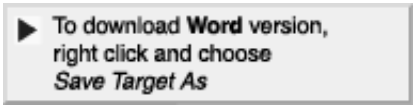
In addition, an unbridled power to acquire or retain underproductive property may be regarded as a nonfiduciary power of administration for purposes of the "grantor trust" rules of IRC §675(4) (see §3.41) so that the trust's income is taxed to a settlor-trustee or the beneficiary-trustee under IRC §678.

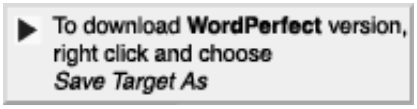
If the power to acquire and retain underproductive property, however, is held in a fiduciary capacity, these provisions of the Internal Revenue Code should not apply to a settlor or beneficiary. *U.S. v Byrum* (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382; *Old Colony Trust Co. v U.S.* (1st Cir 1970) 423 F2d 601. For discussion of IRC §2036 and *Byrum,* see §2.56.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.48 b. Form: Powers Exercisable Only in Trustee's Fiduciary Capacity

§19.48 b. Form: Powers Exercisable Only in Trustee's Fiduciary Capacity





19.48-1 Powers exercisable only in trustee's fiduciary capacity

***Powers Exercisable Only in Trustee's Fiduciary Capacity*. All the powers of the trustee provided for in this instrument are exercisable by the trustee in the trustee's fiduciary capacity and only in that capacity. Despite any other provision of this instrument, no trustee shall have any power under any such provision to enlarge or shift any of the beneficial interests under this trust except as an incidental consequence of the discharge of the fiduciary duties of the trustee.**

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§19.49 5. Trusts Containing Charitable Interests

A transfer to a charitable organization in trust qualifies for a gift tax deduction only if the transfer is made to a qualified charitable remainder trust or a charitable lead trust. IRC §2522(c)(2). In order to qualify as a charitable remainder trust, the trust instrument may not restrict the trustee "from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets." Treas Reg §1.664-1(a)(3). The IRS has interpreted this regulation to mean that a settlor may not require the trustee to retain or acquire certain investments. Rev Rul 73-610, 1973-2 Cum Bull 213; IRS Letter Rulings 7802037, 7803029. Thus, it is not wise to require the trustee of a charitable remainder trust to retain or acquire any assets, including those that are underproductive.

In addition, no deduction for gift, estate, or income tax purposes is permitted unless "the possibility that the charitable transfer will not become effective is so remote as to be negligible." Treas Reg §25.2522(c)-3(b)(1). In IRS Letter Ruling 200341002, the IRS ruled that no charitable deduction was allowed for a charity's unexercised *Crummey* right to withdraw a gift to a trust for a period of 30 days. The trust had both charitable and noncharitable beneficiaries. Each beneficiary was entitled to withdraw certain percentages of amounts contributed to the trust each year, and amounts remaining in the trust on the settlor's death were to be distributed to the beneficiaries in those same percentages. Because the trustee had the power to invade principal for beneficiaries, the chance that the charities would not receive their shares was not so remote as to be negligible. The test for negligibility is a 5-percent probability that the charity will not receive its interest. Rev Rul 77-374, 1977-2 Cum Bull 329. Obviously, such a test is theoretically inapplicable to variable annuity (unitrust) interests. If underproductive property is, however, initially transferred to a charitable remainder trust, the lead interest of which is a *fixed* annuity, the transfer would fail the test if the trust assets are likely to be all transferred to the noncharitable lead beneficiaries before the completion of all annuity payments.

But what happens if the trustee, at the trustee's discretion, acquires or retains underproductive property? The private foundation rules of the Internal Revenue Code generally apply to charitable trusts, except that the jeopardy investment and excess business holdings rules do not apply to charitable remainder trusts and do not apply to certain charitable lead trusts. IRC §4947(b)(3). Thus, it appears that underproductive property per se would not necessarily disqualify a charitable trust or result in an excise tax.

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V. ENCUMBERED PROPERTY

§19.50 A. Settlors Must Provide for Payments on Encumbrance

If encumbered property is to be transferred to an irrevocable trust, the settlors must determine or anticipate the source of the future payments on the encumbrance. "Encumbrance" includes mortgages, deeds of trust and other forms of security, including margin accounts with securities dealers or brokers. The settlors may wish to consider the following possibilities:

- The transfer of income-producing assets to the trust;
- Periodic contributions by the settlors or others for the payments on the indebtedness; and
- The sale of specific other trust assets to make payments on the encumbrance.

Due to the trustee's duty to preserve trust property (see Prob C §16006), unless there is a specific source from which to pay the encumbrance, the trustee may be forced either to sell other trust assets in order to pay the indebtedness or to sell the encumbered property at foreclosure or otherwise. 3 Scott & Ascher on Trusts §17.8 (5th ed 2007). Either of these options is likely to be unsatisfactory to the settlors.

Before the actual transfer, the settlors should also determine whether the transfer of the encumbered property to the irrevocable trust will accelerate the underlying debt. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 8 (4th ed Cal CEB 2009). If the settlors are beneficiaries and the underlying property is a residence, the debt may not be accelerated. CC §2924.6. If the property is not residential property or otherwise does not meet the requirements of CC §2924.6, and if current interest rates are above the rate paid on the debt, the settlors should consider contacting the lender and receiving its permission to transfer the property and its assurance that the debt will not be accelerated. This usually costs only a few hundred dollars.

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B. Allocations of Payments on Encumbrances

§19.51 1. Payments Divided Between Income and Principal

Interest payments on indebtedness are charged to income, and principal payments are charged to principal. Prob C §§16370(c), 16371(a). The trustee may make a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles unless the property is a residence used by a trust beneficiary. Prob C §16372(b). This charge against income will provide principal cash to make all or part of the principal portion of the mortgage payments. For allocation against income and principal for productive property, see §§19.11-19.19. For allocations for underproductive property, see §§19.40-19.42. If the settlors wish to deviate from these statutory provisions, they must make a special provision in the trust instrument. See §19.52.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.52 2. Form: Allocation of Payments

§19.52 2. Form: Allocation of Payments

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19.52-1 Allocation of payments

***Uniform Principal and Income Act*. The trustee shall allocate receipts and expenditures between principal and income in accordance with the provisions of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375)[,]**

[*If appropriate, add one of the following options*]

[*Option 1: Interest payments charged to principal*]

except that interest on _ _[*secured*]_ _ indebtedness shall be charged against principal.

[*Option 2: Principal payments charged against income*]

except that principal payments on _ _[*secured*]_ _ indebtedness shall be charged against income.

Comment: Option 2 probably should not be used with a trust that the settlors intend to qualify for the marital deduction.

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C. Tax Considerations of Transfer of Encumbered Property

1. Income Tax Implications of Payment of Encumbrance

§19.53 a. When Settlors Are Personally Liable on Encumbrance

A settlor's transfer of encumbered property to an irrevocable trust may cause him or her to be taxed on the trust's income if he or she is personally liable on the debt and if payments may be made without the consent of an adverse party or in the discretion of a grantor or a nonadverse party. Treas Reg §§1.677(a)-1(d), 1.677(b)-1(d). See*, e.g., Douglas v Willcuts* (1935) 296 US 1, 80 L Ed 3, 56 S Ct 59; *Commissioner v Blumenthal* (1935) 296 US 552, 80 L Ed 390, 56 S Ct 305; *Clifton B. Russell* (1945) 5 TC 974 (stock transferred was subject to a debt on which grantor was liable; trustees made payments out of trust income). The settlor, however, may not be taxed on the realization of the trust's capital gain simply because the trust's income may be used in this way. *Bush v Commissioner* (1941) 45 BTA 609, acq 1942-1 Cum Bull 3, remanded on other grounds (2d Cir 1943) 133 F2d 1005.

The rule that a settlor will be taxed on the trust's income if it may be used to satisfy a debt has also been applied when the settlor's liability on the debt is contingent. Rev Rul 54-516, 1954-2 Cum Bull 54; 2 Nossaman, Wyatt & McDaniel, Trust Administration and Taxation §42A.08 (rev 2d ed 1966). But see *Edwards v Greenwald* (5th Cir 1954) 217 F2d 632 (debt incurred by trust contemporaneously with its creation and for its benefit; settlors only secondarily liable).

If the settlors do not wish to be taxed on the trust's income, the terms of the encumbrance should be checked for the personal liability of the settlors. For instance, a mortgagee is not personally liable on a mortgage unless expressly stated. CC §2928. If a settlor is personally liable, the settlor should obtain a release from personal liability on the debt before the transfer of the encumbered property to the trust, if that is possible.

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§19.54 b. When Settlors Are Not Personally Liable on Encumbrance

If the settlors have no personal liability on the encumbrance (*e.g.,* for a purchase-money encumbrance, under CCP §580b, or when the settlors have been released from liability) and the trust is not otherwise a "grantor trust" under IRC §§671-679 (see §§3.22-3.44), payment of the encumbrance by the trustee will not cause the trust's income to be taxed to the settlors, whether or not the payments are made out of income. *Estate of Craig R. Sheaffer,* TC Memo 1966-126.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.55 2. Capital Gains Tax Implications of Transfer

§19.55 2. Capital Gains Tax Implications of Transfer

For purposes of the grantor trust rules under IRC §§671-677 (see §§3.22-3.44), if the settlors retain powers that would cause them to be treated as owners of the *entire* trust, or even just the principal portion, the settlors will not recognize any gain on the transfer of encumbered property to the trust. This rule applies whether or not the debt is recourse debt. Treas Reg §1.1001-2(c), Example (5). (Recourse debt is defined as debt for which the lender has recourse against the settlors if the debt is not paid.)

If the settlors retain no such powers, they may realize capital gain on the transfer of encumbered property to a trust if the encumbrance exceeds the settlors' income tax basis in the property. (When the encumbrance is less than the settlors' basis, however, the settlors do not realize any capital gain on the transfer of the property to the trust.) Such a transfer would be treated as part gift and part sale: The gift portion is that amount of the property's value in excess of the encumbrance, and the sale portion is that amount between the settlors' basis and the amount of the encumbrance. Treas Reg §1.1001-1(e); *Malone v U.S.* (5th Cir 1972) 455 F2d 502. But see *Johnson v Commissioner* (6th Cir 1974) 495 F2d 1079, aff'g (1973) 59 TC 791, cert denied (1974) 419 US 1040, 42 L Ed 2d 317, 95 S Ct 527 (part-gift, part-sale approach disregarded in taxing settlor). Specific statutory and regulatory rules exist for such transfers to charitable organizations, including charitable remainder trusts and charitable lead trusts. IRC §1011(b); Treas Reg §1.1011-2.

The income tax basis of the property in the hands of the trustee will be the income tax basis of the settlors, increased by the amount of gain recognized to the settlor and further adjusted for the amount of any gift tax paid with respect to the transfer. IRC §§1015(b), (d)(2).

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§19.56 3. Gift Tax Implications of Transfer

A transfer of encumbered property is valued for gift tax purposes at the fair market value of the equity as of the date of the transfer. *Drybrough v U.S.* (WD Ky 1962) 208 F Supp 279. Discharge of the encumbrance by the trustee with trust assets does not constitute additional taxable transfers by the settlors even if the trust is treated as a "grantor trust" for income tax purposes. For discussion of grantor trusts, see §§3.22-3.44. A power in the trustee to acquire encumbered property or to encumber property and to discharge the encumbrance from income or principal, or both, may result in classification of the beneficiaries' interests as future interests. See *Commissioner v Brandegee* (1st Cir 1941) 123 F2d 58; *Mary R. Nelson* (1942) 46 BTA 653.

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§19.57 4. Estate Tax Implications of Transfer

If the encumbrance is a recourse liability, it might be argued that the payment of the encumbrance by the trust is a step-transaction: The income of the trust used to pay the encumbrance is income to the settlors followed by a gift by the settlors to the trust in the amount of the increase in equity. Such a argument, however, would ultimately lead to a deduction from a settlor's estate for the remaining amount of the encumbrance without an offsetting asset. Thus, the IRS is unlikely to take this position. If the encumbrance is a nonrecourse liability, however, there is no discharge of the settlors' indebtedness, so the increase in equity inures directly to the trust's beneficiaries and there is no argument for a continuing gift. In fact, the Fifth Circuit Court of Appeals has held that, because all the increase in value inures to the trust's beneficiaries, a settlor has not retained any interest sufficient to include the property in his or her gross estate. *Hays' Estate v Commissioner* (5th Cir 1950) 181 F2d 169; *Malone v U.S.* (ND Miss 1971) 326 F Supp 106, aff'd (5th Cir 1972) 455 F2d 502.

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§19.58 VI. TRANSFERS WITH LEASEBACKS

If the settlors wish to continue to use the property to be transferred to the irrevocable trust, they may wish to lease the property back from the trust. As long as the federal income tax rates remain compressed, and particularly as long as trusts continue to be in a disproportionately high income tax bracket vis-à-vis individuals, transferring property to an irrevocable trust coupled with a leaseback by the settlors is not likely to result in a tax savings by shifting the income tax benefits and burdens of owning certain property. The nontax benefit of leasing property from the trust is to provide a ready market for the property and to control the use of the asset.

Under Prob C §16231, the trustee has the power to lease property of the trust for a term within or extending beyond the term of the trust. A sample clause that provides the trustee with this authority is set forth in §10.70.

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A. Income Tax Treatment of Lease Payments

§19.59 1. Income to Nongrantor Trust

The lease payments by the settlors are in general treated like lease payments made by a third party. The rent constitutes gross income to the trust, and the trust is entitled to any applicable deductions such as for property taxes paid, repairs, maintenance, and depreciation. See *Hobart A. Lerner, M.D., P.C.* (1978) 71 TC 290 (rent taxed to trust beneficiaries and not to settlor). The trust has taxable income from rent payments made by the settlor even if the settlors do not receive a deduction for the rent payments. *Van Zandt v Commissioner* (5th Cir 1965) 341 F2d 440, cert denied (1965) 382 US 814.

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§19.60 2. Deductibility of Lease Payments by Settlors

For the settlors to deduct the lease payments from their own income tax return, the payments must be for the use of property of a type used in the settlors' trade or business or for the production of income. IRC §§162, 212; Rev & T C §17201.

There are several other requirements when rent is paid to a related person, including a trust established by the parties seeking to deduct the payments:

- If the related person is a trust, (a) the trust must be irrevocable, (b) the settlors may not have a reversionary or other equitable interest in the property, and (c) the settlors may not retain substantially the same control over the property that they had before the transfer of the property to the trust. This last requirement may be met if an independent trustee is appointed. The settlors may, however, wish to maintain control over the property in other ways. In that situation, it may be appropriate to appoint a special trustee with powers only to negotiate the lease.
- The lease must be bona fide, must require the payment of reasonable rent, and must have a bona fide business purpose. Fortunately, these requirements will also be met if the settlors wish to have the property excluded from their estates under IRC §2036.
- The lease must be in writing.

For case law pertaining to leasebacks with trusts, see *May v Commissioner* (9th Cir 1984) 723 F2d 1434; *Rosenfeld v Commissioner* (2d Cir 1983) 706 F2d 1277; *Quinlivan v Commissioner* (8th Cir 1979) 599 F2d 269, cert denied (1979) 444 US 966; *Skemp v Commissioner* (7th Cir 1948) 168 F2d 598; *Brooke v U.S.* (9th Cir 1972) 468 F2d 1155. See also *Alden B. Oakes* (1965) 44 TC 524, nonacq 1967-1 Cum Bull 3. But see *Perry v U.S.* (4th Cir 1975) 520 F2d 235, cert denied (1976) 423 US 1052, 46 L Ed 2d 641, 96 S Ct 782; *Mathews v Commissioner* (5th Cir 1975) 520 F2d 323, cert denied (1975) 424 US 967, 47 L Ed 2d 734, 96 S Ct 1463; *Van Zandt v Commissioner* (5th Cir 1965) 341 F2d 440, cert denied (1965) 382 US 814.

If the lease transaction is a sham or the trust has no substance, the entire transaction will be disregarded. *Irvine K. Furman* (1966) 45 TC 360, aff'd (5th Cir 1967) 381 F2d 22; Rev Rul 54-9, 1954-1 Cum Bull 22, modified by Rev Rul 57-315, 1957-2 Cum Bull 624. See also *Jack Wiles* (1972) 59 TC 289, acq 1973-2 Cum Bull 4, aff'd (5th Cir 1974) 491 F2d 1406 (settlor denied deductions for rentals paid to trust because transaction lacked business purpose and settlor, as sole trustee, retained broad powers and control over trust property).

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§19.61 3. Treatment of Income for Grantor Trust

If the settlors are considered to be the owners of the trust under the "grantor trust" rules of IRC §§671-679 (see §§3.24-3.46), the trust does not receive taxable rental income and is not entitled to any deductions relating to the rent. Likewise, the rental income is not considered to be income to the settlors, and they are not entitled to any corresponding deductions. The trust is considered to be a grantor trust if the property is encumbered with recourse debt and is gratuitously transferred to the trust. See §§19.55-19.56.

The settlors must, however, still make the lease payments. If the settlors do not, they may be deemed to have an interest in the property for purposes of IRC §2036. See Treas Reg §20.2031-7; IRS Pub 1457.

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B. Sale of Property to Trust

§19.62 1. Advantages and Disadvantages of Sale to Trust

In the course of a transaction in which the settlors lease the property from the trust, the settlors may also wish to sell —rather than gratuitously transfer—the property to the trust. The advantages of a sale of the property to the trust include (a) the possible provision of liquidity to the settlors and (b) the trust's possible receipt of a new basis for depreciation purposes (if the property is depreciable).

The disadvantages of a sale include (a) a possibility of triggering the realization of any capital gains and depreciation recapture so that a tax must be paid and (b) loss of the use of the asset by the settlors. The former is a true economic disadvantage only if capital gain is realized before the receipt of the sales proceeds (such as might happen if any installment program were not properly qualified or if the property were subject to an encumbrance in excess of the settlor's basis). The latter disadvantage may be overcome through the use of a leaseback.

If the settlors are to be the source of the funds used by the trust to purchase the property, the settlors will obviously give up the advantage of the receipt of liquidity. In addition, the IRS may apply the step-transaction doctrine and treat the transaction as a gift of the property to the trust rather than a sale, thus depriving the trust of the new income tax basis for purposes of depreciation. Of course, the settlors may wish to give part of the property as a gift and to sell the other part of the property. In fact, a part-gift, part-sale will be presumed if the property is subject to an encumbrance in excess of the settlors' basis—a common situation with depreciable real property. On encumbered property, see §§19.50-19.57.

A sale of property to an irrevocable trust that is intentionally a grantor trust for income taxes has been suggested as an alternative to a grantor-retained annuity trust (GRAT). The technique uses a note from the trust secured by the asset sold to the trust. The transactions between the settlors and the trust supposedly have no income tax consequences because of Rev Rul 85-13, 1985-1 Cum Bull 184. Like the GRAT, the transaction is supposed to produce estate and gift tax savings if the trust has a total net return in excess of the interest rate on the note, although such savings are at least partially dependent on the idea that the settlors have not made an additional gift of the payment of the income taxes. Unlike the GRAT rules, if a settlor dies during the term of the note, only the note is supposed to be included in the settlor's estate. This technique may work only in theory, however. There do not appear to be any decisions on the technique, which may depend on the trust's *independent* ability to pay the note. See IRS Letter Ruling 9535026. For further discussion, see §§3.44B-3.44C. See also chap 13A.

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§19.63 2. Installment Sale Treatment

If the trust does not have the liquidity necessary to purchase the property outright or if the trustee believes an installment sale is more in keeping with its interests, an installment sale properly structured under IRC §453 may provide the settlors with a liquid income stream that offsets any leaseback payments. The trust will be able to acquire a new income tax basis and begin depreciating the property anew.

Moreover, if the settlors wish to make additional gifts to the trust, the settlors may do so by forgiving the installment payments, although that would not relieve the settlors from recognizing the installment capital gain. If, however, the settlors make the sale with the preconceived idea of making gifts of the installment payments, the gift will be deemed to be of the entire value of the property, and the trust will not receive a new income tax basis. Similarly, unless the trust has other means of making the payments, the IRS will treat the situation as a gift with no income tax basis adjustment.

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§19.64 3. Realization of Capital Gain

If the trust is not a grantor trust for purposes of IRC §§671-679 (see chap 3), the tax treatment of any capital gain realized by the settlors depends on the character of the property in their hands. IRC §§1221, 1231, 1245, 1250.

The capital gain realized by the settlors may not be recognized if the settlors reserve or immediately or simultaneously take back a lease for a period of 30 years or longer. Such a lease is treated as a tax-free exchange under IRC §1031. Treas Reg §1.1031(a)-1(c). However, other consideration (*e.g.,* cash or property not of a like kind) is considered to be "boot," and capital gain will be realized to the extent of the boot. For an argument that gain could also be recognized on the lease, see *Jordan Marsh Co. v Commissioner* (2d Cir 1959) 269 F2d 453, distinguishing *Century Elec. Co. v Commissioner* (8th Cir 1951) 192 F2d 155, cert denied (1952) 342 US 954. See also *Crowley, Milner & Co. v Commissioner* (6th Cir 1982) 689 F2d 635; *Leslie Co. v Commissioner* (3d Cir 1976) 539 F2d 943.

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§19.65 4. Nonrecognition of Capital Loss

If the sale price is below the settlors' basis for the property, IRC §267 appears to disallow a deduction by the settlors for the capital loss. That is because IRC §267 disallows the recognition of capital losses on transactions between certain related persons, including those between a settlor and a trust created by the settlor.

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§19.66 5. When Trust Is "Grantor Trust"

If the irrevocable trust is considered to be a grantor trust for purposes of IRC §§671-679 (see §§3.24-3.46), the sale of the property to the trust will not trigger any capital gains realization for the settlors. Similarly, with no recognition, the trust will not receive a new income tax basis.

If the grantors later repurchase the property from the trust, the grantors will retain the same basis. Although this may give rise to the possibility that the grantors will purchase the property back from the trust, such an option may not be available for qualified personal residence trusts (QPRTs) and, at least in the view of the IRS, nonqualified personal residence trusts (PRTs). Treas Reg §25.2702-5(b)(1), (c)(9). For discussion of QPRTs, see chap 17.

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§19.67 VII. MORTGAGES, DEEDS OF TRUST, AND OTHER SECURED INSTRUMENTS

The trustee has the power to invest in any kind of property. Prob C §16047(e). See chap 10. Moreover, the trustee has the statutory power to make loans to a beneficiary on terms and conditions that the trustee determines to be fair and reasonable. Prob C §16244.

The general power to invest in any kind of property may include the power of the trustee to invest in mortgages, interests in mortgage pools, participating mortgages, deeds of trust, and other forms of security. Sections 19.68-19.73 discuss issues that arise when the trustee holds mortgages as part of the trust's principal.

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A. Power to Subordinate

§19.68 1. Need for Power to Subordinate

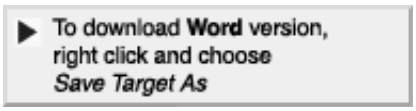
During the course of an investment that is secured, the trustee may wish to subordinate the trust's debt to that of a third party. Such a situation may arise when the property used to secure the investment is part of a business that needs to take on additional investors or lenders who are only willing to do so if the trust's security is subordinate to their own.

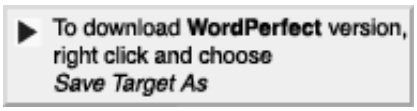
The power of a trustee to subordinate an existing security is not provided by statute. Because the subordination reduces the value of the trust's investment (by reducing the security of the debt), the trustee may have a duty not to subordinate. At the very least, without a power to subordinate provided in the trust instrument, the trustee is in a vulnerable position. The settlors may wish to provide such a power in the trustee, particularly if they know that the trust will invest in debts secured by property.

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§19.69 2. Form: Grant of Power to Subordinate





19.69-1 Power to subordinate

***Power to Subordinate Encumbrance*. The trustee is authorized to subordinate any encumbrance on property if, at the trustee's discretion, such subordination does not unreasonably impair the security held for the loan or obligation.**

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B. Investments in Default

§19.70 1. Need for Power to Foreclose

The power to foreclose on property that is the subject of a security owned by the trustee may be found in the evidence of the security. If the property that is the security for the debt is located in another state, however, the trustee may be comforted by a specific power in the trust instrument. If the debtor defaults on the underlying note, the trustee may sell the property to a third party or acquire the property for the trust.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.71 2. Form: Authorization to Foreclose and Bid on Property

§19.71 2. Form: Authorization to Foreclose and Bid on Property

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19.71-1 Authorization to foreclose and bid on property

***Power to Foreclose on Property*. The trustee is empowered to bid for and purchase any real or personal property in which the trustee may have an interest as lienholder or otherwise and that is sold at any foreclosure, trustee's, or pledgee's sale under any mortgage or deed of trust or at any judicial sale. The trustee may also acquire by purchase at any foreclosure sale, or by deed instead of any foreclosure or sale, property covered by any mortgage, deed of trust, or pledge then in default. The property may be accepted in partial or full satisfaction of the encumbrances against the property.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.72 3. Allocation of Proceeds on Disposition of Property Acquired by Foreclosure

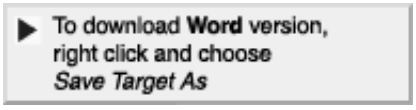
§19.72 3. Allocation of Proceeds on Disposition of Property Acquired by Foreclosure

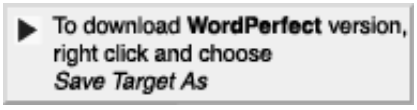
If the property is acquired by the trustee, it may produce income that would be allocated according to the terms of the trust instrument or by statute. Alternatively, the trustee may need to dispose of the underlying property at some point, or the property may be sold to a third party. In any case, the proceeds on disposition of property acquired by foreclosure are allocated to principal unless otherwise provided in the instrument. Prob C §16365(b). For a discussion of underproductive property, see §§19.34-19.49.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.73 4. Form: Allocation of Sale Proceeds of Property Acquired by Foreclosure

§19.73 4. Form: Allocation of Sale Proceeds of Property Acquired by Foreclosure





19.73-1 Allocation of sale proceeds of property acquired by foreclosure

***Disposition of Property Acquired by Foreclosure*. If the trustee acquires property by or in lieu of foreclosure of any mortgage, deed of trust, or other encumbrance, and if the property has not produced an average net income** _ _[*of at least* _ _[*number*]_ _ *percent/at least equal to the prevailing rate paid on regular savings accounts by national banks located in the place of administration of the trust/at least equal to the prevailing rate paid on United States Savings Bonds, Series EE, or any successor series*]_ _ **per year of its** _ _[_ _[*inventory/average/fair market*]_ _ *value as of the* _ _[*beginning/end*]_ _ *of the year*]_ _ **for more than one year, including as income the value of any beneficial use of the property by the income beneficiary, a portion of the net proceeds of the sale of the property shall be treated as delayed income to which the income beneficiary is entitled, regardless of when the property may be sold after it is acquired. The amount allocated as delayed income shall be the difference between the net proceeds of sale and the amount that, had it been invested at simple interest at that** _ _[*percentage/rate*]_ _ **per year while the property was underproductive, would have produced the net proceeds. This amount, plus any carrying charges and ordinary expenses previously charged against income while the property was underproductive, less any income received by the income beneficiary from the property and less the value of any beneficial use of the property by the income beneficiary, is income, and the balance is principal.**

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VIII. BUSINESS INTERESTS

§19.74 A. Chapter 14

No discussion of the establishment of irrevocable trusts with business interests would be complete without a discussion of the implications of Internal Revenue Code, Chapter 14 (IRC §§2701-2704) and the family partnership rules of IRC §704. Chapter 14 is Congress's attempt to prevent so-called estate freezes of closely held business interests (see §§2.25-2.32), while §704 is Congress's attempt at preventing manipulation of the income tax rules through partnerships. Chapter 14 should be reviewed before any transfer of a closely held business interest, and the rules governing the taxation of family partnerships in IRC §704(e) should be reviewed before the transfer of partnership interests.

For more complete discussion of the Chapter 14 rules, see California Estate Planning, chap 25 (Cal CEB 2002).

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.75 1. Transfers of Interests in Corporations and Partnerships

§19.75 1. Transfers of Interests in Corporations and Partnerships

Internal Revenue Code §2701 provides special gift tax valuation rules for transfers of certain interests in corporations and partnerships to members of the transferor's family. The special valuation rules require that certain interests retained by the transferor or an "applicable family member" be ignored for purposes of valuing a gift unless certain statutory requirements are met. IRC §2701(a)(3)(A). The relevant retained interests are liquidation rights; put, call, or conversion rights; and, if the transferor and the transferor's family "control" the corporation or partnership, distribution rights. "Control" is defined as the holding of at least 50 percent of the total voting power or total fair market value of the equity interests in the corporation, at least 50 percent of the capital or profits interest in the partnership, or any interest of a general partner. IRC §2701(a)(1), (b)(1); Treas Reg §25.2701-2(b)(2), (5). Under IRC §2701(a)(3)(B), however, these retained interests are more favorably valued if held in conjunction with certain qualified payment rights. See IRS Letter Ruling 200138028.

PRACTICE TIP: In some situations it is desirable to establish a partnership that provides the older-generation family member with interests that qualify for subtraction when valuing any gifts under IRC §2701. Such partnerships are sometimes referred to as "freeze" partnerships or preferred limited partnerships. For an analysis of this technique, see Dees, *Using a Partnership to Freeze the Value of Pre-IPO Shares*, 33 U Miami Inst Est Plan, chap 11 (1999). The cited ruling suggests a possible method for structuring the retained interest. Some commentators have suggested that planning may include a transfer of the retained interest to another business entity or a sale of the interest to an intentionally defective grantor trust (see §3.44B).

Under Treas Reg §25.2701-2(c)(2), the transferor may elect to treat retained distribution rights (*e.g.,* preferred dividends) as "qualified payments rights" with the consequence that the distribution rights will be taken into account in valuing the retained interest (*e.g.,* preferred stock) and the transferor will be deemed to make gifts to the holders of the transferred interest (*e.g.,* common stock) if in the future the transferor does not actually receive the contemplated distributions. The election must be made at the time of filing the gift tax return. Treas Reg §25.2701-2(c)(5). However, the election may be made on an amended gift tax return if the original gift tax return did not report the transfer, as might occur if the owners of voting common stock received before the effective date of the rules convert a portion of the stock to preferred stock at a time when other family members hold nonvoting common stock received from the original transferor in the same transaction. See IRS Letter Ruling 200839029.

If an equity interest is held by a particular individual in more than one capacity, the interests are treated as held by the individual in the manner that will attribute the greatest total ownership of the equity interest. Treas Reg §25.2701-6(a)(1). A person is considered to hold an equity interest held by a trust to the extent that the person's beneficial interest in the trust may be satisfied by the equity interest, or the income from that interest, assuming the maximum exercise of discretion in favor of the person. Treas Reg §25.2701-6(a)(4).

These special valuation rules do not apply if price quotations from an established securities market are readily available for the asset to be transferred as of the date of the transfer. IRC §2701(a)(1), (2)(A); Treas Reg §25.2701-1(c)(1)-(2). Other special valuation rules may apply, however, if the stock is transferred to a trust in which the grantors retain an interest. IRC §2702. On grantor-retained interest trusts, see chaps 14-17.

The special valuation rules of IRC §2701 also do not apply if the interest retained by the transferors is proportional to the class of interest that is transferred, without regard to nonlapsing differences in voting rights, management rights, or limitations on liability. For example, if the corporation has only one class of stock outstanding, gifts can be freely made without concern about Chapter 14. The same is true if only one kind of general partnership interest exists. The transferors or applicable family member may be able to retain a general partner interest and transfer limited partner interests if they do not have the right to alter the liability of the transferee. IRC §2701(a)(2); Treas Reg §25.2701-1(c)(3). These rules do not apply to the transfer of nonvoting shares of S corporation stock when the transferor retains voting shares. When the corporation or partnership interests contain lapsing rights, the transferor or applicable family member still may be able to make a transfer of interests if the transfer results in a proportionate reduction of each class

of equity interest held by the individual and all applicable family members. Treas Reg §25.2701-1(c)(4).

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.76 2. Buy-Sell and Other Restrictive Agreements

§19.76 2. Buy-Sell and Other Restrictive Agreements

Internal Revenue Code §2703 provides that the value of any transfer of property for gift, estate, and generation-skipping transfer tax purposes will be determined without regard to any agreements, options, rights, or restrictions. Such agreements include any rights to acquire or use the property at a price less than its fair market value and any restrictions on the right to sell or use the property.

The special valuation rules of IRC §2703 do not apply if (IRC §2703(b); Treas Reg §25.2703-1(b)(1)):

- The right or restriction is a bona fide business arrangement;
- The right or restriction is not a device to transfer such property to the "natural object of the transferor's bounty" for less than full and adequate consideration; and
- The terms of the right or restriction, at the time the right or restriction is created, are comparable to similar arrangements entered into by persons in an arm's-length transaction.

This three-part statutory and regulatory test is deemed to be met if more than 50 percent by value of the property subject to the right or restriction is owned, directly or indirectly, by individuals who are not members of the transferor's family or "natural object[s] of the transferor's bounty." Treas Reg §25.2703-1(b)(3). See *Estate of Gloeckner v Commissioner* (2d Cir 1998) 152 F3d 208 (young business manager who benefited from agreement was not natural object of decedent's bounty). Even in such cases, however, the tests developed under case law (*i.e.*, a fixed or formula price, applicable during life, and the estate of an owner obligated to sell at death) and Treas Reg §20.2031-2(h) (*i.e.,* a bona fide business arrangement, absence of testamentary purpose, and adequacy of consideration) need to be met. *Estate of True v Commissioner* (10th Cir 2004) 390 F3d 1210; *St. Louis County Bank v U.S.* (8th Cir 1982) 674 F2d 1207; *Estate of Pearl I. Amelie*, TC Memo 2006-76; *Estate of George C. Blount*, TC Memo 2004-116, aff'd in part and rev'd in part on other grounds (11th Cir 2005) 428 F3d 1338; *Estate of Joseph H. Lauder,* TC Memo 1992-736. For further discussion of these requirements, see Zuckerman & Grall, *Corporate Buy-Sell Agreements as Estate and Business Planning Tools*, 20 Est Plan 599 (2001).

In *Estate of George C. Blount, supra,* the Tax Court held that the value of the decedent's stock in a closely held corporation was not set by a 1996 buy-sell agreement that replaced a 1981 buy-sell agreement because the decedent as majority shareholder and sole surviving party to the 1981 agreement other than the corporation could unilaterally modify the 1996 agreement, rendering it nonbinding during the decedent's lifetime. The requirements of IRC §2703 applied because the 1981 agreement was substantially modified by the 1996 agreement. The court also held that the terms of the modified agreement were not comparable to the terms of similar arrangements entered into by persons in arm's-length transactions. Thus, the court held that the agreement must be disregarded in determining the value of the stock. In *Estate of Pearl I. Amelie*, TC Memo 2006-76, however, the Tax Court held that the estate tax value of closely-held bank stock was determined by the price term of a restrictive agreement entered into by the decedent's conservator and the decedent's prospective heirs. The court held that the price of the stock under the restrictive agreement was fixed and determinable and that the agreement was binding on the decedent both during life and at death, as required by Treas Reg §20.2031-1(h). The court further held that the price term was comparable to similar agreements entered into by persons in arm's-length transactions, as required by IRC §2703(b)(3), based in part on evidence of actual negotiations among the parties and based in part on a survey of comparables by a valuation specialist obtained by the conservator during the negotiations. For further discussion of these decisions and related considerations, see Business Buy-Sell Agreements, chap 2 (Cal CEB 1991).

Pay particular attention to whether the trustee will be subject to any existing rights or restrictions. Such rights or restrictions may be "grandfathered in" so that they may be able to be taken into account in valuing the transfer for purposes of such taxes. IRC §2703(a). Section 2703 applies to agreements, options, rights, or restrictions entered into, granted, or "substantially modified" after October 8, 1990. Treas Reg §25.2703-2. Treasury Regulation §25.2703-1(c) provides that a "substantial modification" is:

- Any discretionary modification that results in other than a de minimus change to the quality, value, or timing of

the rights of a party subject to the rights or restrictions; or

- The addition of "any family member" as a party to a right or restriction, including by reason of a transfer that subjects the family member to "a right or restriction" with respect to the property transferred unless (a) the addition is mandatory under the terms of the right or restriction or (b) the family member is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction.

In IRS Letter Ruling 200625011, the IRS ruled that an amendment to a pre-1990 buy-sell agreement involving S corporation stock, clarifying that the agreement applied only to nonvoting stock owned by shareholders, was not a substantial modification of the agreement.

In IRS Letter Ruling 9620017, property was to be transferred to a trust for the benefit of family members. The other parties to the existing agreement were to consent to the transfer to the trust without the restrictions of the existing agreement. The IRS found that the existing agreement had been "substantially modified" because (a) the change was more than de minimis and (b) the additional family members were members of a generation lower than the lowest generation that was already a party to the agreement.

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3. Family Partnership Income Tax Rules

§19.77 a. Family Partnership Test

Gifts of partnership capital interests will be respected for income tax purposes if the special family partnership test under IRC §704(e) and its regulations are met. These rules are the partnership equivalent of the grantor trust rules under IRC §§671-677. See §§3.22-3.44. The special family partnership test covers both general and limited partnership interests. The test requires that "a substantial portion of the gross income… [be] attributable to the employment of capital in the business conducted by the partnership," that "fees, commissions, or other compensation for personal services" not be the principal source of partnership income, that the donee acquire his or her interest in a bona fide transaction whereby he or she acquires dominion and control over the interest, and that the donee-partner be treated like the "real" owner of his or her interests. Treas Reg §1.704-1(e)(1)(iii)-(iv).

According to this test, the partnership will not be respected for income tax purposes if its income is earned not from capital but through the performance of services by members or employees of the partnership. If capital is a material income-producing factor, the partners must be reasonably compensated for their personal services performed for the partnership. Treas Reg §1.704-1(e)(1)(ii)-(iv). This part of the test prevents a donor from shifting his or her income from personal services to the donee. Similarly, the donor cannot shift only the income interest to the donee but must transfer an interest in the capital as well. Treas Reg §1.704-1(e)(1)(v). For example, the donor would not be able to establish a partnership in commercial real estate and transfer to the donee's partnership interests that are only entitled to income.

The special family partnership rules also apply to trusts or other fiduciary relationships. Treas Reg §1.704-1(e)(2)(vii)-(viii). A trustee who is "unrelated to and independent of the" donor, participates as a partner, and receives the distribution of the income attributable to the trust will be recognized as the owner of the interest for income tax purposes unless the donor has retained controls that are inconsistent with such ownership. See §19.78. If the donor is the trustee or the trustee is "amenable to the will of the" donor, the trust will be respected for income tax purposes "only if" the trustee "actively represents and protects" the interests of the beneficiaries in his or her dealings with the partnership. Similar to the grantor trust rules, such a trustee must be subject to fiduciary duties. Treas Reg §1.704-1(e)(2)(vii).

Although these rules are similar to the grantor trust rules, they are not identical. The term "amenable to the will of the" donor is considered to be more broad that the "related or subordinate party" rules of the grantor trust rules. *Adolph K. Krause* (1972) 57 TC 890, aff'd (6th Cir 1974) 497 F2d 1109, cert denied (1975) 419 US 1108, 42 L Ed 2d 804, 95 S Ct 780.

If the test under IRC §704(e) is not met, the partnership might still be considered to have shifted income from the donor to the donee if the more difficult test found in *Culbertson v U.S.* (1949) 337 US 733, 93 L Ed 1659, 69 S Ct 1210, is met. This test is one of "facts and circumstances" that indicate the partners "in good faith and with a distinct business motive" intended to join together in the present conduct of a business enterprise.

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§19.78 b. When Donor May Be Treated as Substantial Owner of Interest

The donor may be treated as the "substantial owner of the interest," instead of the donee, if the donor retains sufficient controls over the interest. For example, retaining control of distributions of amounts of income would be sufficient to cause the income to be taxed to the donor instead of the donee. Retention of such power, however, would not cause the donor to be taxed on the income if the amounts retained in the partnership were subject to the consent of all the partners or if the donor were the managing partner and the amounts retained were for the "reasonable needs of the business." Treas Reg §1.704-1(e)(2)(ii)(*a*).

The donor may not place any limitations on the donee's right to liquidate or sell his or her interest beyond the limitations that exist for the other partners of the donee's class. See Treas Reg §1.704-1(e)(2)(ix). The donor, however, may wish to restrict the transfer to outsiders and, in that case, may require that the donee sell the asset back for its fair market value on the date of the subsequent transfer. See Treas Reg §1.704-1(e)(2)(ii)(*b*). The donor may not retain management powers "inconsistent with normal relationships among partners." Treas Reg §1.704-1(e)(2)(ii)(*d*).

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§19.79 4. Partnership Interests in General

The transfer of a partnership interest, whether a family partnership or not, presents unique issues. Usually, it is necessary to obtain the partnership's consent to the substitution of the trustee for the settlor of the partnership interest, along with an amendment to the partnership agreement and, if the transfer is of a general partnership interest in a limited partnership, an amendment to the certificate of limited partnership.

Before the actual transfer, however, the settlor needs to consider the potential liability of the trust assets for the partnership liabilities and deal with them accordingly. See Advising California Partnerships, chap 3 (3d ed Cal CEB 1999). For example, if the trustee qua trustee will be a general partner, the other trust assets may be exposed to such liabilities. The settlor and the settlor's partners may be willing to convert the general partnership to a limited partnership. The trustee has a statutory power to consent to reorganizations (Prob C §16237) but does not have the power to participate in an ongoing business unless expressly provided by the trust instrument (Prob C §16222). See §19.80.

The settlor may also wish to include exculpation for the trustee for self-dealing if the trustee will or may also own an interest in the partnership. For such a clause, see §19.81.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.80 B. Power to Retain or Acquire Business Interests

§19.80 B. Power to Retain or Acquire Business Interests

The treatment of closely held business interests in the context of a transfer to and management by the trustee of an irrevocable trust presents many challenges to the estate planning attorney. For purposes of this discussion, these interests include businesses conducted as sole proprietorships, partnerships, corporations, and farms and ranches. This discussion anticipates that the settlors will want the trustee to participate in the management of the business enterprise.

California statutory law does not permit a trustee to participate in an ongoing business enterprise. Probate Code §16222(a) provides a trustee with some of the powers that may be necessary to run a business, including the power to incorporate, dissolve, or make other changes in the form of the organization. Such powers are particularly useful with growing businesses. Probate Code §16222(b), however, essentially forbids a trustee from participating in or continuing the operation of a business enterprise that is part of the trust property unless authorized to perform such functions either by the trust instrument or by a court. The further power to continue the operation of a business enterprise (but, curiously, not apparently the power to "participate in" such an operation) is granted pending a court hearing on such powers or a sale of the enterprise. Prob C §16222(c).

California law merely reflects the traditional rule that trustees may manage investments but not businesses. 4 Scott & Ascher on Trusts §19.1.6 (5th ed 2007). The fact that a settlor may have transferred an ongoing business interest to the trust will not exonerate the trustee. 3 Scott on Trusts §§19.1.6, 19.3.4.

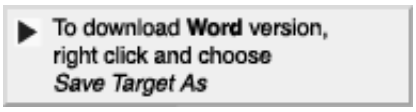
Thus, if the settlors wish to transfer an interest in an ongoing business concern to the trustee and if the settlors expect the trustee to participate in the management of the enterprise (as might be the case with the transfer of a general partnership interest or the transfer of a farm or ranch), the settlors must expressly empower the trustee to do so. *Copley v Copley* (1981) 126 CA3d 248, 278, 178 CR 842. For discussion of estate planning for farmers and ranchers in general, see Kelley & Ludtke, Estate Planning for Farmers and Ranchers (3d ed 2002); Estate Planning for Special Assets, chap 3 (Cal CEB 2004).

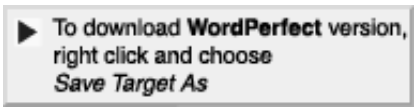
If the business to be transferred to or acquired by the trustee will be a general partnership interest, the other trust assets will be exposed to the risks of the general partnership. Before any transfer by the settlors, the partners of the business may wish to convert the partnership to a limited partnership after considering the gift tax concerns of Internal Revenue Code, Chapter 14 (IRC §§2701-2704). For discussion of these concerns, see §§2.25-2.32. Alternatively, the trustee and the remaining partners may wish to convert a general partnership to a limited partnership.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.81 1. Form: Authority to Invest in Partnerships

§19.81 1. Form: Authority to Invest in Partnerships





19.81-1 Authority to invest in partnerships

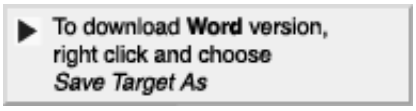
***Power to Invest in Partnerships*. The trustee may, without the order of any court, become or remain a general or limited partner in any type of business enterprise _ _**[, *even though the trustee may also be a partner in such business*]**_ _. The trustee may contribute trust property to the business or permit trust property to remain in it and enter into any partnership agreements relative to that business.**

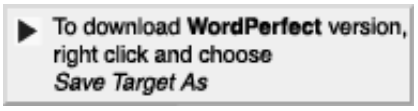
Comment: The bracketed language may be used if the trustee is or may be a member of the partnership as an individual or as the trustee of another trust, and the settlors wish to exonerate the trustee for any self-dealing.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.82 2. Form: Authority to Incorporate, Continue to Operate Business in Corporate or Unincorporated Form, and Form Corporations

§19.82 2. Form: Authority to Incorporate, Continue to Operate Business in Corporate or Unincorporated Form, and Form Corporations





19.82-1 Authority to incorporate, continue to operate business in corporate or unincorporated form, and form corporations

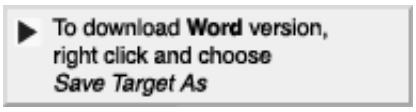
***Power to Operate Business*. The trustee may, without the order of any court, incorporate any business or operate or continue to operate any business in unincorporated form, or form corporations for any purpose (including, to the extent permitted by law, forming S corporations and limited liability companies in any jurisdiction) _ _**[, *even though the trustee may also be a shareholder in such business*]**_ _.**

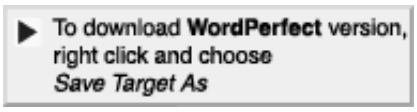
Comment: As with form 19.81-1, the bracketed language may be used if the trustee is or may be a shareholder of the business enterprise as an individual or as the trustee of another trust, and the settlors wish to exonerate the trustee for any self-dealing.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.83 3. Form: Authority to Consent to Corporate Transactions

§19.83 3. Form: Authority to Consent to Corporate Transactions





19.83-1 Authority to consent to corporate transactions

***Power to Consent to Corporate Transactions*. The trustee may, without the order of any court, consent to the merger, reorganization, combination, consolidation, or adjustment of the financing of any public or private corporation, or the sale to another corporation or person of all, substantially all, or any part of the property of any corporation, the bonds, notes, or other securities or the capital stock of which are held in this trust, and become a party to any agreement and perform any other act with reference to such securities or capital stock necessary or convenient to enable the trustee to obtain the benefit of any such merger, reorganization, combination, consolidation, adjustment, or sale.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.84 4. Form: Authority to Retain Specified Business Interest

§19.84 4. Form: Authority to Retain Specified Business Interest

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19.84-1 Authority to retain specified business interest

***Power to Retain Business Interest*. The trustee may, without the order of any court, acquire or retain any interests (including but not limited to general or limited partnership interests and shares of stock) in _ _[*name of business*]_ _. The trustee may also, at the trustee's discretion, operate or continue to operate _ _[*name of business*]_ _ or any successor enterprise.**

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§19.85 C. Directions on Management of Business Enterprise

If a settlor has specific ideas on how a business should be run, he or she may wish to provide the trustee with (1) directions on the management of the business enterprise transferred to the trust or (2) precatory language. Due to the dynamic nature of a business, the authors prefer precatory language coupled with the appointment of a trustee whom the settlors know shares their views on management. Inclusion of precatory language ensures that the settlors' views are known even to trustees appointed by others. Frequently, a committee of special trustees is used to hold voting powers and powers such as powers to direct sale or retention of the business. In that situation, the primary trustee should be directed to follow the instructions of the committee, although the primary trustee should be relieved of liability for the committee's actions. Such a committee can be made self-perpetuating.

For analyses of the courts' willingness to enforce mandatory directions, see *Estate of Colyear* (1964) 230 CA2d 558, 41 CR 88; 2 Scott & Ascher on Trusts §12.13.3 (5th ed 2006); 3 Scott on Trusts §§18.1.8.1-18.1.8.2; Cohan & Frimmer, *The New Breed of Quasi-Fiduciaries, Splitting Duties and Personal Liability for Wrongdoing*, 6 U Miami Inst Est Plan (1972).

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§19.86 D. Exoneration of Trustee From Liability for Management of Business Interest

A trustee may be reluctant to retain a business interest as part of the trust if he or she will be required to manage it because he or she may not possess the necessary skills. One possible solution is for the settlors to exonerate the trustee from liability for the management of the business interest. This alternative may be unsatisfactory, however, if the settlors want the business interest to be run efficiently. Another alternative is for the settlors to allow the trustee to employ managerial personnel to run the business and possibly allow the trustee to be exonerated for the decisions of these managerial personnel. For clauses permitting the trustee to employ managerial personnel and delegate duties, see §19.7-19.10.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.87 E. Trustee's Compensation in Connection With Management of Business

§19.87 E. Trustee's Compensation in Connection With Management of Business

The operation of a business interest by a trustee imposes duties on the trustee in addition to the duties assumed in the usual administration of a trust. If the trust instrument is silent, the trustee is entitled to "reasonable compensation under the circumstances." Prob C §15681. If the trustee is an attorney, however, he or she is limited to either the trustee's compensation or compensation for legal services unless he or she obtains the approval of the trust's beneficiaries. Prob C §15687. Even if the trust provides for the trustee's compensation, the trustee may seek the court's approval for greater compensation (1) if the trustee's duties are substantially different from those contemplated when the trust was created, (2) in extraordinary circumstances, or (3) when the compensation in the trust agreement would be "inequitable or unreasonably low." Prob C §15680.

Particularly if the settlors prefer to fix the trustee's usual compensation as a percentage of the trust's assets rather than relying on "reasonable compensation," the settlors may wish to provide that the trustee will be entitled to additional reasonable compensation for the management of a business interest. Moreover, if the trustee is also an officer of a corporation, the trustee may collect both trustee fees from the trust and the officer's salary from the company, as long as the salary is proper in amount for the services actually rendered to the company as the officer. *Estate of McLaughlin* (1954) 43 C2d 462, 274 P2d 868. To avoid confusion on the issue, the settlors may wish to provide that the trustee is or is not entitled to both types of compensation. The settlors must be careful in limiting the trustee's compensation. The compensation must be at least satisfactory to attract a competent trustee.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.88 1. Form: Reasonable Compensation in Connection With Business Interest

§19.88 1. Form: Reasonable Compensation in Connection With Business Interest

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19.88-1 Reasonable compensation for trustee's services in connection with business interest

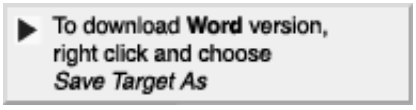
In addition to any compensation for the trustee's services as the trustee, the trustee shall be entitled to reasonable compensation _ _[*to be paid from the trust estate/to be paid from the business interest*]_ _ for the trustee's services rendered in connection with the management of any business interest held in the trust estate.

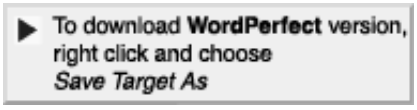
Comment: The settlors may wish to specify whether the trustee's compensation for the management of a business enterprise should be paid from the business or from the trust. If the compensation will be borne by the trust, the settlors may wish to specify whether it should be paid from income, principal, or both.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.89 2. Form: Compensation as Officer of Corporation Not to Interfere With Trustee's Compensation

§19.89 2. Form: Compensation as Officer of Corporation Not to Interfere With Trustee's Compensation





19.89-1 Compensation as officer not to interfere with trustee's compensation

***Compensation of Trustee*. Despite the fact that the trustee may be entitled to compensation as an officer, a director, or an employee of any corporation or other entity (interests of which are owned by this trust) and paid by the corporation or such other entity, the trustee shall be entitled to _ _[*reasonable*]_ _ compensation for services as trustee under this instrument.**

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F. Expenses of Ongoing Business

§19.90 1. Reimbursement of Trustee

Under Prob C §15684, the trustee is entitled to reimbursement of the following expenses:

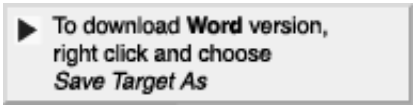
- Those "properly incurred in the administration of the trust"; and
- Those not properly incurred in the administration of the trust "[t]o the extent they benefited the trust."

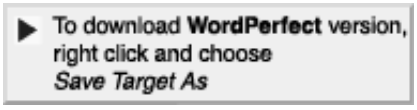
If the expenses to be reimbursed were incurred in the operation of a business, the general rule is that the expenses must be charged against the business and not the trust. 4 Scott & Ascher on Trusts §22.1.4 (5th ed 2007). If the settlors wish to specify that the business's expenses may be charged against the trust, the settlors need to provide direction in the trust instrument.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.91 2. Form: Reimbursement of Trustee for Expenses Related to Business

§19.91 2. Form: Reimbursement of Trustee for Expenses Related to Business





19.91-1 Reimbursement of trustee for expenses related to business

***Reimbursement of Trustee*. The trustee shall be reimbursed from the trust estate, without limitation to particular assets, for all reasonable expenses not incurred in bad faith by the trustee _ _**[*or the trustee's agents or employees*]**_ _ in connection with the management and investment of trust property, or the execution of the trustee's other duties under this instrument, including any expenses incurred in the conduct of any business operated as authorized under the terms of this trust.**

[*If appropriate, add the following option*]

[*Option: Reimbursement of expenses charged against business interest*]

The expenses incurred in the conduct of any such business shall, however, be first reimbursed from that business interest. If the assets of the business are insufficient to make reimbursement, the remainder of the expenses shall be reimbursed from the other assets of the trust.

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§19.92 3. Allocation of Net Receipts and Proceeds of Liquidation

The trustee may account separately for a business or other activity conducted by the trustee instead of accounting for it as part of the trust's general accounting records. Prob C §16352(a). A trustee who accounts separately for a business determines the extent to which net cash receipts will be retained for the capital needs of the business and the extent to which the remaining net cash receipts are allocated to principal and income. If the trustee sells the assets of the business, the proceeds are added to principal to the extent the proceeds are no longer needed in the conduct of the business. Prob C §16352(b).

These provisions are intended to give greater flexibility to a trustee who operates a business in proprietorship form rather than as a separate entity and facilitate the ability of the trustee to decide the extent to which to allocate net receipts to income just as the board of directors of a corporation would decide the amount of the annual dividend to be paid to the trust. However, none of the proceeds on liquidation of a business accounted for separately are allocated to income, even if derived from liquidation of accounts receivable. 29 Cal L Rev'n Comm'n Reports 245, 300 (1999). If the settlors wish to restrict the freedom of the trustee to retain net receipts or provide a different disposition of proceeds on liquidation of a business, the trust instrument must provide accordingly.

If the net income of a flow-through business interest (such as a partnership) remains undistributed, the trust itself (if the trust is a complex trust), the income beneficiary (if the trust is a simple trust), or the settlor (if the trust is a grantor trust under IRC §671 or §678) may be forced to pay an income tax without receiving the benefit of a concurrent cash inflow. For discussion of these three possibilities, see chap 3. The settlors may intentionally wish to pay such income tax, but it would be unusual for them intentionally to put the trust or the income beneficiary in such a position.

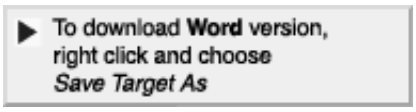
The business entity may have taxable income as well as cash income, but its governing body may decide not to make distributions to its owners, including the trust. Such potential cash flow matters should be discussed with the prospective board of directors or managing partners before the establishment of the business enterprise, or at least before the transfer of the settlors' interest to the trust. This situation can also develop if the business entity realizes capital gains, which are allocated to principal under Prob C §16355. In addition, a beneficiary or trust that has been subject to nondeductible expenses might be pressed for cash even if the business entity distributes current cash income. because the remaining income might not cover the income taxes on the gross income.

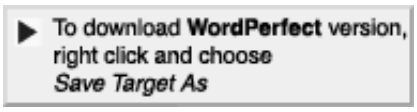
To overcome such potential liquidity issues for an income beneficiary, the settlors may define the "income" to which the income beneficiary is entitled to include capital gain, nondeductible expenses, and depletion allowances. Unfortunately, the settlors alone cannot overcome such difficulties for the trustee. If the trust is a "net-income-only-with-make-up" charitable remainder trust (NIMCRUT), such a definition of income may allow the trust not to make distributions in years in which the trust has no cash flow. On this type of charitable remainder trust, see chap 18. For discussion of the tax treatment of farm income, see Kelley & Ludtke, Estate Planning for Farmers and Ranchers (3d ed 2002).

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.93 a. Form: Definition of 'Income'

§19.93 a. Form: Definition of "Income"





19.93-1 Definition of "business conducted by the trustee"

Definition of "Income." **As used in this instrument, the phrase "business conducted by the trustee" means a business or other activity for which the trustee may account separately, as provided by Probate Code §16352.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.94 b. Form: Allocation of Net Cash Receipts

§19.94 b. Form: Allocation of Net Cash Receipts

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19.94-1 Allocation of net cash receipts

[*Use one of the following alternatives*]

[*Alternative 1: Allocation to income*]

***Allocation of Receipts*. Net cash receipts of a business conducted by the trustee shall be allocated to trust income, except to the extent that _ _**[*describe*]**_ _.**

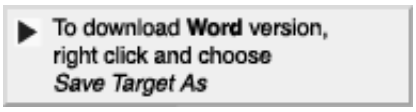
[*Alternative 2: Allocation by trustee*]

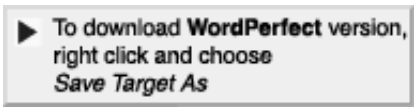
***Allocation of Receipts*. Net cash receipts of a business conducted by the trustee may be retained for the needs of the business or allocated to trust principal or income, as provided by Probate Code §16352.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.95 c. Form: Allocation of Proceeds of Liquidation

§19.95 c. Form: Allocation of Proceeds of Liquidation





19.95-1 Allocation of proceeds of liquidation

***Allocation of Proceeds of Liquidation*. If the trustee sells the assets of a business conducted by the trustee, the trustee shall allocate the proceeds _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income.**

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§19.96 G. Stock in S Corporations

Stock in a corporation qualified under Internal Revenue Code, Chapter 1, subchapter S (an S corporation) may be transferred to or purchased by a trustee without loss of the corporation's S status as long as the trust is (1) a "grantor trust" for purposes of IRC §§671-679, (2) a qualified subchapter S trust (QSST) as defined in IRC §1361(d), or (3) an electing small business trust as defined in IRC §1361(e). On the requirements for a QSST or an electing small business trust, see §§3.57-3.67.

The restrictions placed on S corporations may conflict with the settlors' estate planning goals. The settlors and the other shareholders of the corporation may have to decide between the income tax benefits of using the S corporation form or the flexibility that may be at the heart of the settlors' estate planning goals.

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§19.97 1. Grantor Trusts

A trust that is treated *entirely* as owned by the settlors or another person under the grantor trust rules of IRC §671 is a permitted shareholder of an S corporation's stock as long as the settlors or other person are United States citizens or residents. IRC §1361(c)(2)(A)(i); Treas Reg §1.1361-1(h)(1)(i). The trust may continue to hold the stock for as long as two years after the settlor's death under the terms of the trust agreement. Treas Reg §1.1361-1(h)(1)(ii). Such a trust may be a grantor trust without necessarily risking inclusion of the trust's assets in a settlor's estate for federal estate tax purposes. Grantor trust status is often intended to shift the economic burden of the payment of income tax—or the economic "benefit" of deductible losses—to the settlors while simultaneously allowing the trust and its beneficiaries the economic benefits of the income. Moreover, income will be passed through to the settlors (who may have the liquidity to meet the income tax burden) regardless of whether distributions from the S corporation are actually made to the trust. The IRS, however, has taken a dim view of such tactics for purposes of the application of the gift tax (IRS Letter Rulings 9444033, 9543049) but not for purposes of qualifying the trust to hold S corporation stock.

To qualify as a grantor trust without risking inclusion of the trust's assets in the settlors' taxable estates, the settlors may retain the nonfiduciary power to substitute property of equal value (IRC §675(4)), or the trustee of the trust may be a "subordinate or related person" holding prohibited powers, such as the power to add beneficiaries. See §§5.10-5.11. If the trust is a grantor retained annuity trust (GRAT), it most likely would qualify as the grantor trust of the settlors because of the settlors' retained interests. See chap 15. The trust might also qualify as the grantor trust of the income beneficiary if the beneficiary has *Crummey*-style withdrawal powers. IRS Letter Rulings 9226037, 9448018. See also Rev Rul 67-241, 1967-2 Cum Bull 225; Hall, *IRS Confirms Treatment of S Corporation GRATs as Grantor Trusts and Qualified Annuity Interests*, 7 J S Corp Tax'n 52 (1995).

If grantor trust status is used to qualify the trust as an S corporation shareholder, the settlor or beneficiary will be treated as the owner of the stock for purposes of the pass through of income and losses, including the loss limitation rule of IRC §1366(d), the at-risk rules, the passive loss rules, the income tax basis of the stock for capital gain purposes, and the distribution provisions. In other words, although a distribution of income may be made to the trust from the S corporation, the settlor or beneficiary will report such income on his or her income tax return.

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§19.98 2. Marital Deduction Trusts

The trust may also qualify as a grantor trust if a settlor's spouse has rights or powers in the trust that, if retained by the settlor, would cause the trust to be taxed as the settlor's or spouse's grantor trust. IRC §§671, 678. Usually, a qualified terminable interest property (QTIP) trust or a power of appointment trust under IRC §2056(b)(5) (marital deduction trust) will satisfy any QSST requirements. A power of appointment trust may qualify as a trust that is subject to IRC §678. For the QSST requirements, see §§19.99-19.100. For discussion of QTIPs and power of appointment trusts, see Drafting California Revocable Trusts (4th ed Cal CEB 2003).

One important distinction between marital deduction trusts and QSSTs is that the assets of the marital deduction trust must be income-producing assets, or the spouse must be given the power to convert trust property to income-producing property or have the power to compel the trustee to do so. See Treas Reg §20.2056(b)-5(f)(4). The other shareholders may not wish the spouse to have the power to compel the trustee to sell the trust's investment in the S corporation. Ideally, this situation will have been addressed at the time the corporation was formed or in a buy-sell agreement.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/ 3. Qualified Subchapter S Trusts (QSSTs)/§19.99 a. Requirements

3. Qualified Subchapter S Trusts (QSSTs)

§19.99 a. Requirements

A trust that meets the requirements of IRC §1361(d)(3) may also be a shareholder of an S corporation as long as the beneficiary files a separate QSST election with respect to the stock. IRC §1361(d)(1)-(2). For specific requirements pertaining to the beneficiary's election of S corporation status, see chap 3.

If a trust is to qualify as a QSST, the following requirements under IRC §1361(d)(3) must be met:

- There may be only one current income beneficiary (the "beneficiary");
- Any principal distributed during the life of the beneficiary may be distributed only to the beneficiary;
- The income interest of the beneficiary must terminate on the earlier of the beneficiary's death or the termination of the trust; and
- If the trust terminates during the life of the beneficiary, the trust must distribute all its assets to the beneficiary.

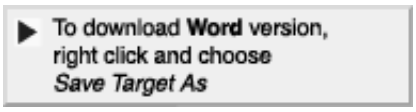
Moreover, all the trust accounting income as defined in IRC §643(b) (not the income of the S corporation) must be distributed currently to the beneficiary, either by the terms of the trust instrument or by the action of the trustee. IRC §1361(d)(3)(B); Treas Reg §1.1361-1(k)(1), Example (4)(i). These rules present some unique issues.

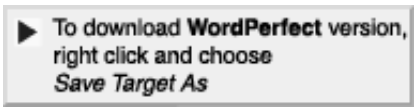
Because IRC §643(b) simply requires that "income" be defined within the parameters of state law and the governing trust instrument, there is an opportunity to define it in such a manner that the settlors' estate planning goals are more easily accomplished without sacrificing S corporation status. If the settlors intend to transfer S corporation stock to the trust, the trust may be drafted to accommodate the specific statutory requirements. A family "pot" trust (in which the trustee may distribute current income to more than one beneficiary (see App A)) would not, without more, qualify as a QSST. Likewise, a trust that permits the trustee to accumulate the current income, without more, would not qualify. Such trusts would qualify as electing small business trusts under IRC §1361(e). See §§3.64-3.67. If, however, the settlors, intend to transfer other assets that might be converted into S corporation stock, and the settlors wish the trust to be at least initially structured with terms in conflict with the QSST provisions, the settlors may wish to provide for a change in the trust's terms on conversion into S corporation stock.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.100 b. Form: Qualification of Trust as QSST

§19.100 b. Form: Qualification of Trust as QSST





19.100-1 Qualification of trust as QSST

***Qualification of Trust as QSST*. Despite any other provision of this instrument, if any stock in any corporation that is an electing small business corporation within the meaning of Internal Revenue Code, chapter 1, subchapter S would otherwise be held in this trust, and this trust is not otherwise qualified to hold such stock, the stock shall be held by the trustee in a separate qualified subchapter S trust (QSST) for the benefit of the primary beneficiary (called the beneficiary) of this trust. The QSST shall have terms that are identical to this trust except that:**

(a) During the lifetime of the beneficiary, there shall be only one income beneficiary;

(b) Any corpus distributed during the life of the beneficiary may be distributed only to the beneficiary;

(c) The income interest of the beneficiary shall terminate on the earlier of the beneficiary's death or the termination of the trust; and

(d) On the termination of the trust during the life of the beneficiary, the trust shall distribute all its assets to the beneficiary.

[*If appropriate, add one of the following options*]

[*Option 1: Trustee has power to distribute income of QSST to beneficiary*]

Moreover, the trustee shall have the power to distribute all the income, within the meaning of Internal Revenue Code §643(b), of the QSST to the beneficiary.

[*Option 2: Special trustee has power to distribute income of QSST to beneficiary*]

Moreover, the special trustee shall have the power to distribute all the income, within the meaning of Internal Revenue Code section 643(b), of the QSST to the beneficiary.

Comment: If the trustee is independent of the settlors and beneficiaries, Option 1 may be used when the trustee does not otherwise have the unfettered discretion or duty to distribute the trust income. If a settlor or a "tax-sensitive" beneficiary is the trustee, either the trust should otherwise require the distribution of the trust's income to the beneficiary or Option 2 should be used with an independent special trustee. If Option 1 were to be used with such a trustee, the trustee may be deemed to have the power to alter the beneficial enjoyment for purposes of IRC §2036, §2038, or §2041 through the trustee's power to select the S corporation stock as an investment.

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4. Liquidating Distributions

§19.101 a. Disparate Provisions in Internal Revenue Code and Regulations

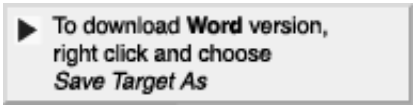
Internal Revenue Code §1361(d)(1)(B) provides that the QSST beneficiary will be taxed on any gain from the trust's disposition of the S corporation's stock. The final regulations, however, provide a different rule: The gain or loss with respect to such disposition by a QSST is recognized to the trust and not the beneficiary. Treas Reg §1.1361-1(j)(8).

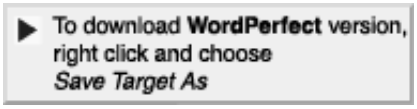
The settlors may wish to preserve the options presented by the confusion between the statute and the regulations through the power provided in form 19.102-1.

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§19.102 b. Form: Power to Make Distributions to Pay Capital Gains Tax





19.102-1 Trustee's power to make distributions to pay capital gains tax

***Distributions to Pay Capital Gains Tax*. The trustee, at the trustee's discretion, may distribute to or for the benefit of the income beneficiary an amount of principal equal to the amount of any federal or state income tax levied on the income beneficiary on the gain from the sale of property otherwise allocated to principal.**

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§19.102A 5. Electing Small Business Trusts

Under IRC §§1361(b)(2)(A)(v) and 1361(e), an electing small business trust (ESBT) may hold S corporation stock. If the trust meets the statute's requirements for ESBT status, and the trustee of the trust makes the required election (see §3.65), the portion of the trust consisting of stock of one or more S corporations is subject to special rules that modify the customary rules for taxation of trusts. Generally, the portion of the trust consisting of S corporation stock is treated as a separate trust and is taxed at the highest income tax bracket. See §3.67 for discussion of the special taxation rules applicable to ESBTs. Subject to certain limitations, a QSST can be converted to an ESBT and vice versa. See Treas Reg §1.1361-1(j)(12), (m)(7).

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H. Stock of "Controlled" Corporations

§19.103 1. When Settlors May Retain Right to Vote

The retention of the right to vote, directly or indirectly, shares of stock of a "controlled corporation" will cause the shares to be included in the transferor's gross estate. IRC §2036(b). A controlled corporation, for these purposes, is a corporation in which a transferor, at any time after the transfer and during the three-year period ending on the date of the transferor's death and after applying the attribution rules of IRC §318, owned or had the right (alone or in conjunction with any person) to vote stock possessing at least 20 percent of the total combined voting power of all classes of stock of the corporation. IRC §2036(b)(2).

The proposed regulations cloud the picture as to when a transferor may retain voting rights in a fiduciary capacity. "Stock that possesses voting rights in only extraordinary matters, such as mergers or liquidations" *will not be* subject to this rule if the transferor's retention of voting rights "is only in a fiduciary capacity." However, "[s]tock carrying voting rights that will vest only when conditions occur, such as preferred stock which gains voting rights only if no dividends are paid" *will be* subject to this rule but only when the conditions occur that give the transferor the right to vote the stock, if the transferor's retention of voting rights also "is only in a fiduciary capacity." Prop Treas Reg §20.2036-2(a). In other cases, a fiduciary power is a right to vote stock within the meaning of the rule. Prop Treas Reg §20.2036-2(c).

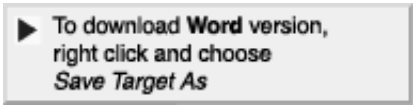
Whether or not the transferor has retained voting rights apparently depends on facts and circumstances. The proposed regulations provide that any shift of the "formal voting power" away from a transferor will not be treated as a relinquishment of such power if "in substance" the transferor has retained such power, and voting power will be deemed retained when there is any express or implied agreement that the holder of the voting power will vote or will not vote the stock in a specified manner. The proposed regulations indicate that the attribution rules of IRC §318, while applicable to the question of whether the corporation is "controlled," are not applicable to the retention of voting rights for purposes of IRC §2036. Therefore, the fact that a "relative" is the trustee of a trust to which a settlor has transferred stock "shall not in itself require a finding that the [transferor] indirectly retained the right to vote that stock." Nevertheless, if the transferor may revest the power to vote the stock, the transferor has retained the right to vote the stock. Prop Treas Reg §20.2036-2(c).

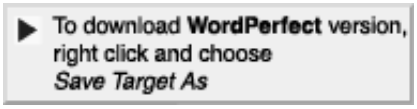
If a settlor intends to transfer the stock of such a controlled corporation, one alternative to this IRC §2036(b) issue is to appoint an independent trustee of the trust, who may be either an individual or a corporate fiduciary. If the settlors are unwilling to give up fiduciary control over other aspects of the administration of the trust, however, it will be necessary to carve out the power to vote such stock from the other duties and powers and vest the power in a special trustee.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.104 2. Form: Power to Vote Stock of 'Controlled' Corporation

§19.104 2. Form: Power to Vote Stock of "Controlled" Corporation





19.104-1 Power to vote stock of "controlled" corporation

***Power to Vote Stock of Controlled Corporation*. Despite any other provision of this instrument, the voting trustee, rather than the trustee, shall have the power to vote, or to establish or participate in any voting trust with respect to, any shares of stock of a controlled corporation (within the meaning of Internal Revenue Code §2036(b) or any successor provision) that are transferred to this trust, directly or indirectly, by any person or persons who are then acting as the trustee.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.105 I. Stock Subject to Securities Acts Restrictions

§19.105 I. Stock Subject to Securities Acts Restrictions

This section discusses issues in connection with stock subject to restrictions under the following provisions:

- Securities Exchange Act of 1934 §10(b) (15 USC §78j(b)); Rule 10b-5 (17 CFR §240.10b-5). See §19.106.
- Securities Exchange Act of 1934 §16 (15 USC §78p). See §19.107.
- The Securities Act of 1933 (15 USC §§77a-77aa), including General Rules and Regulations (17 CFR §§230.100-230.904); Rule 144 (17 CFR §230.144). See §19.108.

Although other sections of various Acts and rules might also apply, discussion of them is beyond the scope of this chapter. For further discussion, see ABA Section of Business Law, A Fiduciary's Guide to Federal Securities Laws (1994).

In general, the laws and rules applied or enforced by the Securities and Exchange Commission (SEC) affect the identity of the trustee chosen by the settlors or the amount of stock to be transferred to the trust by the settlors. Similar to the manner in which state law is applied to the actions of a trustee, the laws and rules of the SEC take a practical approach and focus on the issue of whether the trustee would be in a position to manipulate the price of the stock or to use information that would unfairly benefit the trust.

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§19.106 1. Rule 10b-5

Rule 10b-5 of the Securities Exchange Act of 1934 was designed to thwart trading on so-called insider information. The rule prohibits the use of "material" nonpublic information in the sale or purchase of any security. It has been suggested that, absent the securities laws prohibitions on such information, traditional trust law concepts might require the use of the information. See ABA Section of Business Law, A Fiduciary's Guide to Federal Securities Laws 213 (1994). This situation would be an issue if the information turned out to be nonmaterial and the trustee refrained from trading. ABA Guide 235-236.

The question has not yet been answered by California law, but the SEC believes that a "reasonable belief" in the potential violation of Rule 10b-5, although mistaken, would protect a fiduciary from such liability. *Investors Mgmt. Co.* (1971) 44 SEC 633, 647, 1971 SEC Lexis 962. If the settlors wish to provide specific protection, the settlors might incorporate the SEC's apparent rule in an exoneration clause. For such a clause, see §10.39.

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§19.107 2. Section 16

Section 16 of the Securities Exchange Act of 1934 (15 USC §78p) is designed to thwart trading on insider information by penalizing the so-called short-swing trading that may be done by officers, directors, and 10-percent stock holders (insiders) of issuers that have a class of equity securities registered under Exchange Act §12 (15 USC §78*l*). Under 17 CFR §240.16a-8(a)(1), the trust will be considered to be an insider, regardless of who is the trustee or a cotrustee, if the trust is a beneficial owner of more than 10 percent of any such class of equity securities as provided in 17 CFR §240.16a-1(a)(1). In this type of situation, the trustee would make the filings on behalf of the trust but would report the trustee's own holdings and transactions only if the trustee were otherwise an insider.

For trusts with less than 10 percent of the company, the identity of the trustee is crucial to the determination of whether the trustee also is subject to §16. The SEC defines the trustee as the beneficial owner of securities held by the trust, in addition to securities held by the trustee. 17 CFR §240.16a-8(a)(2).

For purposes of determining ownership of stock, a person is deemed to be a "beneficial owner" of any shares for which the person has or shares voting power or investment power. The SEC adopted the beneficial ownership rules of Exchange Act §13(d) (15 USC §78m(d)) and 17 CFR §240.13d-3 for these purposes. 17 CFR §240.16a-1(a)(1). Banks and most financial institutions are excepted from this rule if they acquire the equity securities as a fiduciary in the ordinary course of business without the purpose *or effect* of changing or influencing the control of the issuer.

The equity securities that are the subject of the rule are essentially any securities traded on a national securities exchange and include some that are traded in the over-the-counter market. The penalty requires disgorging the profit realized from any purchase or sale of such equity securities within a period of less than six months. Each insider must file a statement with the SEC (and with at least one of the national securities exchanges on which any of the issuer's securities is listed) that discloses the insider's "beneficial ownership" of the issuer's equity securities and any changes in such ownership. 15 USC §78p(a).

If the trust is found to have received short-swing profits and must disgorge the profits, the trustee might be liable for the disgorgement. This problem is especially acute if the trust is an insider because one or more trustees are insiders. Of course, the settlors may exculpate the trustee from such liability. For an exoneration clause, see §10.39.

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§19.108 3. Securities Act and Rule 144

The restrictions on transferability contained in the Securities Act of 1933 also affect the identity of the trustee. If an issuer of securities, or an "affiliate" or "underwriter" (defined below) of an issuer, wishes to sell its securities to the general public, the seller must comply with certain registration requirements. Securities Act §5 (15 USC §77e). Any person who purchases securities sold in violation of these requirements may rescind the transaction or sue for damages up to 1 year after the transaction. Securities Act §§12(1), 13 (15 USC §§77e(1), 77m). Certain exemptions to these registration requirements exist, all of which are beyond the scope of this chapter other than the safe-harbor exemption provided by Rule 144 (17 CFR §230.144). This is the most common exemption.

It may be relatively simple to comply with Rule 144 because there are no additional registration requirements. Among other things, it has volume restrictions on how much may be sold under its safe-harbor provisions and restricts sales to "brokers' transactions" or a "market maker." 17 CFR §230.144(e)-(f).

The trustee must first ascertain whether the securities owned by the trust in question are "restricted securities" or "control securities." Restricted securities are those acquired from the issuer or an affiliate of the issuer in an unbroken chain without a public offering. One year (6 months if the issuer is subject to certain reporting requirements) after the private sale by the issuer or the latest private sale by the affiliate, the person who then owns the securities (if that person has not been an affiliate for the prior 90 days) may sell the securities. 17 CFR §230.144(d)-(e). If the securities are restricted, the trustee may rely on the Rule 144 provisions.

If the securities are unrestricted, the trustee must ascertain whether the trust or the trustee is a statutory underwriter for purposes of the Securities Act. The trust or the trustee will be considered to be an underwriter if the trust is a control person (an "affiliate") because of the trust's ownership of a control position. The trust or trustee may be a statutory underwriter if the trustee is an affiliate or if the aggregated position of the trustee (in whatever capacity) in the securities of the issuer make the trustee an affiliate. For purposes of defining affiliates, the Securities Act does not provide a definition of "control persons." Rule 405 (17 CFR §230.405) provides that "control" is essentially the power to direct the management and policies of a person, whether through ownership of voting securities, by contract or otherwise. Presumably, all directors and officers would be control persons as well as, perhaps, 10-percent owners. If the trust or the trustee is considered to be an affiliate, the trustee may need to rely on the Rule 144 provisions to sell the securities.

There are differing opinions as to whether the trust will be considered to be an affiliate if it has a trustee who is an affiliate. The SEC apparently will not treat two or more trusts as one control person merely because they have a common trustee, although the SEC would apply its aggregation rules when two or more trusts are acting "in concert." *Alfred L. Hoedeman, Esq.*, SEC No-Action Letter (Aug. 26, 1991) 1991 SEC No-Act Lexis 1030; *Wilmington Trust Co.*, SEC No-Action Letter (Aug. 13, 1982) 1982 SEC No-Act Lexis 2678; *Jesse E. Brill*, SEC No-Action Letter (Aug. 22, 1979) 1979 SEC No-Act Lexis 3489, CCH Fed Sec L Rep ¶82,431; *United Jersey Banks*, SEC No-Action Letter (May 28, 1976) 1976 SEC No-Act Lexis 1231; *Donald W. Gruettner, Esq.,* SEC No-Action Letter (Jul. 7, 1975) 1975 SEC No-Act Lexis 1346; *New York Clearing House*, SEC No-Action Letter (Oct. 5, 1972) 1972 SEC No-Act Lexis 3683, CCH Fed Sec L Rep ¶79,343. The conservative approach would be to treat the trust as an affiliate if the trustee is an officer, a director, or an owner of a "control position" owing to the trustee's individual account or to aggregation.

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IX. ASSETS SUBJECT TO DEPLETION (WASTING ASSETS), INTELLECTUAL PROPERTY, AND RETIREMENT PLANS

§19.109 A. Use of Wasting Assets to Fund Trust

Assets subject to depletion through use (*e.g*., leaseholds or mineral or timber interests), the passage of time (*e.g.,* intellectual property), or perhaps both use and time (*e.g.*, retirement plans) depreciate in value. Therefore, an asset of this type may not be an ideal choice to fund an irrevocable trust intended to save estate taxes in the future. These assets may be valued for gift tax purposes at a higher value than they would be valued for estate tax purposes at the settlor's death. Moreover, sometimes these assets carry with them certain income tax deductions that may be better used by the settlors than either the trust or its beneficiaries.

Selection of wasting assets, however, may qualify for the marital deduction for gift taxes for transfers to a trust that otherwise so qualifies. If the settlors own such an asset (*e.g.*, a patent or retirement annuity) and that is the only interest in the property, then, although such an interest is a terminable interest, it may still qualify for the marital deduction. As long as no one may enjoy the asset either before or after the spouse, the settlors may be entitled to a marital deduction.

Assuming that the transfer of wasting assets nonetheless is called for in the establishment of an irrevocable trust, issues concerning the allocation of income and expenses will arise if the trust neither is a unitrust (see chaps 14-16) nor accumulates income. Because these assets have unique economic properties and can create conflicting obligations for the trustee, the settlors may wish to deviate from statutory law or to make refinements to ambiguous accounting rules applied to these assets directly in the trust instrument—particularly for trusts designed to take advantage of the marital deduction or to be exempt from the generation-skipping transfer tax. For discussion of wasting assets, see California Trust Administration, chaps 5, 8 (2d ed Cal CEB 2001); Estate Planning for Special Assets, chap 8 (Cal CEB 2004).

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B. Allocation of Expenses and Income

§19.110 1. Rules for Allocation of Receipts

Probate Code §§16363 and 16364 provide the statutory rules for the distribution of receipts from property subject to depletion or amortization. These rules often depend on definitions of the particular receipts and not necessarily on economic reality. The rules are as follows:

- If the receipt is "rent" on a lease, the receipt is income. Prob C §16363(a)(1). This rule assumes that the asset on which the rent is paid is principal.
- If the receipt is a "production payment," the amount of the payment that is attributable to interest, or its equivalent, is income. The balance is allocated to principal. Prob C §16363(a)(2).
- If the receipt is a "royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental" or other amount received from a working interest in minerals or other natural resources, the trustee must allocate the receipt 90 percent to principal and 10 percent to income, except that "nominal" amounts are allocated to income. Prob C §16363(a)(3).
- If the natural resource to be exploited is timber, the trustee must allocate receipts to income to the extent that the amount of timber removed does not exceed the rate of growth of the timber, and otherwise to principal. Prob C §16364.

Receipts from "liquidating assets" such as leaseholds, patents, copyrights, and royalty rights other than mineral rights must be allocated 90 percent to principal and 10 percent to income. Prob C §16362. Also, in general, the trustee is not required to set aside a reserve from income for depletion or the amortization of trust property unless required by the trust instrument. Prob C §16372. A reserve may be appropriate if the property will need to be renovated at the end of a long term lease or the wasting asset is the only property of the trust; if a reserve is not established, the income beneficiaries will be favored over the remainder beneficiaries.

The trustee's power to allocate the receipts from these types of assets between income and principal and the trustee's power to establish a reserve from income may be troublesome for any trustee. Because of the potential to favor income beneficiaries over remainder beneficiaries and vice versa, a trustee might be tempted to go to court for direction—an expensive possibility. The settlors may thus wish to provide particular rules for the trustee to follow.

For a "tax-sensitive" trustee, when the trust is designed to benefit the trustee but not be attributable to the beneficiary-trustee's estate for tax purposes, such a power might cause inclusion in the beneficiary-trustee's estate. Likewise, if a settlor wishes to be trustee but also wishes to exclude the assets in the trust from the settlor's taxable estate, the settlor will, at the least, wish to have these administrative powers limited to a fiduciary context.

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.111 2. Form: Establishment of Reserve for Depreciation, Depletion, and Amortization

§19.111 2. Form: Establishment of Reserve for Depreciation, Depletion, and Amortization

▶ To download **Word** version, right click and choose *Save Target As*

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19.111-1 Establishment of reserve for depreciation, depletion, and amortization

[*Use one of the following alternatives*]

[*Alternative 1: Trustee must establish reserve*]

***Reserve for Depreciation*. Despite any other provision of this instrument, the trustee shall establish reasonable reserves for:**

(a) Depreciation of all income-producing real and personal property and of capital improvements and extraordinary repairs;

(b) Depletion of all depletable natural resources, including but not limited to oil, gas, minerals, and timber property; and

(c) Amortization of all intangible property with a limited economic life, including but not limited to patents, copyrights, and rights to receive payments on a contract for deferred compensation.

[*Alternative 2: Trustee may establish reserve*]

***Reserve for Depreciation*. Despite any other provision of this instrument, the trustee may, at the trustee's discretion, establish a reserve from income for the depreciation, depletion, or amortization of any asset. Any such reserve shall be established on the assumptions and in the amounts as the trustee, at the trustee's discretion, shall determine.**

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C. Natural Resources

§19.112 1. Trust's Lease or Ownership of Property Containing Natural Resources

A trustee has the power to enter into a lease or other arrangement for the exploration and removal of gas, oil, other minerals, or geothermal energy, and for a term extending beyond the term of the trust. Prob C §16232. On the trustee's power to enter into, or grant options for, such leases, see §10.70.

If the interest is located outside California, the settlors, drafter, or trustee must determine whether the interest is real or personal property under the law of the other state. If the property is considered to be real property, the trustee must check local law to ascertain which types of statutory powers the trustee will have. In addition, complex requirements may exist for the transfer of the interests to the trustee or to the remainder beneficiaries at the appropriate time. For these reasons, such assets are often placed in limited partnerships before establishment of the trust.

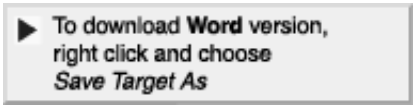
If the trust "owns" the oil, gas, or mineral interests through a limited partnership, the settlors may wish to consider defining trust accounting income to include only the income of the limited partnership that is actually distributed to the trust—particularly when the settlors have no control over the distributions from the limited partnership. Because the income tax liability on the income of the limited partnership will be the same regardless of whether the income is actually distributed or not, the settlors might also consider providing the trustee with the power to make invasions of principal for the income beneficiary in an amount that will cover the income tax liability with the establishment of a reserve from future income to reconstitute the principal. See form 19.111-1.

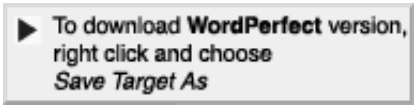
Royalty statements can be complex documents, and a special advisor may be necessary to review them. See Comment, *The Oil and Gas Lease as a Trust Asset*, 7 UCLA L Rev 358 (1960). See also Eubank, *Estate Planning for Oil and Gas Interests*, Estate Planning 1980, chap 7 (Cal CEB 1980); Crawford, *Estate and Gift Tax Planning for Oil and Gas Interests*, 31 Oil & Gas Tax Q 31 (1982).

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.113 2. Form: Trustee to Allocate to Income Given Percentage of Receipts From Property Containing Natural Resources

§19.113 2. Form: Trustee to Allocate to Income Given Percentage of Receipts From Property Containing Natural Resources





19.113-1 Trustee must allocate to income given percentage of receipts

***Allocation of Receipts From Natural Resources*. The trustee shall allocate to income all receipts from property containing natural resources, to the extent that these receipts do not exceed _ _[*e.g., 5*]_ _ percent per annum of the fair market value of the property on the date on which the property became subject to the trust or, if the resources were discovered after the property became subject to the trust, the date on which the resources were put into commercial use.**

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.114 D. Intellectual Property

§19.114 D. Intellectual Property

Patents, trademarks, copyrights, and royalties (whether the originals of the settlors or rights obtained by the settlors by other means) lose their value over time. For copyrights in particular, the copyright and the original work of art to which it relates may be separated and may be the subject of separate gifts. This separation is also recognized for gifts and bequests to public charitable organizations. IRC §§2055(e)(4), 2522(c)(3). See Estate Planning for Special Assets, chaps 7-8 (Cal CEB 2004); California Estate Planning, chap 23 (Cal CEB 2002).

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Source: Estate Planning/Drafting California Irrevocable Trusts/19 Issues Related to Nature of Trust Assets/§19.115 1. Assignment and Licensing of Copyrights

§19.115 1. Assignment and Licensing of Copyrights

The assignment of a "statutory" copyright may only be done by a written instrument signed by the "proprietor," preferably acknowledged so that it may be recorded. 17 USC §§201, 204-205. Licensing of a statutory copyright may be done orally or by written instrument or may be implied from conduct. Nevertheless, the preferred method of licensing is by written agreement. Moreover, the proprietor or, if deceased, a majority of the surviving spouse and children, may terminate a prior grant of rights and reacquire a copyright or other subsidiary right previously granted by the author. 17 USC §203.

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§19.116 2. Copyright Term and Renewal and Termination Rights

The date on which the original statutory copyright was created is important to the trustee's ability, if any, to renew the copyright. Copyrights created on or after January 1, 1978, have a term of the author's life plus 70 years. For a joint work of two or more authors, the 70-year period runs from the surviving author's death. For works published anonymously or under a pseudonym or for works made for hire, the copyright term is the lesser of 95 years from the year of publication or 120 years from the year of creation. These copyrights cannot be renewed. 17 USC §302.

Works that were in their first copyright term on January 1, 1978, have a copyright term of 28 years from the date of the first copyright with a renewal term of 67 years. Works that were in a renewal term on October 27, 1998, have a copyright term of 95 years from the date of the original copyright. 17 USC §304(a), (b). If the copyright has renewal rights, they must be separately assigned. *Edward B. Marks Music Corp. v Charles K. Harris Music Publishing Co.* (2d Cir 1958) 255 F2d 518; *Followay Prods., Inc. v Maurer* (9th Cir 1979) 603 F2d 72. An anticipatory assignment of such renewal rights, however, would be effective only if the author survived the original term. On the author's death, the right to renewal automatically passes to the surviving spouse and children, if then living. 17 USC §304(a). Thus, the spouse and children of the author would need to join in any anticipatory assignment of renewal rights.

For copyrights created on or after January 1, 1978, the author retains a right of termination of transfers and licenses beginning 35 years after the date of execution of the grant, which right also passes automatically to spouses, children, and grandchildren. 17 USC §203(a). For copyrights existing on January 1, 1978, transfers and licenses may be terminated 56 years after the original copyright date under a similar provision. 17 USC §304(c). For copyrights in works that were in a renewal term on October 27, 1998, for which the termination right has expired by that date, transfers and licenses may be terminated after 75 years with respect to the last 20 years of the copyright term. 17 USC §304(d).

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§19.117 E. Retirement Plans

Retirement plans (including defined benefit plans, profit-sharing plans, money-purchase pension plans, stock bonus plans, target benefit plans, and individual retirement accounts (IRAs)) may not be transferred to an irrevocable trust established by the settlor-participant during the settlor's life. Such plans that are subject to the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461) (qualified plans) must contain anti-alienation and anti-assignment clauses, and the participant is generally the only one who can receive distributions during the lifetime of the participant except for distributions under a qualified domestic relations order (QDRO). IRC §401(a)(13). *Boggs v Boggs* (1997) 520 US 833, 138 L Ed 2d 45, 117 S Ct 1754; *Branco v UCFW-Northern Cal. Employers Joint Pension Plan* (9th Cir 2002) 279 F3d 1154; *Ablamis v Roper* (9th Cir 1991) 937 F2d 1450; *Marriage of Shelstead* (1998) 66 CA4th 893, 78 CR2d 365. IRAs may not be transferred either, without triggering income tax and penalties, because the transfer would be treated as a withdrawal by the participant, followed by the transfer. *Michael G. Bunney* (2000) 114 TC 259.

In addition, the participant's surviving spouse has rights in qualified plans under federal law. Although the applicable statutes apparently do not apply to IRAs, the participant's surviving spouse may have community property rights in the IRA. See California Estate Planning, chap 21 (Cal CEB 2002).

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20

Multistate Trusts

Joseph L. Wyatt, Jr.
Patrick R. McCabe

I. MULTISTATE LIVING TRUSTS
- A. Scope of Chapter §20.1
- B. Conflict of Laws
  - 1. Nature of Problem §20.2
  - 2. Continuing Change in Conflict-of-Laws Theories §20.3
  - 3. Interest-Analysis Theory §20.4
  - 4. Form: Trustee May Apply Principle of Validation §20.5
- C. Hypothetical Case: The Jones Trust §20.6
- D. Use of Out-of-State Counsel §20.7

II. GENERAL RULES ON VALIDITY, CONSTRUCTION, INTERPRETATION, AND ADMINISTRATION OF LIVING TRUSTS
- A. Analyzing Conflicts of Laws in Terms of "Characterization" §20.8
- B. Validity of Trust §20.9
  - 1. Real Property §20.10
  - 2. Equitable Conversion of Real Property §20.11
  - 3. Personal Property §20.12
  - 4. Real and Personal Property §20.13
  - 5. Determining Character of Property as Real or Personal §20.14
- C. Interpretation and Construction of Trust §20.15
  - 1. Real Property §20.16
  - 2. Personal Property §20.17
  - 3. Real and Personal Property §20.18
- D. Administration of Trust §20.19
  - 1. Real Property §20.20
  - 2. Personal Property §20.21
  - 3. Real and Personal Property §20.22
  - 4. Change in Place of Administration §20.23
  - 5. Form: Trust Governed by Law of Place of Administration §20.24
  - 6. Form: Savings Clause for Unforeseen Tax Consequences §20.25
- E. Jurisdiction to Resolve Various Issues §20.26
  - 1. Jurisdiction to Determine Conflicting Rights and Claims to Trust Property §20.27
  - 2. When Courts of State Other Than Situs State May Act §20.28
  - 3. When Federal District Court May Refuse Jurisdiction Despite Existence of Diversity §20.29
  - 4. Validity of Choice-of-Forum Clauses §20.30
  - 5. Form: Choice of Forum §20.31
- F. Investments §20.32
- G. Trustee's Liabilities; Exculpatory Clauses §20.33
- H. Trustee's Compensation §20.34
- I. Planning for Validity, Construction, Interpretation, and Administration of Trust §20.35
  - 1. Revocability §20.36
  - 2. Defining Technical Terms §20.37
  - 3. Enforceability and Desirability of Choice-of-Law Clause §20.38
  - 4. Form: Choice of Law (All Real and Personal Property in One State) §20.39
  - 5. Form: Choice of Law (Real Property in Several States and Personal Property) §20.40
  - 6. Application to Hypothetical Case §20.41

III. SPECIAL PROBLEMS OF MULTISTATE TRUSTS
- A. Who Can Act as Trustee §20.42
  - 1. Application to Hypothetical Case §20.43
  - 2. Form: Appointing Trustee for Real Property §20.44
- B. Validity of Pourover Bequests to Living Trusts

1. When Permitted §20.45
2. Application to Hypothetical Case §20.46
C. Transfer of Community or Separate Property to Trust in Another Jurisdiction §20.47
1. Nature of Problems
a. Separate or Community Character of Property Transferred §20.48
b. Character of Property for Death Tax Purposes §20.49
c. Marital Rights §20.50
d. Income Tax Effects of Transfer of Community Property §20.51
e. Form: Choice of Law for Community Property §20.52
f. Effect of Agreement and Trust Instrument Between Spouses §20.53
2. Steps to Take on Transfer §20.54
3. Effect of Change of Settlors' Residence §20.55
4. Application to Hypothetical Case §20.56
D. Trusts in Violation of Family Rights
1. Surviving Spouse's Rights §20.57
2. Children's Rights §20.58
3. Application to Hypothetical Case §20.59
E. Assignment, Attachment, and Disclaimer of Beneficiary's Interest; Creditors' Rights §20.60
F. Powers of Appointment
1. Applicable Law §20.61
2. Drafting Considerations §20.62
a. Form: Exercise of Power of Appointment §20.63
b. Form: Choice of Law Governing Exercise of Power of Appointment §20.64
3. Application to Hypothetical Case §20.65
G. Charitable Trusts
1. Nature of Problems §20.66
a. Effect of State Law §20.67
b. Rule Against Perpetuities §20.68
c. Marital Rights §20.69
d. Administrative Problems §20.70
2. Application to Hypothetical Case §20.71

IV. TAXATION OF MULTISTATE TRUSTS §20.72
A. State Death Taxes §20.73
1. Real Property and Tangible Personal Property §20.74
2. Intangible Personal Property §20.75
3. Exemption and Arbitration Statutes §20.76
a. Characterization of Property §20.77
b. Multiple Domiciles §20.78
4. Computation of State Death Tax Credit or Deduction for Federal Estate Tax §20.79
5. Pick-Up Tax §20.80
6. Character of Decedent's Interest §20.81
B. Application to Hypothetical Case; Determining Settlors' Domicile
1. Avoiding Multiple Domiciles §20.82
2. Planning to Minimize State Death Taxation §20.83
C. Payment of State Death Taxes and Apportionment
1. Nature of Problem §20.84
2. Planning for Payment of Death Taxes
a. Problems and Solutions §20.85
b. Application to Hypothetical Case §20.86
D. State Death Taxation of Beneficiary's Interest §20.87
E. State Gift Taxation
1. Taxation of Real Property and Tangibles §20.88
2. Taxation of Intangibles §20.89
3. Planning for Gift Taxes §20.90
4. Application to Hypothetical Case §20.91
F. Income Taxes
1. Taxation of Trusts and Beneficiaries §20.92
2. Tax Credit Statutes §20.93
3. Application to Hypothetical Case §20.94
4. Planning for Income Taxes §20.95
G. Property Taxes
1. Basic Principles §20.96
2. Taxation of Intangibles by Settlors' Domicile §20.97
3. Taxation of Intangibles by Beneficiary's Domicile §20.98

4. Application to Hypothetical Case §20.99
5. Planning for Property Taxes §20.100

V. CHECKLIST: MULTISTATE TRUSTS §20.101

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I. MULTISTATE LIVING TRUSTS

§20.1 A. Scope of Chapter

This chapter discusses the principles of conflict of laws in the field of living trusts and applies those principles to a hypothetical case described in §20.6. Because conflict-of-laws problems occur in both revocable and irrevocable trusts, both types of living trusts are discussed. The law relating to testamentary trusts differs in many respects, because the settlors' domicile at death is of much greater importance.

This chapter relates only to conflict-of-laws problems of United States living trusts. Conflict-of-laws problems involving trusts with assets outside the United States are not covered. For a treatment of problems relating to the recognition of trusts in civil law jurisdictions that traditionally have not recognized the Anglo-American trust as a juridical institution, see Hendrickson & Silverman, Changing the Situs of a Trust, chap 11 (1982).

The international trust picture is complicated by the fact that many civil law jurisdictions have adopted trust statutes. See Diamond & Diamond, Tax Havens of the World (1974). Another relevant resource for civil law jurisdictions is the Convention on the Law Applicable to Trusts and on Their Recognition, adopted by the Hague Conference on Private International Law in 1985. The Convention establishes rights of ownership in trust property and procedural rules for suits to enforce or interpret trusts in civil law countries. See Gaillard & Trautman, *Trusts in Non-Trust Countries: Conflict of Laws and the Hague Convention on Trusts*, 35 Am J Comparative L 307 (Spring 1987); Schoenblum, *Choice of Law and Succession to Wealth: A Critical Analysis of the Ramifications of the Hague Convention on Succession to Decedent's Estates*, 32 Va J Int'l L 83 (Fall 1991).

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B. Conflict of Laws

§20.2 1. Nature of Problem

An individual's estate plan presents potential conflict-of-laws problems whenever the laws of two or more jurisdictions may affect the plan. Common examples include:

- A husband and wife own (separately or together) property physically located in more than one state.
- The client resides in one state, and the trustee of the client's trust is located in another state.
- The donee of a power of appointment resides in one state, and the donor of the power (or the trustee) resides in another state.
- The donee or the donor of a power of appointment reside in one state and the appointee, appointees, or takers in default of appointment reside in another state or states.
- A client has (or a husband and wife have) residences in two or more states.

If an estate plan crosses state borders, the estate plan must treat these and other multistate issues. Furthermore, as a consequence of population mobility, a multistate situation may arise (a) after the estate plan has been prepared but before some aspects of the plan become fully operative, (b) during the trust's administration, or (c) at the time of distribution, whether interim or final.

When a conflict of laws among the various states involved exists (or seems likely), using a funded or unfunded living trust can help resolve the problem. In planning a multistate trust, the attorney must determine which conflict-of-laws problems might arise concerning validity, construction, administration, and taxation of the trust and which jurisdiction will decide these matters.

The choice of law applicable to these problems depends on such factors as the nature of the issue, the character of the property, the relation of the parties involved, or a state's interest in the subject matter. For example, the law of one state may determine questions relating to the validity of the trust (*e.g.,* the capacity of the parties, formalities of execution, violation of the rule against perpetuities). The law of another state may determine questions relating to interpretation and construction of a trust (*e.g.,* the meaning of certain words, the legal effect of terminology like heirs at law, and the settlor's intent) or questions relating to administration of the trust (*e.g.,* the powers, rights, and obligations of the trustee and the rights and duties of beneficiaries, their spouses, a settlor's spouse, or creditors). Furthermore, the different states may have different jurisdictional rules regarding which forum should decide disputes on any of the foregoing matters. In each of these instances, it is necessary to know not only the conflict-of-laws rules but also the underlying substantive law of each state.

Besides conflict-of-laws problems, numerous tax problems may be created by a multistate trust. See §§20.72-20.100, discussing potential multiple state imposition of death, gift, income, and property taxes and planning possibilities. An awareness of the differences in applicable tax laws can help to minimize tax problems and to reduce taxes payable by these trusts.

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§20.3 2. Continuing Change in Conflict-of-Laws Theories

Although this chapter sets out the general rules for solving choice-of-law problems, the practitioner should remember that the law on this subject is unsettled. In the conflict-of-laws arena, the cases are sometimes "rather unsatisfactory," the statutes are "ambiguous," and many problems are untouched by either case or statute. 7 Scott & Ascher on Trusts §46.9 (5th ed 2010). In addition, there has been a shift in choice-of-law theories from the "territorial location of vested rights" approach of Joseph Beale (Restatement of Conflict of Laws (1934)) and the "most significant relationship" approach (Restatement (Second) of Conflict of Laws (1971)) to the more modern doctrines of the "governmental interests" test of Brainerd Currie (Currie, Selected Essays on the Conflict of Laws (1990)) strongly criticized by the late Friedrich Juenger of the University of California at Davis (Juenger, Selected Essays on the Conflict of Laws (2001)) and the "considerations" approach of Robert Leflar (McDougal, Felix, Whitten & Leflar, American Conflicts Law (5th ed 2001)).

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§20.4 3. Interest-Analysis Theory

In resolving a conflict-of-laws problem by using the interest-analysis approach, the discrete interests of the litigants and each state involved are considered, and the law of the state with the greater interest in the issue, rather than the law of the situs, may be applied. Interest analysis assumes that states have special interests in litigation affecting persons domiciled or residing in that state. Other factors, such as the place where an event occurred or the place where the litigation is being heard, may be taken into account, but the asserted link between domicile (or residence) and state interests is the pivot on which interest analysis usually turns. See Corr, *Interest Analysis and Choice of Law: The Dubious Dominance of Domicile*, Utah L Rev 651 (1983) (criticizing general influence of domicile as main factor in interest-analysis cases). See California Civil Procedure Before Trial §§6.67-6.68 (4th ed Cal CEB 2004) (distinction between domicile and residence in context of asserting personal jurisdiction).

California has generally adopted the interest-analysis principle in resolving conflict-of-laws questions. See *Offshore Rental Co. v Continental Oil Co.* (1978) 22 C3d 157, 163, 148 CR 867. But see Prob C §21103 (directing construction of instrument according to state law selected by transferor unless contrary to surviving spouse's community or quasi-community property rights or other public policy); *Wong v Tenneco, Inc.* (1985) 39 C3d 126, 216 CR 412 (applying principle of comity to choice-of-law question, criticized in Sprague, *Choice of Law: A Fond Farewell to Comity and Public Policy*, 74 Cal L Rev 1447, 1469, 1475 (1986) for not using interest analysis to reach same result).

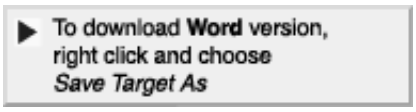
Applying the interest-analysis theory to trusts, however, may mean that the policy that favors giving effect to the settlors' intentions also favors resolving choice-of-law problems by looking to the law of any state substantially related to the transaction that will validate the intended disposition. See, *e.g., Hanson v Denckla* (1958) 357 US 235, 2 L Ed 2d 1283, 78 S Ct 1228; 1 Nossaman & Wyatt, Trust Administration and Taxation §10.03 (rev 2d ed 1966). California trust law gives extensive deference to the same policy of giving effect to the settlors' intentions. See, *e.g.,* Prob C §§16000 (duty to administer according to trust instrument), 16040(b) (prudent investor rule conditioned to accomplish purposes described in trust instrument), 16335(a)(1) (allocation of principal and income receipts and expenditures), 21102(a) (intention of transferor controls disposition under any instrument).

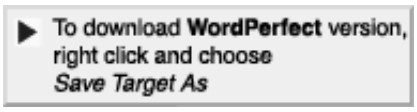
Therefore, the drafter must meticulously draft a multistate living trust to anticipate and prevent any conflict-of-laws problems. If possible, potential problems should be reduced or eliminated by concentrating substantially all the trust elements in one state.

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/§20.5 4. Form: Trustee May Apply Principle of Validation

§20.5 4. Form: Trustee May Apply Principle of Validation





***Statement of Intent*. In administering this trust and construing its provisions, the trustee (and any court considering the matter) shall look to the law of any state related to the trust, any transaction involved, or persons involved that will validate the intended disposition or other transaction should any conflict between the laws of any jurisdictions arise. It is my overall intent to create a valid trust with valid disposition of its assets.**

Comment: If it is not possible to concentrate all of the trust elements in one state, a clause such as this one may be used. It specifically tracks the principle of validation set forth in *Hanson v Denckla* (1958) 357 US 235, 2 L Ed 2d 1283, 78 S Ct 1228. See §20.4.

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§20.6 C. Hypothetical Case: The Jones Trust

Robert Jones, a 65-year-old married man, is an executive of a New York corporation. He lived and worked in New York until 5 years ago, when he was transferred to the corporation's Los Angeles office. He often travels to New York City on business for prolonged periods, and while in New York City occupies an apartment in a building that he owns. He has family, friends, a club, and church affiliations in New York City and Los Angeles.

Mr. Jones's assets, all of which are in his name alone, and the source of the funds used to acquire them are as follows:

Assets	*Source*
New York apartment building (unencumbered)	Funds inherited from father
Los Angeles home (unencumbered)	New York earnings after marriage
Oklahoma oil interests	California earnings after marriage
Securities in New York brokerage account	New York earnings after marriage

Mr. Jones wishes to give his wife only that share of his estate to which she is entitled by law (see §§20.47-20.50), to leave his securities in trust for a nonprofit New York hospital for 10 years, and to leave the remainder of his estate in a discretionary trust for the benefit of his two adult married children (one son, one daughter), both residents of New Jersey, giving them a testamentary power of appointment over the trust corpus exercisable in favor of their issue. He has one adopted minor grandchild, adopted by his daughter and son-in-law. Mr. Jones would like to name a New York bank as trustee and to give his children the right to select a cotrustee to act with the bank after his death.

If Mr. Jones leaves his property by a will that includes a testamentary trust, several conflict-of-laws problems are presented. It is necessary to have probates of Mr. Jones's will in New York and California and possibly in Oklahoma if the oil interests are considered to be real rather than personal property under Oklahoma law. (For the inconsistent language of Oklahoma and federal decisions on whether Oklahoma oil interests are treated as real or personal property, see 1 Williams & Meyers, Oil & Gas Law §214.2 (1973).) In addition, several testamentary trusts may be necessary because of the multistate properties. The proper state to administer Mr. Jones's estate is also in question, because his legal residence may be in California or New York—or both. For discussion of multiple domiciles, see §20.78.

A common method of avoiding multiple probate administrations and multiple testamentary trusts is to establish a revocable living trust that provides for disposition of assets on the client's death. The assets can be either distributed outright or held in trust in accordance with the client's desires. Mr. Jones decided to transfer his assets to a revocable trust for his benefit during his lifetime. On his death, his wife will receive the interest accorded to her by law (see §§20.50, 20.53, 20.57), and the remainder will be retained in trust for the benefit of the New York hospital and Mr. Jones's children.

Although a living trust resolves the need for multistate probate administration, it must be drafted carefully to avoid other conflict-of-laws problems inherent in situations when the trustee, trust corpus, settlor, or beneficiaries are located in or move to different states.

Mr. Jones's attorney must determine which laws apply to the validity, construction, interpretation, and administration of the trust—both now and in the future. The attorney must also consider (1) problems of court jurisdiction over the trust, the trustee, and the beneficiaries for accountings and (2) possible actions for breach of trust, interpretation of the trust, or instruction to the trustee. Further questions may arise regarding the naming of a trustee, the validity of a pourover bequest to the trust, the transfer of community and separate property to a trust in another jurisdiction, his widow's statutory share, the creditors' rights, and the charitable trust. There are also substantial tax ramifications, and

Mr. Jones's attorney must be aware of the death, gift, income, and property tax problems of the trust and how different jurisdictions treat them.

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§20.7 D. Use of Out-of-State Counsel

When multiple states are involved, it is essential to have local counsel in each state review the trust and its plan of operation to ensure (1) conformity with local law or practice and (2) that both counsel may discover and resolve issues arising in their respective jurisdictions and any conflicts between them. See Schoenblum, Multistate and Multinational Estate Planning (2d ed 1999), discussing problems of professional responsibility, unauthorized practice of law in a foreign jurisdiction, malpractice in advising on foreign law, retention of foreign counsel, and methods of dealing with these problems. See also Wyckoff, *Multijurisdictional Estate Plans Including Foreign Trusts*, NYU 51st Inst Fed Tax, chap 28 (1993).

One other factor for lawyers to consider is the application of possibly conflicting rules of professional conduct to their multistate practice. See Daly, *Ethics and the Multijurisdictional Practice of Law: Resolving Ethical Conflicts in Multijurisdictional Practice—Is Model Rule 5 the Answer, an Answer, or No Answer At All?* 36 S Tex L Rev (1995), discussing treatment of multijurisdictional conflicts in the Model Code of Professional Responsibility and the Model Rules of Professional Conduct.

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II. GENERAL RULES ON VALIDITY, CONSTRUCTION, INTERPRETATION, AND ADMINISTRATION OF LIVING TRUSTS

§20.8 A. Analyzing Conflicts of Laws in Terms of "Characterization"

The process by which conflict-of-laws problems have been analyzed has been defined by some scholars as "characterization." See Bogert, The Law of Trusts and Trustees §293 (2d ed 1977) (citing various law review articles). This terminology has been adopted to some degree by the courts. See, *e.g.*, *Grant v McAuliffe* (1953) 41 C2d 859, 865, 264 P2d 944; *Estate of Victor W. Richman,* TC Memo 1994-421.

The characterization most frequently recognized in the choice-of-law process in trust matters is classification between matters of validity, construction, or administration as well as matters of substantive versus procedural law and whether the trust estate assets involved are to be treated as real or personal property (see, *e.g.*, §§20.10, 20.12-20.13). Thus, the analysis of a trust problem potentially raises three major issues:

- *Validity.* Is a valid trust created, or is a particular clause valid?
- *Construction and interpretation.* What is the meaning of a particular clause of the trust in particular circumstances?
- *Administration.* What are the rights and duties of the trustee and the rights of the beneficiaries and other interested parties, such as the creditors of the settlors or the spouses of beneficiaries?

These issues are discussed below. Other characterization issues may relate to the basic determination of whether the matter involved is a trust (as distinguished from a tort, contract, or other segment of the law) and whether the applicable rules are substantive or procedural. Answers to any of these questions may affect the resolution of conflict-of-laws issues.

Validity. Questions of validity include technical problems (such as compliance with formal requirements and the parties' legal capacity, *e.g.,* who may act as trustee) and substantive problems (such as the rights of a spouse, children, or certain creditors of the settlors or of certain beneficiaries); the purpose of the trust; and compliance with local rules of law (such as rules against perpetuities, accumulations, testamentary disposition requirements, and limitations on charitable gifts).

Construction and interpretation. Questions of construction and interpretation relate to the actual meaning of the words used in the trust instrument, the settlors' intents, gaps in the instrument, the legal effect of technical terms (*e.g.,* "heirs at law" and "lawful issue"), and whether an interest is vested or contingent. A question of interpretation may result from the drafter's imprecise language. Therefore, a properly drafted estate plan will present fewer questions of interpretation and, theoretically, will pose no problems of governing state law. Ambiguities in a document inevitably arise, however, and are resolved only by rules of construction that may be inconsistent within one state and may differ between one state and another. Sometimes ambiguities arise because legal language means different things in different states—the state where the trust was drafted versus the state where it is now being administered or enforced. See, *e.g.,* 1 Nossaman & Wyatt, Trust Administration and Taxation §11.09 (rev 2d ed 1966), discussing different meanings attributed to the word "heirs" in different states, depending on how states deal with the venerable Rule in Shelley's Case and Doctrine of Worthier Title.

Administration. Questions of trust administration include all matters dealing with operation of the trust. For the trustee, these may include:

- The powers of sale, mortgage, and investment of trust assets;
- The allocation and payment of principal and income;
- The obligation to account, to provide information to the beneficiary, to invest and manage the trust estate with prudence, and to make prompt and correct distribution under the terms of the trust;
- Liability for breach of any of the duties described above, measure of damages for breach of these duties, and

the effect of various exculpatory clauses and the extent to which they excuse the trustee from such liability;
- Compensation; and
- The trustee's resignation and the appointment of a successor trustee.

Failure to define in detail the trustee's administrative powers leaves the scope of the powers to be determined by state law. This is not desirable. If the estate plan affects more than one state, the governing state law must be determined. Additional questions of trust administration involve the beneficiary's right to assign his or her interest or terminate the trust, a creditor's right to reach a beneficiary's interest, and the settlors' rights to revoke the trust. The latter is a special problem of administration for trusts with a California contact, in view of Prob C §15400, which provides that all trusts are revocable by the settlors unless expressly stated to be irrevocable in the trust instrument. For discussion of revocability, see §20.36.

The issues are not always clearly defined and often overlap. For example, a direction to the trustee to accumulate a portion of the trust income for the benefit of the settlors' issue may raise a question of the validity of an accumulation of income, a question of construction regarding the definition of "issue," and a question of administration about the share of income to be accumulated.

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§20.9 B. Validity of Trust

When establishing a trust, it is essential to know which state's law governs the validity of the trust. This is usually determined by the nature of the trust property, *i.e.,* whether it is an interest in real property, personal property, or both. (Although the terms "movables" and "immovables" are generally used in the field of conflict of laws, the terms "personal property" and "real property" will be used in this chapter.)

In the hypothetical Jones case described in §20.6, the execution of the trust, the naming of a trustee, the rights created for the benefit of Mr. Jones's wife and children, the charitable bequest, and any accumulation and perpetuities clauses are all governed by the law of the state that determines the validity of the trust.

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§20.10 1. Real Property

If a trust includes only real property and immovable tangible personal property with a permanent situs (sometimes collectively referred to as real property), the traditional rule is that the law of the situs of the property governs the validity of the trust. Other factors, such as the settlors' intentions regarding the law to be applied, the place of administration of the trust, and the domicile of the settlors, beneficiaries, and trustee are usually considered to be immaterial. Thus, for example, in California "[r]eal property within the State is governed by the law of this State, except where the title is in the United States." CC §755. See *Estate of Patterson* (1980) 108 CA3d 197, 208, 166 CR 435 (probate sale of California property in ancillary administration of Maryland decedent's estate governed by California law). Compare *Estate of Patmore* (1956) 141 CA2d 416, 419, 296 P2d 863 (surviving spouse's right to take Kansas real property by election against will must be determined by law of Kansas), with *Campbell-Kawannanakoa v Campbell* (1907) 152 C 201, 92 P 184 (trust under Hawaiian decedent's will, to be funded with California land, violated California's law and was held void). See also 1 Nossaman & Wyatt, Trust Administration and Taxation §10.06 (rev 2d ed 1966); 7 Scott & Ascher on Trusts §46.4.2 (5th ed 2010) (discussing issues of settlor's capacity, formalities involved in execution of trust, and problems of substantial validity).

The application of the interest-analysis theory (see §20.4) may change the traditional situs rule. For example, when one spouse transfers real property in trust in a state that does not recognize the other spouse's marital rights, the state where the settlor and spouse reside has a greater interest in having its law determine the validity of the trust than the situs state. Therefore, in resolving the matter, the situs state (if it makes such an interest analysis) may apply the law of the domiciliary state rather than its own law.

In a Massachusetts decision seeking to enforce an oral trust of Massachusetts real property in favor of the deceased settlor's minor child against the settlor's brother, the Massachusetts court, after examining the interests of New York and Massachusetts and of the interstate system, concluded that the validity of a trust (express or constructive) of land in Massachusetts should be determined by the law of New York. See *Rudow v Fogel* (Mass App Ct 1981) 426 NE2d 155, 159. The court reasoned that New York had a greater interest in the transaction because the transferor, transferee, and beneficiary were all New Yorkers at the time of the transfer, and the transferor therefore expected that New York law would apply. The court also determined that New York had the greater interest in enforcing intrafamily obligations, and that no third party, good-faith purchaser was involved (an interest Massachusetts might normally wish to protect). The court found that this same result could occur even if a written trust instrument had directed which state law should be applied.

NOTE: If Massachusetts law had been applied, no constructive trust would have been found, and the minor beneficiary of the constructive trust would have had no rights to the property.

See also *Town of Lee v Town of Lincoln* (Me 1976) 351 A2d 554, 556 (trust involved Maine trustee and beneficiary and California settlor, but trust instrument was executed in California and provided that California law controlled; court concluded that settlor's choice of California law should be given effect).

The changing rules of conflict of laws may eventually result in applying the law of one state to a trust that includes real property in several states, rather than applying the separate law of each situs state to property situated within that state. Unless authority in a situs state has adopted the broader interest-analysis viewpoint, however, the careful drafter should try to ensure that the trust is valid under each situs state as well as that of the state having a superior interest.

For the hypothetical Jones trust described in §20.6, application of the traditional situs rule means testing the validity of the trust under the laws of New York, California, Oklahoma, and New Jersey.

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§20.11 2. Equitable Conversion of Real Property

If the trust instrument includes a direction for sale of real property and reinvestment in personal property or real property situated in another state, the law of that state may determine the validity of the trust if it does not violate public policy of the situs state. See *Estate of Dunphy* (1905) 147 C 95, 81 P 315 (trust holding Nevada real property, with direction to sell property and reinvest proceeds in California real property, was considered to be trust of California real property under doctrine of equitable conversion).

Under the traditional conflict-of-laws approach, absent a specific direction to sell, the trustee's sale of trust real property and reinvestment in personal property does not prevent the law of the situs of the real property from determining the validity of the trust. This rule may not be applied in the future, however, because of the changing conflict rules noted in §§20.3-20.4 and the courts' tendency to apply the law of a state related to the trust that will uphold the validity of the trust. See *Hanson v Denckla* (1958) 357 US 235, 2 L Ed 2d 1283, 78 S Ct 1228.

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§20.12 3. Personal Property

The validity of a trust of intangible or tangible personal property is determined by the law of the state designated by the settlors as long as it has a substantial connection with the trust and does not violate any strong public policy of the state having the most significant relationship to the trust on the matter at issue. See Prob C §21103. See also 1 Nossaman & Wyatt, Trust Administration and Taxation §10.03 (rev 2d ed 1966) (cases illustrating this rule and variations from it).

If the settlors have not designated the law to apply, and their intents cannot be ascertained from the trust instrument or other circumstances, for some purposes the law of the owner's domicile governs rights in personal property. See CC §946. This rule is subject to exceptions so numerous as to outnumber the cases in which the rule is applied. Domicile is only one of the factors that are applied today in resolving conflicts of law, and the law of the place of trust administration will generally govern validity in respect to these cases. 7 Scott & Ascher on Trusts §45.4.2 (5th ed 2010). If the place of administration has not been fixed, validity will be determined by the law of the state having the most significant relationship to the trust.

Important factors in determining the most significant relationship are:

- The place where the trust property is kept;
- The place of administration;
- The place where the trust was created;
- The settlor's domicile when the trust was created; and
- The trustee's and beneficiaries' domiciles.

See *In re Griswold's Trust* (Sup Ct 1950) 99 NYS2d 420 (court applied New Jersey law to uphold validity of trust with contacts in New York, New Jersey, and Rhode Island). The general tendency in determining the applicable law is to apply the law of whatever state will uphold the validity of the trust, presuming that that law best upholds the settlors' intents. Restatement (Second) of Conflict of Laws §270, Comment d (1971). See §§20.5, 20.11, 20.14.

In the past, a change in the situs of an element of the trust after its creation generally would not affect the law that applies to its validity, because validity was determined when the trust was established. See Land, Trusts in the Conflict of Laws 38 (1940). But see *Wilmington Trust Co. v Wilmington Trust Co.* (Del 1942) 24 A2d 309 (when beneficiaries substituted Delaware trustee for New York trustee, and substitute trustee transferred trust assets from New York to Delaware, Delaware law governed validity of exercise of power to appoint substitute trustee).

When the trust may be invalid under the law of one jurisdiction, however, and the trust expressly states that validity is to be determined under the law of a new place of administration, this clause may be given effect in view of the tendency of the courts to uphold the validity of a trust whenever possible. See §20.4. A form retaining the original law generally, while applying the law of the new situs to administrative matters, is included in §20.39 as Alternative 3.

PRACTICE TIP: New York has enacted a statute relating to the validity of multistate trusts. See NY Est Powers & Tr L §7-1.10, which provides that New York law governs the validity, effect, and interpretation of a trust created by a nonresident who holds personal property located within or outside New York when the instrument designates New York law as the governing law and appoints a New York trustee. This statute also provides that New York law governs a trust of any property situated in New York when the trust is created, if the instrument so provides, even if the trustee is not a resident of New York. This statute governs the hypothetical Jones trust described in §20.6, except for foreign real property, if New York law is specified as the governing law. For clauses specifying the governing law, see §§20.39-20.40.

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§20.13 4. Real and Personal Property

If a trust includes both real and personal property, the applicable law is uncertain because of the changing conflict-of-laws principles and the traditional rule that the law of the situs of real property governs the validity of a trust of real property. In the past, when the trust included real property in only one state, the law of the situs of the real property applied either to the entire trust or at least to that portion of the trust relating to the real property. In the latter circumstance, the validity of the trust of the personal property would be determined by the law of the state governing personal property. See Land, Trusts in the Conflict of Laws 116 (1940).

Under the changing rules for conflict of laws, however, in the future the situs state may give effect to the settlor's designation of the law to apply, may apply the law of the state with the greater interest in the trust, or may apply the law of the state that will uphold the validity of the trust. Until the law is more certain, it seems advisable, in a multistate trust of real and personal property, to include a clause designating (a) the law of each situs state to determine the validity of the trust of real property within the state and (b) the law of a state with a substantial connection with the trust, which does not violate strong public policy of a related state, to determine the validity of the trust of personal property. For appropriate trust clauses, see §§20.39-20.40.

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§20.14 5. Determining Character of Property as Real or Personal

Sometimes the peculiar character of the trust property may create a question about which law governs the validity of the trust. For example, leasehold interests, oil interests, or notes secured by encumbrances on real property may be considered real property in some states and personal property in others. The law of the situs of the property generally determines whether the trust property is real or personal. Hendrickson, Interstate and International Estate Planning §6.5 (1968).

In the hypothetical Jones case described in §20.6, it is necessary to examine carefully the nature of the oil interests and to determine whether they are considered real or personal property under Oklahoma law. Although the oil interests may be considered to be real property by Oklahoma in determining the validity of the trust, they may be considered personal property by other states for other purposes (*e.g.,* asserting claims of income or inheritance taxation). See §§20.74, 20.92.

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§20.15 C. Interpretation and Construction of Trust

The settlor can generally designate the law of any state to apply to interpretation and construction of a trust of real or personal property, regardless of the amount of contact between the trust and the designated state, if the law selected is not contrary to the public policy of a state having a close connection with the trust. 7 Scott & Ascher on Trusts §46.3 (5th ed 2010); Restatement (Second) of Conflict of Laws §277 (1971). From a practical standpoint, it is usually advisable to designate the law of the trustee's place of business to govern interpretation and construction, because a corporate trustee may refuse to act if these matters are to be governed by the law of another state. In the hypothetical Jones case described in §20.6, problems of interpretation and construction can be solved by expressly stating in the trust instrument that the law of New York, the trustee's place of business, applies to the interpretation and construction of the instrument. For suggested clauses, see §§20.39-20.40.

When the settlors have not designated the law to apply, and no factors show their intentions, the applicable law depends on the nature of the question and whether the trust property is real, personal, or mixed. For example, the law of one state may apply to a question of construction relating to trust administration (*e.g.,* the settlors' intents regarding compensation payable to the trustee), and the law of another state may apply to a question of construction relating to disposition of trust property (*e.g.,* whether an adopted child is to be included as a trust beneficiary). See *Staley v Safe Deposit & Trust Co.* (Md 1947) 56 A2d 144, 147 (trust drafted in Illinois for Illinois trustor and Maryland trustee construed according to Illinois law); 7 Scott & Ascher on Trusts §45.3.2 (5th ed 2010); 1 Nossaman & Wyatt, Trust Administration and Taxation §11.02 (rev 2d ed 1966).

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§20.16 1. Real Property

For trusts consisting only of real property, when the settlors have not designated a particular law, the law of the situs of the real property generally determines interpretation and construction problems. See *Hutchinson v Hutchinson* (1941) 48 CA2d 12, 119 P2d 214 (California court applied Illinois law to determine validity and interpretation of trust holding Illinois real property). The courts of the situs state, however, may apply the law of the settlors' domicile to determine certain questions, such as the extent of a beneficiary's interest. Restatement (Second) of Conflict of Laws §227, Comment c (1971); 1 Nossaman & Wyatt, Trust Administration and Taxation §11.02 (rev 2d ed 1966). This rule is explained by the tendency of the courts to give effect to the settlors' intents. See §20.4.

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§20.17 2. Personal Property

Questions of interpretation and construction of trusts of personal property, absent a designation by the settlors, are usually determined by the law of the state having the most substantial contact with the trust. This may be the domicile of the settlors when the trust was created, the trustee's or beneficiaries' domicile, the situs of the trust property, the place of administration, or the place where the trust was created. Compare CC §946 (personal property governed by law of "owner's" domicile) with *Brandeis v Atkins* (Mass 1910) 90 NE 861 (law of Massachusetts applied to compromise agreement regarding testamentary trust when trustee, administration of trust, location of assets, and compromise agreement all occurred in Massachusetts, but beneficiary had later moved to New York). When the question of construction relates to administration of the trust, the construction issue often is governed by the same law that governs administration of the trust. See Land, Trusts in the Conflict of Laws 183 (1940). On administration, see §§20.19-20.23.

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§20.18 3. Real and Personal Property

In mixed trusts, when a choice-of-law clause has been omitted, the court may apply the law of (a) the situs of the real property, (b) the place of administration, or (c) the state having substantial contact with the trust. In the leading case of *Cary v Carman* (Sup Ct 1921) 190 NYS 193, the court applied the law of Massachusetts—the settlor's, trustee's, and beneficiaries' residence when the trust was created—to determine the meaning of the term "heirs at law," even though the real and personal property of the trust was in New York, the last beneficiary to die was resident of New York, and it was her "heirs at law" who were the subject of the suit. For suggested forms, see §§20.39-20.40.

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§20.19 D. Administration of Trust

Trust administration involves implementing the trust's objectives through the powers and obligations of the trustee: the administrator of the trust.

The law that applies to questions of trust administration depends on the nature of the trust property because the rules applicable to trusts of real property differ from those applicable to trusts of personal property.

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§20.20 1. Real Property

The law of the situs generally determines administrative matters of real property trusts. See Land, Trusts in the Conflict of Laws 200 (1940). In *Hardy v Hardy* (1958) 164 CA2d 77, 330 P2d 278, the California court applied Illinois law to determine whether the Illinois real property interest of a California resident in a spendthrift trust could be reached for payment of costs and attorney fees in a California divorce action. The settlors' intents regarding the applicable law may, however, govern on administrative matters that are not contrary to public policy of the situs state. See Land, Trusts in the Conflict of Laws 242 (1940); Restatement (Second) of Conflict of Laws §279, Comment b (1971).

When the trust instrument includes a direction for sale of real property and reinvestment of the proceeds in another state where the trust is to be administered, the law of the latter state may determine questions of administration. See §20.11.

Sometimes, when the trustee has mismanaged or repudiated the trust, administrative matters may be determined by the court of a state that has jurisdiction over the person of the trustee. See *Starr v Berry* (NJ 1958) 138 A2d 44 (court found New Jersey to be proper forum for trial of mismanagement allegations but did not decide whether it would apply its own law or law of situs state). On jurisdiction generally, see §20.26.

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§20.21 2. Personal Property

In trusts holding personal property, the settlors may designate the law of any state to apply to administrative matters having no element of public policy (*e.g.,* the trustee's commissions or permissible investments), even if that state has no connection with the trust. On matters that may affect public policy (*e.g.,* alienability of beneficiaries' interests or exculpatory clauses), however, only the law of a state that has substantial contact with the trust may be designated. 7 Scott & Ascher on Trusts §45.2.2.1 (5th ed 2010). Absent a choice-of-law clause, the law of the state with which the trust administration has its most significant relationship governs. 7 Scott on Trusts §45.2.2.2. The trustee's domicile is usually the place of administration, but other factors may also be considered, *e.g.,* the settlors' domicile when the trust was created, the place of execution of the trust, the situs of the trust property, the purpose of the trust, or the beneficiary's domicile. See Land, Trusts in the Conflict of Laws 231 (1940).

Civil Code §946 provides that if there is no law to the contrary in the jurisdiction where personal property is situated, the property is deemed to follow the owner and is governed by the law of the owner's domicile. In *Estate of Nolan* (1955) 135 CA2d 16, 17, 286 P2d 899, the court applied the law of Montana (the decedent's domicile) to defeat California's escheat law for California bank accounts, citing CC §946. Section 946 has not yet been applied to trusts, however, and one may speculate whether a settlor, the trustee, or the beneficiary of an, *e.g.,* revocable trust is the "owner" under that statute. See *Title Ins. & Trust Co. v Duffill* (1923) 191 C 629, 647, 218 P 14 (quoting English case law that "under the system now prevailing the cestui que trust is regarded as the real owner of the property, the trustee being merely the depositary of the legal title"); *Estate of Feuereisen* (1971) 17 CA3d 717, 720, 95 CR 165.

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§20.22 3. Real and Personal Property

When the trust includes both real and personal property, the law of the situs of the real property may control administration of the entire trust if there are other close contacts with the trust. Without these contacts, the law of the situs may apply only to administrative matters relating to real property, and the law of a state designated by the settlors or having a substantial contact with the trust may apply to govern administrative matters relating to personal property. Land, Trusts in the Conflict of Laws 241 (1940). As noted in §20.20, however, there is an increasing tendency for the situs state to apply the law designated by the settlors to govern administrative matters of real property trusts unless it violates public policy of the situs state.

In applying the foregoing rules to the hypothetical Jones trust described in §20.6, it appears that the settlor may designate the law of one state to govern administration of the entire trust unless some provision of the designated law violated public policy of the situs state. For example, if New York law is designated to govern administration of the trust, and its spendthrift law differs from the spendthrift laws of the other situs states (California and possibly Oklahoma if the oil interests are real property), it is questionable whether New York law applies to a California or an Oklahoma creditor's rights. The answer may depend on where the creditor came from and in what forum the creditor is enforcing his or her rights. See §20.60, suggesting that the result may depend on which state is considered to have the most substantial contacts with the transaction.

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§20.23 4. Change in Place of Administration

Absent a statute or an express clause in the trust instrument, no general rules determine what law applies to administrative matters when the place of administration of a trust of personal property changes because of a move by the trustee or a change in the situs of the property. The cases differ about whether a change in the place of administration changes the governing law. Although some cases provide that it does not, the better rule for trusts not involving "tax-sensitive" powers seems to be to permit a change in the law governing administration when there is a change in the place of administration. See *Wilmington Trust Co. v Wilmington Trust Co.* (Del 1942) 24 A2d 309. This result is generally desirable because it enables the trustee to apply the law with which he or she is familiar and under which the trustee can act most efficiently. It also avoids the added expense and delay of employing out-of-state counsel before action is taken. For a clause providing for a change in administration, see §20.24.

In a marital deduction trust, however, or any tax-sensitive trust in which a nonindependent trustee (*e.g.,* a settlor or beneficiary) is acting, a change in the law of administration may result in undesirable tax consequences. The trustee's powers may be so changed that the marital deduction is lost, trust income will be taxed to a nonindependent trustee, or the trust corpus will be included in his or her gross estate for estate tax purposes. See IRC §§671-678, 2041, 2056-2056A; 2 Nossaman & Wyatt, Trust Administration and Taxation §§38.18[6], 38.19[8], 39A.18[3], 42A.06 (rev 2d ed 1966). For a savings clause to prevent against such unforeseen tax consequences, see §20.25.

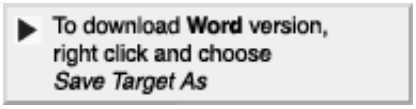
For a delineation of the Internal Revenue Service's varying attitude toward such restrictive clauses, compare Rev Rul 75-440, 1975-2 Cum Bull 372 (clarification of intent permissible), with Rev Rul 65-144, 1965-1 Cum Bull 442 (condition-subsequent "saving" clause ineffective to restrict trustee's actions; deduction disallowed), and IRS Letter Ruling 7905088 (comparing these two revenue rulings in a gift tax situation). It is the opinion—or at least the educated hope—of the author that the form in §20.25 comes within the permissible limits set by the IRS. Use of this clause might cause powers to be extended (or restricted) by the laws of the two jurisdictions—the old place of administration and the new. Such an event is recognized by Restatement (Second) of Conflict of Laws §187, Comment i (1971).

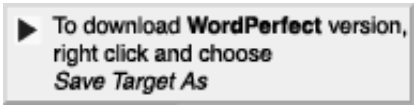
Although a change in the place of administration may cause a change in the law governing administrative matters, in the past this change ordinarily did not affect the law governing the validity or construction of the trust instrument. See Land, Trusts in the Conflict of Laws §249 (1940). The trend may be otherwise, however, particularly if there is a specific clause to that effect in the trust instrument. See §20.12. On the settlor's death in the hypothetical Jones case described in §20.6, his children (who are residents of New Jersey) may select a New Jersey corporate trustee to act. The trust instrument should expressly provide whether, in this event, New York or New Jersey law governs administration of the trust. For discussion of this issue and suggested alternative clauses, see §§20.39-20.40.

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/§20.24 5. Form: Trust Governed by Law of Place of Administration

§20.24 5. Form: Trust Governed by Law of Place of Administration





***Governing Law*. Matters concerning the administration of this trust shall be governed by the law applicable in the place of administration. My intent is to encourage ease of administration by the trustee and to adapt administration to the local law with which the trustee is most familiar.**

Comment: This form provides for a change in the law governing administration of the trust. It should be used when it is likely that the place of administration may change. See §20.23 for possible tax consequences of this clause.

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§20.25 6. Form: Savings Clause for Unforeseen Tax Consequences

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

***Estate Tax Savings Clause*. Despite any of the foregoing, any _ _[*trustee/successor trustee to the trustor-trustee*]_ _ is specifically forbidden from holding or exercising any power as trustee (whether or not in combination with any other right or power, held as trustee or in any other capacity, and whether asserted by choice of applicable law or otherwise) that causes any part of any trust created by this instrument to be taxed to the _ _[*trustee/successor trustee*]_ _ on his or her death. It is not my intent to confer, and I do not in this trust confer, any such power on any _ _[*trustee/successor trustee*]_ _.**

Comment: This form may be used as a savings clause designed to ensure that no unforeseen estate tax consequence will occur by the operation of (among other things) conflict-of-laws principles. See §20.23. See also 1 Nossaman & Wyatt, Trust Administration and Taxation §15.30[1] (rev 2d ed 1966).

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§20.26 E. Jurisdiction to Resolve Various Issues

Besides questions of validity, construction, and administration, questions of court jurisdiction over issues and parties must also be considered when multiple jurisdictions are involved. See 1A Nossaman & Wyatt, Trust Administration and Taxation §§34.06, 34.08-34.09 (rev 2d ed 1966) (discussing trust jurisdiction generally in federal versus state courts, and venue).

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§20.27 1. Jurisdiction to Determine Conflicting Rights and Claims to Trust Property

The court having jurisdiction of the trust res, whether real or personal property, has jurisdiction to determine conflicting rights and claims to the trust property. *McNeil v Dow* (1948) 89 CA2d 370, 200 P2d 859 (court resolved conflicting claims to real property involving constructive trust, estoppel, and failure to join indispensable parties); *Glasser v Wessel* (2d Cir 1945) 152 F2d 428 (despite lack of personal service on all claimants, federal court gave effect to decree obtained by trustee in Connecticut court determining ownership of fund among several claimants); *Gulda v Second Nat'l Bank* (Mass 1948) 80 NE2d 12 (suit by purported settlor to set aside trust for fraud). Equitable actions by trustees for instructions fall within this category, permitting service of summons by publication on nonresident beneficiaries. *Franz v Buder* (8th Cir 1926) 11 F2d 854; *First Trust Co. v Matheson* (Minn 1932) 246 NW 1.

This same doctrine has been applied to reach the surplus income of a trust payable to a nonresident, in the following situations:

- In a case of a creditor's bill. See *Spellman v Sullivan* (2d Cir 1930) 43 F2d 762, 764.
- To an action to fill a vacancy when a trustee died. See *Dyer v Leach* (1891) 91 C 191, 193, 27 P 598. See also *Bowles v Superior Court* (1955) 44 C2d 574, 584, 283 P2d 704 (appointment of receiver on resignation of two trustees and removal of a third).
- To an action to remove a trustee and appoint a successor. See *Sanders v Hall* (10th Cir 1934) 74 F2d 399, 404; *Moody v Branson* (Okla 1943) 136 P2d 925.
- To an action by remainder beneficiaries of a testamentary trust having terminated. See *State ex rel Bensberg v Hartmann* (Mo 1929) 19 SW2d 637.

When several states have equally substantial contacts with a trust of personal property, multiple assertions of jurisdiction may occur and the beneficiaries' interests may be affected by courts of one state even though the settlors have provided that a different state's law is to control. In *Cocke v Duke Univ.* (NC 1963) 131 SE2d 909 and a related case, *Davison v Duke Univ.* (NC 1973) 194 SE2d 761, the instrument provided that New Jersey law governed administration of the trust, which a New Jersey domiciliary had created in that state. Suit was brought in North Carolina by trustees seeking to change the investments mandated by the trust. Over objection on behalf of some beneficiaries, the North Carolina court concluded that it had jurisdiction. The state had significant ties with the trust because it had been created to benefit institutions in North Carolina and South Carolina, the settlor had desired the majority of trustees to be domiciliaries of these states and nine were from North Carolina, and the trustees had established a principal office in North Carolina.

The jurisdiction where corpus real property is located likewise may acquire jurisdiction over nonresident trustees in a declaratory relief action to determine distributive interests in corpus. *Avery v Bender* (Vt 1964) 204 A2d 314. When there are multiple trustees, it may be sufficient that the court has jurisdiction over only one of them. See *Schwartz v Capital City First Nat'l Bank* (Fla App 1978) 365 So2d 181, 183 (permissible unless one trustee shows that he or she cannot alone represent trust); *Estate of Thompson* (NH 1978) 386 A2d 1280, 1283 (jurisdiction to apportion death taxes between probate and nonprobate assets).

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§20.28 2. When Courts of State Other Than Situs State May Act

Although the courts of the situs state have jurisdiction over a trust of real property and have the power to decide questions about the trust, the courts of another state will sometimes act. For example, a California court with jurisdiction over the necessary parties has appointed a trustee to fill a vacancy for a trust of real property situated in Washington. See *Smith v Davis* (1891) 90 C 25, 27 P 26.

In cases involving a trustee's mismanagement (*e.g.,* suits to surcharge or remove the trustee or to compel an accounting) of a trust including real and personal property, the courts of any state in which the trustee can be served will exercise jurisdiction over the matter. See *Jones v Jones* (Sup Ct 1894) 30 NYS 177, 178. In *McElroy v McElroy* (1948) 32 C2d 828, 198 P2d 683, the trustee appeared in a California suit even though he was a resident in Oregon and the trust res was located in Oregon. The court concluded that the trustee's appearance conferred jurisdiction over the trustee to award judgment in favor of a beneficiary against the trustee. See *Estate of Knox* (1942) 52 CA2d 338, 126 P2d 108 (California court assumed jurisdiction over an Illinois trustee who voluntarily appeared in an action for an accounting, settling account for both California and non-California trust assets).

If neither the trust property nor the trustee is within a state, however, its courts cannot exercise jurisdiction over the trust. See *Harvey v Fiduciary Trust Co.* (Mass 1938) 13 NE2d 299; Note, *Comity in the Administration of Trust Estates*, 48 Yale LJ 670 (1939). See also *Hardy v Hardy* (1958) 164 CA2d 77, 330 P2d 278 (California court could not impose lien on California resident's interest in spendthrift trust of Illinois real property because lien was invalid attempt by California court to affect title to real property in another state).

In cases involving a voluntary action by the trustee of a real property trust (*e.g.,* an accounting or a petition for instructions), the court of the situs has jurisdiction even though the beneficiaries may not be subject to the jurisdiction of that court. *Franz v Buder* (8th Cir 1926) 11 F2d 854, 858; *First Trust Co. v Matheson* (Minn 1932) 246 NW 1 (suit by trustee to have trust declared valid, in the face of threats by settlor's children to invalidate trust); 7 Scott & Ascher on Trusts §45.2.2.3 (5th ed 2010).

In a trust of personal property, if administration is fixed in a certain state, the trustee may file an accounting or other voluntary action in a court of that state, and the court's decree is binding on the beneficiaries who have received adequate notice of the proceeding, even if some of them are nonresidents of the state. See *Mullane v Central Hanover Bank & Trust Co.* (1950) 339 US 306, 313, 94 L Ed 865, 70 S Ct 652. If there is no fixed place of administration, the proceeding should be filed in a state in which the main elements of the trust are located. The elements considered are:

- The settlors' domicile when the trust was created;
- The trustee's domicile;
- The location of the trust property;
- The place of execution of the trust; and
- The beneficiary's domicile.

See Land, Trusts in the Conflict of Laws 266 (1940).

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§20.29 3. When Federal District Court May Refuse Jurisdiction Despite Existence of Diversity

When federal diversity jurisdiction otherwise exists, a district court may exercise its discretion not to take jurisdiction under the judge-made doctrine of abstention, but only in certain special circumstances (*e.g.,* when resolution of state law questions by a state court might dispose of certain federal constitutional issues raised in the case, to avoid unnecessary conflict with a state in the administration of its own affairs, or when an unsettled question of state law may be authoritatively established only by a state tribunal). Compare *Wohl v Keene* (4th Cir 1973) 476 F2d 171, 174 (diversity action seeking declaratory judgment to void certain settlement agreements about testamentary trusts and for removal of settlement trustees, accounting, and other relief; abstention by district court reversed on appeal), with *Reichman v Pittsburgh Nat'l Bank* (3d Cir 1972) 465 F2d 16, 18 (although district court might have jurisdiction over testamentary trust litigation on basis of diversity of citizenship, dismissal of complaint would be affirmed under abstention doctrine because of state court's special ability to decide issues and greater administrative efficiency permitted by adjudication in court having jurisdiction over all beneficiaries).

Apart from abstention, the federal courts have applied the rule that "the court first assuming jurisdiction over property may maintain and exercise that jurisdiction to the exclusion of the other" to exclude federal courts from proceeding on state living trust matters. See *Norton v Bridges* (7th Cir 1983) 712 F2d 1156, 1165 (Wisconsin state court's jurisdiction to deal with various requests for relief held to exclude federal jurisdiction).

Note that the probate exception to diversity jurisdiction has not been applied to trusts. See *Beach v Rome Trust Co.* (2d Cir 1959) 269 F2d 367, 372 (upholding dismissal of action interfering with "previously attached" surrogate court jurisdiction over testamentary trust, but retaining federal jurisdiction over other breach of trust claims); *Barnes v Brandup* (SD NY 1981) 506 F Supp 396, 399 (following *Beach* in retaining jurisdiction over both testamentary and living trusts when Connecticut probate court did not have continuing jurisdiction over trusts by virtue of accounts previously filed and settled four and six years before, and when no proceeding in connection with trusts occurred until federal complaint filed against trustee); *Weingarten v Warren* (SD NY 1990) 753 F Supp 491, 494 (following *Barnes* in remainder beneficiary's action against attorney for trustee). In *Marshall v Marshall* (2006) 547 US 293, 164 L Ed 2d 480, 126 S Ct 1735, the Court held that the probate exception recognized in *Markham v Allen* (1946) 326 US 490, 90 L Ed 256, 66 S Ct 296, reserves to state probate courts the probate or annulment of a will and the administration of the decedent's estate, but does not bar federal courts from adjudicating matters outside those confines.

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§20.30 4. Validity of Choice-of-Forum Clauses

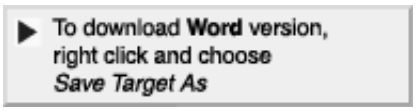
In a nontrust case of first impression, *Hall v Superior Court* (1983) 150 CA3d 411, 197 CR 757, a choice-of-*forum* clause in a private California securities agreement was not enforceable, because the choice-of-*law* clause in the same agreement violated the Corporations Code and the public policy of California. A clause like the one struck down in the *Hall* securities agreement, however, would presumably be upheld in a private trust if not unreasonable and if public policy is not thereby violated. See *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 494, 131 CR 374 (contract case); *America Online, Inc. v Superior Court* (2001) 90 CA4th 1, 108 CR2d 699 (contract case); *Furda v Superior Court* (1984) 161 CA3d 418, 428, 207 CR 646 (contract case distinguishing *Hall*). For a clause that could be used in a private trust, see §20.31.

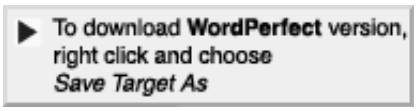
Even with such a clause, a party may resist suit by raising the doctrine of forum non conveniens. See *Appalachian Ins. Co. v Superior Court* (1984) 162 CA3d 427, 440, 208 CR 627 (clause agreeing to submit disputes to "any court of competent jurisdiction" in insurance contract case).

Azarian v Ettinger (Sup Ct 1982) 450 NYS2d 115, an action by beneficiaries living in various states against an individual New York cotrustee, arose from the cotrustee's purchase of a house in New York with funds borrowed from the trust interest free and resold at a profit. The plaintiffs filed actions in both New York and Massachusetts for constructive trusts, accounting, and damages from misappropriation. In the New York action, a motion to dismiss on grounds of forum non conveniens was granted by the New York court, remitting the entire matter to Massachusetts on the condition that the New York defendants submit to Massachusetts jurisdiction. The trust and a pourover will had been created in Massachusetts, the decedent died in Massachusetts, one cotrustee was a Massachusetts corporate fiduciary, and both the trust and will were governed by Massachusetts law.

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§20.31 5. Form: Choice of Forum





[*Use one of the following alternatives*]

[*Alternative 1: Disputes subject to resolution in courts of specified state*]

***Choice of Forum*. It shall be a condition to acceptance of any trusteeship or any beneficial rights under this instrument that all disputes between or among beneficiaries or trustees shall be resolved, if not otherwise settled, in the courts of _ _**[*name of state*]**_ _.**

[*Alternative 2: Disputes subject to arbitration*]

***Choice of Forum*. It shall be a condition to acceptance of any trusteeship or any beneficial rights under this instrument that all disputes between or among beneficiaries or trustees shall be resolved, if not otherwise settled, in an arbitration conducted in _ _**[*name of state*]**_ _ and in accordance with its laws.**

Comment: Alternative 2 should be used if arbitration is an alternative to litigation. For suggested use of arbitration to resolve disputes, see 1A Nossaman & Wyatt, Trust Administration and Taxation §35.07[5] (rev 2d ed 1966). See also 3 Nossaman & Wyatt, Trust Admin and Tax, chap 53, which gives an overview of alternative dispute resolution (ADR) and trust matters, the historical precedent, statutes and trust clauses authorizing ADR, possible legal limitations, the advantages and disadvantages of using ADR in trust matters, and factors that may influence the choice of one method or another.

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§20.32 F. Investments

Which state's rules govern the investments of a multistate trust? For example, the separate states still vary in the extent to which they apply the prudent-person rule and the principle of diversification. See 1A Nossaman & Wyatt, Trust Administration and Taxation §§29.02 (limitations on investments), 29.04 (prudent-person rule), 29.14 (diversification) (rev 2d ed 1966).

This matter can be fully determined by the settlors' choice of applicable law, unlimited by constraints of policy. The settlors may provide that the trustee's investments be governed by the law of the state of the settlors' domicile (see *Application of City Bank Farmers Trust Co.* (Sup Ct 1957) 166 NYS2d 772), of the state of the trust's administration, or of some other state. Absent such a clause, the law where the designated trustee administers the trust ordinarily applies, unless the settlors disclose an intent to determine the propriety of trust investments by the law of the settlors' domicile.

For examples applying the law of the state where the trustee administers the trust, see *Irving Trust Co. v Natica, Lady Lister-Kaye* (Sup Ct 1935) 284 NYS 343 (English settlor, New York trustee; New York law applied to determine propriety of investments); *In re Carter's Trust* (Sup Ct 1958) 178 NYS2d 569 (Hawaiian settlor; similar result on whether retention of investments was proper); *In re Lowman's Trust* (Sup Ct 1949) 92 NYS2d 238 (Ohio settlor; result similar to that in *Irving*).

For an example applying the law of the settlors' domicile, see *Stetson v Morgan Guar. Trust Co.* (Conn 1960) 164 A2d 239, involving a Connecticut couple who created a living trust for their children of which the husband was the original trustee and a New York trust company the successor trustee on his death. The court held that a Connecticut statute permitting retention of original investments allowed the trust company to retain its own stock in the trust. Because the trust was created in the domiciliary state of the settlor, the trustee, and the beneficiaries, the fact that a New York fiduciary was named as successor trustee and that it actually became the fiduciary did not change the law governing investments.

In summary, it appears that a choice-of-law clause is valuable for disposition of the investments of a multistate trust. See the forms suggested in §§20.39-20.40.

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§20.33 G. Trustee's Liabilities; Exculpatory Clauses

State law does not uniformly impose surcharge liability for a trustee's breach of trust. The law applicable to investments determines liability for losses resulting from improper investments. The law of the place of administration determines whether the trustee is liable for self-dealing. *Campbell v Albers* (Ill App 1942) 39 NE2d 672.

The terms of the trust may provide that the trustee is relieved from liability for breach of trust or may permit self-dealing, which would otherwise be improper. See 1A Nossaman & Wyatt, Trust Administration and Taxation §§27.16, 28.21 (rev 2d ed 1966). But suppose that extending such permission to self-deal is against public policy? See 1A Nossaman & Wyatt, Trust Admin and Tax §27.04[2], describing local statutes that prohibit self-dealing. The case of *Three Bears, Inc. v Transamerican Leasing Co.* (Tex App 1978) 574 SW2d 193, aff'd in part and rev'd in part (Tex 1979) 586 SW2d 472, cited a 1935 case and a Texas statute for the proposition that "[i]t would be contrary to the public policy of this State to permit the language of a trust instrument to authorize self-dealing by a trustee." In that situation, the settlors may not be able to avoid a restriction imposed by the law of their domicile by designating as controlling the law of some other, more lenient state or by locating the administration of the trust in another state. See 7 Scott & Ascher on Trusts §45.6.6 (5th ed 2010).

For the hypothetical Jones trust described in §20.6, a more cautious approach is to avoid any general exculpatory clause and instead to relieve the trustee from some particular obligation otherwise generally imposed on trustees, such as the duty to dispose of unproductive property by a specific limited clause to that effect.

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§20.34 H. Trustee's Compensation

Which rules determine how and what the multistate trustee is to be paid? The amount of the trustee's compensation varies among the different states. Some statutes provide for whatever is "reasonable" under the circumstances (without particular uniformity in determining what is reasonable); others provide commissions based on percentages of income received or percentages of principal. Rules on extra compensation for extraordinary services and on the sharing of compensation among several trustees or successive trustees also vary. See Bogert, The Law of Trusts and Trustees §§977-978 (2d ed 1977); 4 Scott & Ascher on Trusts §§21.1-21.1.10 (5th ed 2007).

Most compensation issues in multistate situations treated in reported decisions have arisen in testamentary trusts. See, *e.g.,* 7 Scott & Ascher on Trusts §45.6.1 (5th ed 2010) (citing three New York lower-court cases).

For a living trust, if the settlors have fixed the administration of the trust in a particular state (*e.g.,* by appointing a resident of that state as trustee), the law of the place of administration should determine the trustee's compensation. If no place of administration is fixed by the settlors, compensation should be decided by the law of the state having the most significant relationship to the trust. In cases involving requests for extraordinary compensation, the law of the state having the most significant relationship to the transactions justifying the request for compensation should prevail.

Note, however, that the issue of the trustee's compensation may be affected by other conflict-of-laws questions. For example, *Du Pont v Southern Nat'l Bank* (SD Tex 1983) 575 F Supp 849, aff'd in part and rev'd in part (5th Cir 1985) 771 F2d 874, is a diversity case in which the issue of whether the trust paid excessive trustee fees depended on resolving a dispute of the classification of shares of stock in a cooperative apartment in New York City. If the property was realty, it was excluded from the base for computation of trustees fees. Thus, the threshold issue before the court was which state's law governs the characterization of the shares as realty or personalty: Texas (the forum) or New York (the situs). In *Du Pont*, the court chose New York as the jurisdiction with the most significant relationship to the property.

A clause on this issue should be included in the hypothetical Jones trust described in §20.6, covering both the amount of compensation and the choice of law. See form in §20.39. See also Restatement (Second) of Conflict of Laws §187 (1971) (illustrations of choice-of-law clauses); *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 466 n4, 11 CR2d 330 (example from trust hypothetical in Restatement 187(1) that appears to allow parties in some circumstances to specify law of state with no relation to parties or transaction). In *Nedlloyd,* the court noted that Restatement §187(1) did not apply because there was no evidence that the parties had incorporated by reference extrinsic material to fill a gap in their contract. In *CMR Mortgage Fund, LLC v Canpartners Realty Holding Co. IV LLC* (*In re CMR Mortg. Fund, LLC)* (Bankr ND Cal 2009) 416 BR 720, the court held that, because the making of a contract was not in dispute, the law chosen by the parties did not need to have any reasonable relationship to the place of creation or performance of the contract. The court noted that such a relationship was necessary under Restatement §187 only when parties sought to specify choice of law governing issues concerning the formation or validity of a contract. 416 BR at 729.

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/§20.35 I. Planning for Validity, Construction, Interpretation, and Administration of Trust

§20.35 I. Planning for Validity, Construction, Interpretation, and Administration of Trust

Apart from any special choice-of-law questions, the trust instrument should clearly express the settlors' intentions on the identity of the trust beneficiaries, their interests in the trust, the administration of the trust, and the ultimate distribution of the trust estate. Clarifying these issues will minimize later questions regarding the validity, construction, or administration of the trust—about which a subsidiary choice-of-law issue may be presented. See the checklist in §20.101 for general planning of the trust and §§20.36-20.41 for salient points that should not be overlooked.

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§20.36 1. Revocability

The trust instrument should expressly state whether the trust is revocable, because the rules of revocability differ among the states. In California, a trust is revocable unless the trust instrument expressly states that it is irrevocable. Prob C §15400. In other states, however, a trust is presumed to be irrevocable unless the trust instrument contains a clause to the contrary. Restatement (Third) of Trusts §63 (2003); Restatement (Second) of Trusts §330 (1959); 5 Scott & Ascher on Trusts §35.1 (5th ed 2008).

The absence of a clause regarding revocability can have severe tax consequences. In *Hughes v Commissioner* (9th Cir 1939) 104 F2d 144, 147, a California settlor was subject to gift taxes on transfer of securities to a Massachusetts trustee on the grounds that the trust was irrevocable because it was governed by Massachusetts law (the place of administration) and did not include a statement of revocability. The fact that the trust was executed in California and would have been revocable under California law was not considered controlling.

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§20.37 2. Defining Technical Terms

Technical terms (*e.g.,* "issue," "children") should be carefully defined because meanings may vary from state to state. For example, in some states "issue" and "children" may include adopted children; in others, the terms may exclude them. See, *e.g.,* Prob C §6450 (defining an adopted child to be the same as a natural child for purposes of succession).

The hypothetical Jones trust described in §20.6 should therefore state expressly that these terms include adopted children, because a child's exercise of a power of appointment in favor of an adopted child should not be open to question under the variations in state laws.

Forms defining "issue" and "children" are set forth in §10.134.

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§20.38 3. Enforceability and Desirability of Choice-of-Law Clause

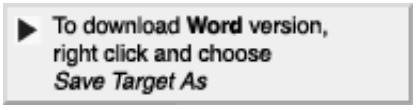
Although no California case has specifically dealt with choice-of-law clauses in trusts, California does not have a public policy against a choice-of-law clause, when otherwise appropriate. In a contract case involving the application of a choice-of-law clause to a claimed breach of fiduciary duty, the California Supreme Court followed the Restatement (Second) of Conflict of Laws §187(2) (1971). In *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 466 n4, 11 CR2d 330, the court held that the choice-of-law clause, which required that the contract be "governed by" the law of Hong Kong, was fully enforceable and applicable to claims for breach of the implied covenant of good faith and fair dealing and for breach of fiduciary duties as well as for breach-of-contract claims. The court found that Hong Kong was a jurisdiction having a substantial connection to the parties, and there was a substantial basis for choosing Hong Kong law. In *Washington Mut. Bank v Superior Court* (2001) 24 C4th 906, 103 CR2d 320, the court held that a trial court considering certification of a nationwide class action against a mortgage lender for breach of contract and breach of the implied covenant of good faith and fair dealing must apply the analysis in *Nedlloyd* to evaluate disputed claims that class causes of action were subject to a choice-of-law clause in the deed of trust, which required that the instrument be governed by federal law and the law of the jurisdiction in which the lender was located. In *America Online, Inc. v Superior Court* (2001) 90 CA4th 1, 108 CR2d 699, the court held that a forum selection clause was unenforceable because class action relief was not available in the designated jurisdiction (Virginia). See also *Van Slyke v Capital One Bank* (ND Cal 2007) 503 F Supp 2d 1353 (same). An agreement designating a foreign law is ineffective, however, if it violates a strong California public policy on a related issue. See *Application Group, Inc. v Hunter Group, Inc.* (1998) 61 CA4th 881, 72 CR2d 73.

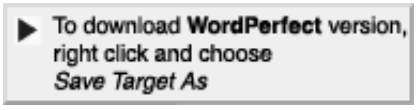
Apart from these considerations of public policy, it is generally advisable for the trust instrument to include clauses specifying the law applicable to the validity, construction, interpretation, and administration of the trust. Some attorneys believe, to the contrary, that a choice-of-law clause may be detrimental because a direction to apply certain laws may preclude a court from later resolving unanticipated problems in a different and perhaps more equitable way. Properly drafted choice-of-law clauses, however, should not interfere with the settlors' intents and can be as flexible as the rest of the instrument if sufficient care is taken.

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/§20.39 4. Form: Choice of Law (All Real and Personal Property in One State)

§20.39 4. Form: Choice of Law (All Real and Personal Property in One State)





[*Use one of the following alternatives*]

[*Alternative 1: Specified state law governs administration of trust*]

***Governing Law*. All questions concerning the validity, construction, interpretation, and administration of this trust _ _**[*including, by way of illustration only, investment, management, and distribution of the trust estate, and trustee's compensation*]**_ _ shall be governed by the law of the state of _ _**[*specify state*]**_ _ in force _ _**[*on the date of the creation of this trust/from time to time*]**_ _.**

[*Alternative 2: Change of situs does not change law governing administration*]

***Governing Law*. All questions concerning the validity, construction, interpretation, and administration of this trust _ _**[*including trustee's compensation*]**_ _ shall be governed by the law of the state of _ _**[*specify state*]**_ _ in force _ _**[*on the date of the creation of this trust/from time to time*]**_ _, regardless of whether the situs or place of administration of the trust has changed.**

[*Alternative 3: Change of situs changes law governing administration*]

***Governing Law*. All questions concerning the validity, construction, interpretation, and administration of this trust _ _**[*including trustee's compensation*]**_ _ shall be governed by the law of the state of _ _**[*specify state*]**_ _ in force _ _**[*on the date of the creation of this trust/from time to time*]**_ _. If, however, the situs or place of administration of the trust is changed to another state, the law of that state shall govern the administration of the trust.**

Comment: Alternative 1 makes the law of a single state govern the validity, construction, interpretation, and administration of a trust of personal and real property situated within that state.

Alternative 2 is similar to Alternative 1, but it also specifies that a change in the situs of the trust does not affect the law governing administration of the trust.

Alternative 3 permits a change in the law governing administration. This type of clause may sometimes be desirable. For example, in the hypothetical Jones case described in §20.6, if his children select a New Jersey trustee to act after his death, it may be more practical to permit New Jersey law to apply to administration of the trust by a New Jersey trustee. Careful thought should be given, however, to a clause that changes the law governing administration because, under the new law of administration, the rights and powers of the settlors, trustee, and beneficiaries may be enlarged or reduced, thereby affecting substantive matters of the trust as well as taxation of the trust, its settlors, and the beneficiaries. Among other effects, the principal and income law of the new place of administration may change the trustee's powers to such an extent that a nonindependent trustee (*i.e.,* a settlor or beneficiary) will be taxed with trust income during his or her lifetime and trust corpus on death.

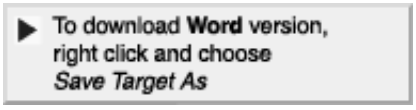
Alternative 2 is designed to meet these problems and to avoid the limitations imposed by *Commissioner v Procter* (4th Cir 1944) 142 F2d 824. In that case, the court held to be void, as against public policy, a so-called savings clause that recalled a gift if the transfer were held to be subject to gift tax. The court held the clause void on the ground that it would have a tendency to discourage collection of tax by public officials. See McCaffrey, *Transferring Property by Defined Value Clauses*, Estate Planning 2004, chap 6 (Cal CEB 2004). A savings clause may be valid, however, if it is not dependent on some subsequent adverse action by the IRS, but demonstrates an intent to confine a particular power from the outset to one that cannot have an adverse tax effect. See Rev Rul 65-144, 1965-1 Cum Bull 442; IRS Letter Ruling 7916006.

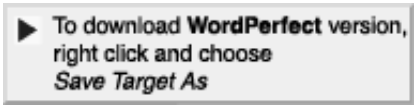
In addition, if the new law thus chosen is contrary to the public policy of the situs of the real property, the courts of the situs will probably not apply that law. See the cases cited in §20.38.

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/§20.40 5. Form: Choice of Law (Real Property in Several States and Personal Property)

§20.40 5. Form: Choice of Law (Real Property in Several States and Personal Property)





[*Use one of the following alternatives*]

[*Alternative 1: Law of situs governs real property; specified state law governs personal property*]

***Governing Law*. The validity of this trust for real property shall be governed by the law of the state of its situs. The validity of this trust for personal property, and all matters concerning the construction, interpretation, and administration of this trust _ _**[*including trustee's compensation*]**_ _ for all property, shall be governed by the law of the state of _ _**[*specify state*]**_ _ in force _ _**[*on the date of creation of this trust as amended/from time to time*]**_ _.**

[*Alternative 2: Change of situs does not change law governing administration*]

***Governing Law*. The validity of this trust for real property shall be governed by the law of the state of its situs. The validity of this trust for personal property, and all matters concerning the construction, interpretation, and administration of this trust _ _**[*including trustee's compensation*]**_ _ for all property, shall be governed by the law of the state of _ _**[*specify state*]**_ _ in force _ _**[*on the date of creation of this trust as amended/from time to time*]**_ _, regardless of whether the situs or place of administration of the trust changes.**

[*Alternative 3: Change of situs changes law governing administration*]

***Governing Law*. The validity of this trust for real property shall be governed by the law of the state of its situs. The validity of this trust for personal property, and all matters concerning the construction, interpretation, and administration of this trust _ _**[*including trustee's compensation*]**_ _ for all property, shall be governed by the law of the state of _ _**[*specify state*]**_ _ in force _ _**[*on the date of creation of this trust as amended/from time to time*]**_ _. If, however, the situs or place of administration of the trust is changed to another state, the law of that state shall govern administration of the trust.**

Comment: For trusts that include real property in several states or both real and personal property (*e.g.,* the hypothetical Jones trust described in §20.6), traditional choice-of-law clauses designate the law of the situs state to govern validity for real property and the law of a state having a substantial connection with the trust to govern the validity of the trust for personal property and the construction and administration of the trust for all property. In any case, it is advisable to designate the law of the place of administration as the governing law because of the trustee's familiarity with such law. The attorney should ensure, however, that the designated law does not violate the public policy of another state having a close connection with the trust.

In the future, the courts of the situs of real property may recognize more widely a choice-of-law clause designating the law of another state to apply to the validity of the trust for real property within the state. See, *e.g., Rudow v Fogel* (Mass App Ct 1981) 426 NE2d 155, 159. At present, however, it seems prudent to follow the traditional conflict rules to avoid possible litigation.

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§20.41 6. Application to Hypothetical Case

Because the trust corpus in the hypothetical Jones trust described in §20.6 will include real and personal property situated in three states, the trust should probably designate the law of New York to apply to construction, interpretation, and administration of the trust. The drafter should, however, first carefully review New York law to ensure that the trust will carry out the settlors' intents, that it will not violate a strong public policy of California (and Oklahoma, if the oil interests are considered to be real property; see *Hall v Superior Court* (1983) 150 CA3d 411, 197 CR 757), and that it will not adversely affect taxation of the trust. It is advisable to have counsel in the designated state and each situs state review the trust instrument to ensure compatibility with local law and policy.

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III. SPECIAL PROBLEMS OF MULTISTATE TRUSTS

§20.42 A. Who Can Act as Trustee

Any corporate or individual trustee, regardless of place of business or residence, can generally act as trustee of a living trust of personal property, because the settlor can transfer these assets in trust to a resident of any state. If, however, a trust includes real property in a state other than the trustee's residence or place of business, a question may arise about the trustee's right to act.

An individual—whether a resident or nonresident of the state where the real property is situated—can serve as trustee in most states. Many states, however, including California, have statutes limiting a foreign corporation's right to act as trustee. These statutes either absolutely prohibit a foreign corporation from acting as trustee or allow it to serve only if the state of its incorporation offers reciprocal clauses to its domestic corporate trustees or if the corporation qualifies to do business in the state (often under burdensome conditions). Although some statutes apply to both living and testamentary foreign corporate trustees, others do not apply to a living foreign corporate trustee or a foreign corporate trustee receiving a pourover bequest from a will. See *Administration of Out-of-State Assets by Corporate Trustees*, 103 Tr & Est 997 (1964); Hendrickson, Interstate and International Estate Planning §§5.24-5.28 (1968).

California generally prohibits a foreign corporation from acting as a living or testamentary trustee, except a national banking association authorized to conduct a trust business in California or a bank from another state. See Fin C §§1503, 1750-1751.

Before selecting a corporate trustee, therefore, the practitioner should review the law of the trust situs to ascertain whether the trustee can act. The opinion of local counsel is often desirable whenever the corporate trustee's right to act is in doubt. Even if the corporate trustee can act, often it may not wish to act, to avoid problems it may encounter when doing business in a foreign state.

If a trust includes real property situated in a state that prevents a nonresident corporate trustee from acting, or if the corporate trustee prefers not to act in that state, one solution is to (1) appoint an individual cotrustee to serve with the corporate trustee and (2) give the individual cotrustee all rights and powers for the real property. The law of the situs state must be reviewed, however, to ensure that the individual trustee can serve as a cotrustee with limited powers. New Jersey, for example, does not permit this. Another solution is to permit the corporate trustee to appoint another corporate trustee situated in the situs state to act as trustee of the real property. The trust instrument should permit the primary corporate trustee to make suitable compensation arrangements with the situs trustee so that it may be compensated from trust funds. The primary corporate trustee should be consulted when the trust instrument is drafted, because it may desire an exculpatory clause against liability for acts of the appointed trustee.

Whenever a cotrustee is appointed for the purpose of holding title to real property, the cotrustee's domicile should be carefully considered; appointing a trustee with a domicile differing from that of the corporate trustee may significantly affect taxation of the trust. See §20.92. Therefore, it may sometimes be more advantageous for tax reasons to appoint an individual rather than a corporate cotrustee because the individual and corporate trustees can be domiciliaries of the same state.

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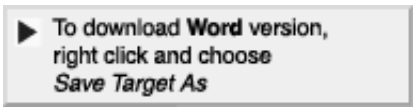
§20.43 1. Application to Hypothetical Case

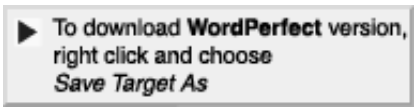
In the hypothetical Jones case described in §20.6, either an individual trustee or a California corporate trustee must act as trustee for California real property if (as is probable) the New York corporate trustee is not a national bank authorized to conduct a trust business in California and therefore cannot act as trustee in California. Whether another trustee is necessary for the Oklahoma oil interests depends on whether they are categorized as real or personal property. If the interests are considered to be real property, an individual trustee would probably be required. The individual trustee must be carefully selected because taxation of the trust may be based in part on the trustee's residence. See §§20.92, 20.94.

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/§20.44 2. Form: Appointing Trustee for Real Property

§20.44 2. Form: Appointing Trustee for Real Property





***Appointment of Trustee for Real Property*. If the trust estate includes any real property situated in a state other than the corporate trustee's place of business, and the corporate trustee is unable or unwilling to hold title to such property as trustee, the individual cotrustee shall take title to the property in his or her own name, shall hold or dispose of the property according to the terms of this Declaration of Trust, and shall act as sole trustee for that property. When the property is sold or otherwise disposed of, the corporate trustee shall act as cotrustee (or sole trustee if no other trustee is then acting) of the proceeds or other property received in exchange, if the corporate trustee can legally do so. If no individual trustee is then acting and the trust estate includes property described above, the corporate trustee shall appoint an individual or corporate trustee to take title of this Declaration of Trust. When the property is converted into property that the corporate trustee can legally hold, the appointed trustee shall transfer title to the corporate trustee and forthwith resign. An individual trustee who holds title to property is authorized to appoint the corporate trustee as his or her agent to handle all receipts and disbursements for the property.**

Comment: This form can be adapted for use in any multistate trust. It is not tailored to the hypothetical Jones trust described in §20.6.

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B. Validity of Pourover Bequests to Living Trusts

§20.45 1. When Permitted

Most states, including California, have enacted the Uniform Testamentary Additions to Trusts Act (Prob C §§6300-6303) or other statutes expressly permitting testamentary bequests to living trusts. California permits such a transfer if the trust is identified in the testator's will and the trust is executed before or concurrently with the will.

In states without legislation authorizing a transfer to a living trust, the validity of a pourover bequest depends on the doctrine of incorporation by reference or the doctrine of independent legal significance. See Bogert, The Law of Trusts and Trustees §§107, 264.5 (2d ed 1977); 1 Scott & Ascher on Trusts §§7.1.1-7.1.4 (5th ed 2007); 1 Nossaman & Wyatt, Trust Administration and Taxation §5.06 (rev 2d ed 1966).

In any matter involving a pourover of assets from a will to a living trust situated in another state, it is essential to review the law of the testator's domicile (that governs the validity of the pourover bequest) to determine whether a transfer of assets to a foreign trust is permissible and to ascertain requirements of the trust. The trust must generally be executed before or concurrently with the will, and in some states it must be acknowledged by the parties. See, *e.g.,* NY Est Powers & Tr L §3-3.7(a). The trust should not be amended without reviewing the applicable law to determine the validity of an amendment, because in some states an amendment after execution of the will makes the bequest invalid. The invalidity can generally be avoided, however, by republishing the will by a codicil immediately after execution of the trust amendment.

The pourover device can sometimes be used to avoid statutory prohibitions against the appointment of a foreign corporate testamentary trustee. Unless state law expressly prohibits it, a testator may be able to have the personal property of his or her probate estate distributed to a corporate trustee in another state to be held according to the terms of a living trust established before death. See 5A Scott, Trusts §563.

It may be possible for this technique to be used in California because Prob C §§6300-6303 do not prohibit a transfer to a foreign trustee. Because of the many restrictions on a corporate trustee's right to act for foreign real property, it is questionable, however, whether real property can be poured over to a corporate trustee in another state. See §20.42.

In situations involving a pourover of testamentary assets to a living trust in another jurisdiction, the following questions should be considered, and the laws of the testator's domicile and those applicable to the trust should be reviewed:

- Will the testator's domicile permit a pourover to a trust in another jurisdiction?
- What are the surviving spouse's rights to trust assets? See §§20.50, 20.57.
- If there are charitable bequests, do any mortmain statutes of the testator's domicile or of the trust situs apply? See §20.67.
- What are the pretermitted heirs' rights? See §20.58.
- How are estate and inheritance taxes to be paid? See §§20.84-20.86.

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§20.46 2. Application to Hypothetical Case

In the hypothetical Jones case described in §20.6, the settlor's will should include a pourover bequest to the living trust so that all nontrust assets held on the date of death will be transferred to the trust and administered as part of it. Because both California and New York have adopted statutes permitting a pourover bequest (see Prob C §§6300-6303; NY Est Powers & Tr L §3-3.7), a testamentary bequest to the living trust is valid as long as, for New York property, the settlor and trustee have acknowledged the trust instrument. Although Mr. Jones's real property will be transferred to the trust before his death, if transfer were delayed until after death and accomplished by means of a pourover bequest, a problem would arise regarding inability of the New York corporate trustee to hold title to California real property (and possibly the Oklahoma oil interests). See §20.43.

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§20.47 C. Transfer of Community or Separate Property to Trust in Another Jurisdiction

The transfer of community or separate property to a trust situated in a state that has a different property system may create tax and substantive law problems. See, *e.g., Paley v Bank of America* (1958) 159 CA2d 500, 324 P2d 35 (move from separate to community property state). These problems are described and solutions suggested in §20.48-20.56.

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1. Nature of Problems

§20.48 a. Separate or Community Character of Property Transferred

Separate property and community property generally retain their status as separate and community property, even though the property may be transferred to a trust in a state with a different property system or used to acquire real property in that state. See *Addison v Addison* (1965) 62 C2d 558, 43 CR 97 (separate personal property brought to California); *Tomaier v Tomaier* (1944) 23 C2d 754, 146 P2d 905 (community funds invested in Missouri real property); *People ex rel Dunbar v Bejarano* (Colo 1961) 358 P2d 866 (employee death benefits accumulated in community property states and paid in a separate property state); Restatement (Second) of Conflict of Laws §259 (1971). See also Cline, *Selected Planning Issues for the Migrant Client*, Estate Planning 2006, chap 6 (Cal CEB 2006).

Although the transferred property may retain its character, the future income from the property does not necessarily have the same character. For example, under Texas law a spouse is regarded as the owner of half of all income received by the other, including income from separate property. See *Marriage of Long* (Tex Civ App 1976) 542 SW2d 712, 718; *Mercantile Nat'l Bank v Wilson* (Tex App 1955) 279 SW2d 650, 654. Consequently, the beneficiary of a trust that holds separate property in California and separate property in Texas will find the California separate property producing separate income while the Texas separate property produces income belonging half to each spouse.

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§20.49 b. Character of Property for Death Tax Purposes

The courts of the situs state sometimes have incorrectly disregarded the original nature of the property for tax reasons. For example, community property used to purchase real property in a common-law state has been subjected to inheritance taxes in the situs state on the husband's death as if it were his separate property. See, *e.g., Estate of Kessler* (Ohio 1964) 203 NE2d 221 (securities acquired in California as community property taxed on husband's death by Ohio, his domicile at date of death); *Estate of Hunter* (Mont 1951) 236 P2d 94 (on death of husband, a California resident, Montana taxed both spouses' share of community real property situated in Montana).

Similar transfer tax problems can arise in a more subtle manner. For example, Texas treats income from separate property as community property, with half belonging to each spouse. Consequently, the IRS has taken the position on two separate occasions that lifetime transfers of one spouse's community property interest to the other spouse (to give the other spouse a separate-property ownership of the asset) do not prevent the inclusion of part or all of the value of the transferred community property interest in the transferor spouse's estate under IRC §2036, on the theory that the transferor spouse, under Texas law, retains a one-half income interest in the transferred property. See *Estate of Charles J. Wyly, Sr.* (1977) 69 TC 227, rev'd (5th Cir 1980) 610 F2d 1282; *Estate of Winston C. Castleberry* (1977) 68 TC 682, rev'd (5th Cir 1980) 610 F2d 1282. In each case, the Fifth Circuit Court of Appeals overruled the Tax Court decisions that upheld the IRS position, noting that a right to income such as that given by Texas community property law does not amount to a retained right to income within the meaning of IRC §2036.

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§20.50 c. Marital Rights

If the situs state considers community property to be the husband's separate property for tax purposes, questions may also arise about the widow's marital rights. Is she entitled to the community share that would be awarded her by the domiciliary court, or is she entitled to a statutory share under the law of the situs state? Similarly, if separate property is transferred to a trust in a community property state, the surviving spouse's marital rights may be defeated if the situs state does not recognize a surviving spouse's entire interest in separate property and the law of the situs state governs the spouse's rights. See Hendrickson, Interstate and International Estate Planning 58 (1968) (citing Louisiana statute).

The laws of the community property states vary on a nonresident spouse's rights for property situated within the jurisdiction. For example, in Texas and Washington, the surviving spouse has no right to a nondomiciliary decedent's separate real property situated within the state and bequeathed by will. See Gilchrist, *Washington Disinherits the Non-Native Wife*, 46 Wash L Rev 283 (1971). In California and Idaho, however, for real property situated within the state, the surviving spouse has the same right to elect to take against the nondomiciliary decedent's will as if the real property had been situated in the decedent's domicile. In effect, California and Idaho apply the law of the domiciliary state when determining the survivor's right to real property within the state. See Prob C §120.

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§20.51 d. Income Tax Effects of Transfer of Community Property

There may be income tax problems on the transfer of community property to a revocable trust in a common-law state. If property is determined to be community property under state law, then it is community property for purposes of IRC §1014(b)(6) regardless of the form in which title was taken. If the situs state does not recognize the community nature of the property, the surviving spouse may not be entitled, on the first spouse's death, to a stepped-up basis for income tax purposes on his or her share of the community trust assets under IRC §1014(b)(6). Under Rev Rul 66-283, 1966-2 Cum Bull 297, a stepped-up basis is permitted for the survivor's half of community property in a California revocable trust.

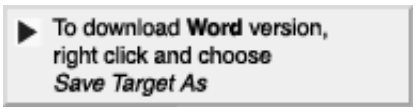
In Rev Rul 68-80, 1968-1 Cum Bull 348, the IRS disallowed a stepped-up basis for New Mexico community property traded for Virginia real property held by the spouses as tenants-in-common. The Virginia property was held not to be community property under state law even though it was acquired in exchange for community assets. Therefore, the property was not treated as community property for purposes of IRC §1014(b)(6). That ruling was distinguished in a later ruling applied to Oklahoma property considered to be statutory community property by Oklahoma as the situs state. See Rev Rul 87-98, 1987-2 Cum Bull 206.

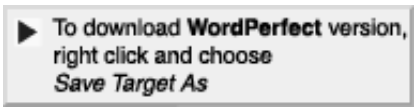
To avoid controversy, the parties should agree in writing that any property intended to be community property is community property, even though title is held in another form. See Fam C §852 (requirements for valid transmutation of property). To avoid the problem entirely, the parties should not transfer community property that has appreciated in value to a trust in another jurisdiction. Instead, the parties should retain the property in a trust in the community property state, with an express clause designating the law of that state to apply to its validity, construction, interpretation, and administration.

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/§20.52 e. Form: Choice of Law for Community Property

§20.52 e. Form: Choice of Law for Community Property





***Governing Law*. It is intended by this clause that any community property of my spouse and myself shall be governed by the law of _ _**[*specify community property state in question*]**_ _.**

Comment: This clause may be used to modify the forms in §§20.39-20.40 to accommodate an expression of intent that the law of a community property state applies to the validity, construction, interpretation, and administration of a trust.

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§20.53 f. Effect of Agreement and Trust Instrument Between Spouses

The character of separate or community property transferred to a trust may be changed by an agreement to hold the property under the law of the situs state. See, *e.g.*, *Wyatt v Fulrath* (1965) 264 NYS2d 233, 211 NE2d 637 (New York court permitted New York joint-tenancy bank accounts belonging to Spanish national and resident to be distributed to surviving spouse under New York law, although distribution was invalid under Spanish community property laws).

Even without a formal agreement changing the character of property, its character may be changed by the terms of the trust. For example, in a revocable trust of community property, executed or consented to by both spouses, if the husband is given, as a settlor, complete control over the trust assets and the right to all income and principal and the wife is given no rights, the wife may have made a taxable gift to her husband of her share of the community property. In addition to gift tax problems created by the conversion, substantial estate tax problems may arise on the husband's death. See *Katz v U.S.* (9th Cir 1967) 382 F2d 723.

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§20.54 2. Steps to Take on Transfer

If separate or community property must be transferred to a trust in a state with a different property system, the following steps should be taken to minimize tax and substantive problems:

- Property that is clearly separate or community property should be identified as such.
- If the property is community property, both spouses should be the settlors. This step may help the parties avoid the situation of *Estate of Hunter* (Mont 1951) 236 P2d 94, in which the community property in the husband's name was presumptively owned by him and taxed to him under Montana inheritance tax laws.
- The trust instrument should specify that the trust property and the income will remain separate or community property.
- The surviving spouse's rights should be set out.
- No rights should be given to a settlor, spouse, or any beneficiary that would alter the character of the property.
- The requirements of any applicable statutes should be followed.

If California community property is to be transferred to a trust in another state, the provisions of Fam C §761 should be followed to preserve the community character of the property. That section expressly provides that when community property is transferred to a revocable trust, the spouses' interests in the trust will remain community property if the trust instrument conforms to the statute's requirements.

When a trust consists of community property situated in different community property states, the laws of the community property states vary concerning the nature of community property and the rights of each spouse. Accordingly, the law of each state in which property is situated must be reviewed to determine the exact interests of the spouses.

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§20.55 3. Effect of Change of Settlors' Residence

Additional problems arise if the settlors subsequently become residents of the state in which trust property is situated. Although the basic nature of the trust property may not change while the settlors are alive, on death it may be treated differently for succession purposes. For example, in California all personal property wherever situated, and all real property situated in California, acquired by a spouse while domiciled outside California is defined as "quasi-community property" for succession purposes on death if that property would have been community property if acquired while the spouse was domiciled in California. Prob C §66. California treats half the quasi-community property of a married person whose death occurs while domiciled in California as belonging to the surviving spouse. Prob C §101.

A change in the settlors' domicile may also affect the character of income of the trust property. In Texas, Idaho, and Louisiana, income derived by residents from separate property becomes the husband and wife's community property. In California, income from true separate property remains the separate property of the owner (Fam C §770(a)(3)), but income from quasi-community property is subject to the surviving spouse's succession rights under Prob C §101. Therefore, when the settlors become residents of the state of the trust situs, the situs state's tax, succession, and other applicable laws should be reviewed to determine their effect on the trust property and income and on the settlors' dispositive plans.

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§20.56 4. Application to Hypothetical Case

If, in the hypothetical trust described in §20.6, Mr. Jones is considered to be a resident of New York at the time of his death, his spouse's marital rights in his California real property are not affected by a transfer of his property into a trust. On Mr. Jones's death, California will apply New York law to determine his wife's interest in the property, and she will be entitled to receive the same interest in the property as though it had been situated in New York.

If Mr. Jones is considered to be a California resident at the time of his death, however, the California law of succession will apply. His widow will be entitled to elect against his will and to receive outright half of his quasi-community property (*i.e.,* his California real property and his New York securities account) because the property was acquired with Mr. Jones's earnings after marriage and would have been community property had the parties lived in California when it was acquired. Prob C §§66, 101.

Under California law, Mr. Jones cannot extinguish his wife's interest in his property by transferring it to a revocable trust. He can do so only by transferring the property before his death and retaining no rights of ownership or control at the time of his death, *e.g.,* by an irrevocable transfer in trust for the benefit of third parties or by an outright gift. See Prob C §102 (listing transfers subject to restoration of surviving spouse's quasi-community property interest).

Although Mrs. Jones may receive an increased share of the California real property and the New York securities account if Mr. Jones dies while he is a resident of California, he can defeat his wife's statutory rights in the New York real property if he wishes to do so. California law does not give a spouse of a deceased resident any rights over separate real property situated outside the state, and New York does not provide a forced share of New York property for spouses of nonresidents unless the decedent has elected to have the disposition of his or her New York property governed by the law of New York. NY Est Powers & Tr L §5-1.1-A(c)(6). Accordingly, by establishing the trust in California rather than in New York and by providing for California law to govern the trust and his will, Mr. Jones can preclude his wife from receiving any part of his New York separate real property. If the trust is established in New York, however, with New York law to govern, she would be entitled to a share of the property. See NY Est Powers & Tr L §5-1.1-A.

For the Oklahoma oil interests, Mrs. Jones's rights would depend on whether Mr. Jones is a resident of New York or California, whether the oil interests are real or personal property under Oklahoma law, and whether the applicable laws of succession are those of New York, California, or Oklahoma. If the oil interests are personal property and Mr. Jones is a resident of California, the interests would be considered community property, and his wife would be entitled to a one-half vested interest under California law. If the interests are transferred to a trust to be governed by New York law, however, it is not clear whether New York would apply its law or California law in determining the wife's rights. If Mr. Jones is a resident of New York, the interests would be considered to be separate property because they were derived from his earnings, and Mrs. Jones would be entitled to her statutory share under New York law. If the interests are considered to be real property, however, her rights would be determined by Oklahoma, which may apply its own law or the law of Mr. Jones's domicile in determining his wife's rights.

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D. Trusts in Violation of Family Rights

§20.57 1. Surviving Spouse's Rights

Most common-law states permit a surviving spouse to share in the decedent's estate. For a summary of state laws, see Hendrickson, Interstate and International Estate Planning, App E, Table II (1968). If a settlor residing in such a state creates a living trust in another state with different laws or with laws that protect only a resident surviving spouse, a question arises about the settlor's right to defeat his surviving spouse's domiciliary marital rights.

A disgruntled spouse may bring suit alleging that such a trust is a fraud against his or her rights or that the trust is "illusory." See 1 Nossaman & Wyatt, Trust Administration and Taxation §5.04 (rev 2d ed 1966). If the trust has contacts outside the decedent's domicile, the forum court must first decide which state's law governs the validity of the trust. The appropriate law must then be applied, and only if the trust is held invalid for the spouse does the spouse have a right to a specified share in the trust property. Determining the size of that share and the effect of invalidity may be governed by the law of a different jurisdiction from the one whose law applies to govern trust validity. In some family situations, the choice could provide an incentive to transfer personal property (*e.g.,* securities) to a state in which the surviving spouse would have no right to share in that property.

A settlor was permitted to defeat his wife's rights in *National Shawmut Bank v Cumming* (Mass 1950) 91 NE2d 337. Applying the law of Massachusetts (as designated by the trust instrument), the court held that the surviving spouse of a Vermont decedent who created a revocable trust in Massachusetts was not entitled to any share of the trust assets, because the trust was not invalid as a testamentary disposition in violation of the Massachusetts Statute of Wills, and Massachusetts law did not permit a surviving spouse to take assets of a revocable trust.

The *Cumming* decision has been criticized, and it is questionable whether the same result would be reached by courts in states other than Massachusetts. Under the current trend in conflict of laws, the surviving spouse's rights should be a matter to be determined by the law of the settlor's domicile because, for this purpose, domicile has the most significant relationship to the trust. See *Estate of Crichton* (1967) 281 NYS2d 811, 228 NE2d 799 (court applied law of settlor's domicile); *Rose v St. Louis Union Trust Co.* (Ill 1969) 253 NE2d 417 (court applied law of settlor's domicile when trust was created); 7 Scott & Ascher on Trusts §45.4.2.4 (5th ed 2010).

This position has been adopted in a New York case involving a disposition by will. In *Estate of Clark* (1968) 288 NYS2d 993, 236 NE2d 152, the New York Court of Appeals applied Virginia law to give a widow her full statutory share of the estate of a Virginia resident, although most of the decedent's assets were in New York and his will provided for testamentary dispositions to be determined under New York law.

Clark may have been effectively overruled, however, by *Estate of Renard* (Sur Ct 1981) 437 NYS2d 860, aff'd (App Div 1981) 447 NYS2d 573, aff'd (1982) 453 NYS2d 625, 439 NE2d 341, in which the New York court upheld a French domiciliary's choice-of-law direction that New York law apply to New York assets, rejecting her son's claim to a forced share in these assets (as was required under the laws of France). The court noted that the legislative history of the controlling statute (NY Est Powers & Tr L §3-5.1(h)) supported the conclusion that the statute was intended to permit a nonresident testator to invoke New York law for his assets physically located in New York and thereby avoid the forced heirship of his domicile.

Both *Clark* and *Cumming* involved a decedent's attempts to defeat his wife's rights. Sometimes, the wife's rights can be increased by establishing a trust in a nondomiciliary state. In *Hutchison v Ross* (1933) 262 NY 381, 187 NE 65, the law of New York, the trust situs, governed (and upheld) the validity of the trust and the interest given to the wife under the trust, although the trust would have been void under the law of Quebec, the settlor's domicile.

Therefore, before establishing a trust in a state other than the settlor's domicile, the parties should review the laws of the situs and domiciliary states to determine the marital rights of a surviving spouse. Otherwise, the spouse may be given unexpected and unintended rights that can disrupt the settlor's dispositive plan or he or she may be deprived of rights that were intended. See *Estate of Rhoades* (Sup Ct 1994) 607 NYS2d 893 (when *Estate of Clark, supra*; *Estate of Renard, supra*; and NY Est Powers & Tr L §3-5.1 do not apply, New York domiciliary can defeat spouse's rights

under New York's right of election by changing domicile at any time before death and executing will in other state, disinheriting spouse).

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§20.58 2. Children's Rights

Although, in this country, children's forced heirship rights (commonly referred to as "the legitime") exist only in Louisiana, controversies can still result from domestic efforts to enforce foreign-conferred rights (see *Estate of Renard* (Sur Ct 1981) 437 NYS2d 860, aff'd (App Div 1981) 447 NYS2d 573, aff'd (1982) 453 NYS2d 625, 439 NE2d 341) or from different local laws on questions of legitimacy (see Anno, *Conflict of Laws as to Legitimacy or Legitimation or as to Rights of Illegitimates, as Affecting Descent and Distribution of Decedent's Estate*, 87 ALR2d 1274 (1963)), pretermitted heirship (see Anno, *Conflict of Laws as to Pretermission of Heirs*, 99 ALR3d 724 (1980)), or adoption (see Anno, *Conflict of Laws as to Adoption as Affecting Descent and Distribution of Decedent's Estate*, 87 ALR2d 1240 (1963)). Therefore, it is necessary to consider the statutory interests of surviving children in planning wills and probate estates. With the exception of adoption, these issues have not involved living trusts.

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§20.59 3. Application to Hypothetical Case

In the hypothetical Jones case described in §20.6, if Mr. Jones is considered to be a resident of New York, his wife's rights will not be affected by establishment of the trust, because Mr. Jones's domicile and the situs of the trust will be the same. If Mr. Jones is considered to be a resident of California, however, his wife's succession rights on his death will be changed. Under California law, she will be entitled to a one-half share of the community property and the quasi-community property but to none of the separate real property situated in New York acquired with inherited funds. See Fam C §§65, 125, 760, 770; Prob C §§28, 66, 100-101.

In this event, the question arises whether New York, the trust situs, will apply its law or California law (or possibly Oklahoma law if the oil interests are real property) in determining the wife's rights, in view of *Estate of Clark* (1968) 288 NYS2d 993, 236 NE2d 152; *Estate of Renard* (Sur Ct 1981) 437 NYS2d 860, aff'd (App Div 1981) 447 NYS2d 573, aff'd (1982) 453 NYS2d 625, 439 NE2d 341; and New York statutory provisions denying the right of election to the spouse of a nonresident. See NY Est Powers & Tr L §5-1.1-A(c)(6). See also *Estate of Rhoades* (Sup Ct 1994) 607 NYS2d 893 (construing former NY Est Powers & Tr L §5-1.1(d)(7)).

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§20.60 E. Assignment, Attachment, and Disclaimer of Beneficiary's Interest; Creditors' Rights

The laws regarding attachment and assignment of a beneficiary's trust interest vary from state to state. In some states, a spendthrift clause is invalid; in some, it is valid for income but not for principal; and in others, it is valid for creditors but not for a beneficiary's dependents. For a summary of state laws, see Hendrickson, Interstate and International Estate Planning, App E, Table III (1968).

The law of the situs of a trust of real property and the law of the designated place of administration of a trust of personal property generally determine whether a beneficiary's interest can be assigned by him or her or reached by a creditor. For personal property, if there is no fixed place of administration, the law of the state having the most substantial contact with the trust governs. See 1 Nossaman & Wyatt, Trust Administration and Taxation §24.03[7] (rev 2d ed 1966); 7 Scott & Ascher on Trusts §45.7.1.2 (5th ed 2010).

The settlor's intent cannot vitiate statutes regulating spendthrift clauses, because these laws are considered a matter of public policy. If the settlor desires a strong spendthrift clause, it may be advisable to have a trust of personal property administered in a state that permits a strong clause, unless that would be contrary to public policy in the settlor's domicile. For example, in the hypothetical Jones case described in §20.6, if Mr. Jones were concerned about the spendthrift tendencies of his children, he might transfer his personal property to a trust in a jurisdiction such as Illinois, which gives creditors fewer rights than do New York, California, or many other states. It is doubtful, however, whether he could avoid the spendthrift laws of situs states for real property, because these laws are generally a matter of public policy that the situs state has an interest in enforcing.

For transfer tax purposes, having a beneficiary assign or disclaim his or her interest may be advantageous. Internal Revenue Code §§2046 and 2518 have sought to establish a *federal* transfer tax law of disclaimers. That makes partially irrelevant the local law (and, therefore, any conflicts of local law) regarding the *validity* of any disclaimer for transfer tax purposes; however, local law still governs to determine the identity of the ultimate transferee.

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F. Powers of Appointment

§20.61 1. Applicable Law

Complex conflict-of-laws problems can arise from the inclusion of a power of appointment in a multistate trust. The law applicable to questions relating to the interpretation and scope of a power (*e.g.,* whether it is a general or special power of appointment and who can be the appointees) may differ from the law applicable to questions about validity of the exercise of the power (*e.g.,* whether exercise of the power violates the rule against perpetuities or is invalid because of lack of the donee's capacity or failure to comply with necessary formalities). In addition, the law applicable to a power given to a beneficiary may differ from the law applicable to a power reserved by the settlors. See §§9.54-9.57, 10.6; California Estate Planning, chap 9 (Cal CEB 2002); 1A Nossaman & Wyatt, Trust Administration and Taxation §36.31 (rev 2d ed 1966). See also Durand & Herterich, *Conflict of Laws and the Exercise of Powers of Appointment*, 42 Cornell L Rev 185 (1957) (comprehensive discussion of problems of powers of appointment).

In real property trusts, questions regarding the validity of exercising a power of appointment have traditionally been determined by the law of the situs of the real property. The scope of the power is a question of construction determined by the same law that applies to construction of the trust: either the applicable law designated by the settlor in the trust instrument or, absent a designation, the law of the situs. If the donee exercises his or her power by a further appointment in trust, under the traditional rules, the law of the situs governs questions concerning the validity of the disposition.

In trusts of personal property, the law varies so much from state to state that no general rules can be set out. The applicable law may be the law of the state intended by the settlors, the law of the settlors' or beneficiary's domicile, or the law of the place where the trust property is administered or situated. The California power of appointment statutes do not refer to multistate powers. See Prob C §§600-695. In *Estate of Erdman* (1968) 264 CA2d 335, 70 CR 774, the court held that the testamentary exercise by a California donee of a limited power of appointment over two testamentary trusts and one living trust, established in Illinois by the donee's deceased parents, was not effective. The California court applied Illinois law to the trusts, which held that intangible personal property was to be controlled by Illinois trustees.

When the donee wishes to exercise a power over personal property by a further appointment in trust, the following questions arise:

- Does the power permit a further appointment in trust and the creation of new powers?
- Will the exercise of the power violate any perpetuity rules?
- Can the donee select a trustee in another jurisdiction to administer the trust?

In general, the law governing validity of the original trust governs the validity of the appointment and the perpetuities problem, but there are exceptions. In *In re Morgan Guar. Trust Co.* (1971) 320 NYS2d 905, 269 NE2d 571, the court held that the rule against perpetuities of the donee's domicile (California) should be applied in determining whether the exercise of a general power of appointment under a New York living trust was valid. The majority opinion held that the law of the donee-testator's domicile governed in determining the meaning of his will, apparently distinguishing the meaning of his will from his exercise of a power of appointment by that will. The validity of the exercise of power was to be determined under New York law, after the meaning of the will had been determined by the state of domicile. See Comment, *Choice of Law Rules and Validation of Powers of Appointment*, 29 Wash & Lee L Rev 143, 146 (1972).

The law is uncertain regarding the selection of a new trustee to administer a trust created by a power of appointment. In cases involving testamentary trusts, the donor's domicile may not permit the assets to be transferred, to the extent that the court of his or her domicile retains continuing jurisdiction over the trust. See *Estate of Eginton* (Sur Ct 1959) 193 NYS2d 828, 831. In California, Prob C §§17400-17457 provide for the transfer of either testamentary or living trust administration to another jurisdiction in the court's discretion if specified statutory conditions are satisfied. For California or other states with similar statutes, if the settlors' intent indicates that the place of administration may be changed, the trust assets should be transferred to the new trustee. See also Restatement (Second) of Conflict of Laws

§272, Comment b (1971).

In *Estate of McMullin* (Pa 1980) 417 A2d 152, the Pennsylvania Supreme Court held that Pennsylvania courts should accord comity to an Iowa court's determination (in its proceeding probating the Iowa donee's will) that the donee, by her will, had validly and effectively exercised a general testamentary power of appointment over a testamentary trust created by a Pennsylvania donor when the donor directed in his will that the donee transfer principal of his trust by *her* will. There was no indication that the donor intended that the validity of the donee's will be determined by any particular court, so it was reasonable to conclude that the donor intended the donee to exercise her testamentary power to appoint with a will whose validity was determined according to the law of the state in which the will was duly probated.

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/§20.62 2. Drafting Considerations

§20.62 2. Drafting Considerations

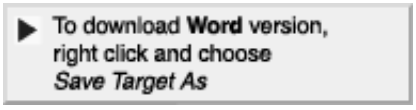
Because of the many issues that can result from a power of appointment and the uncertainty of the applicable law in a multistate trust, the power must be carefully drafted, with conflict-of-laws questions in mind. The trust instrument should state:

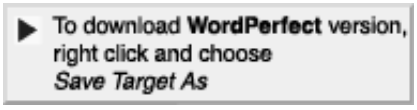
- How the power is to be exercised (whether by will or other instrument and whether express mention of the power is necessary);
- Whether there can be further appointments in trust (and, if so, whether the trust assets can be transferred to a trustee in another state); and
- Whether the power can be released.

The trust should include an express clause specifying the law to apply to the scope and validity of the power of appointment. When drafting a choice-of-law clause, the drafter should remember that the designated law may not govern the validity of the exercise of a power over real property located elsewhere if the traditional rule applies, determining the validity of the exercise by the law of the situs state. See form in §20.63.

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§20.63 a. Form: Exercise of Power of Appointment





***Exercise of Power of Appointment*. The power of appointment granted in this instrument must be exercised by a will or any codicil to it (1) that is executed according to the formalities required at the time of the donee's death by the laws of the state of his or her domicile and (2) that specifically refers to this power. The property subject to this power may be appointed outright or in trust. If a trust is created, the donee may designate any person or persons, otherwise qualified to act, as trustee, and the trust property shall be transferred to the designated trustee, regardless of the place of his or her domicile. Subject to the limitations contained in this instrument, the donee may confer further powers of appointment. The donee may disclaim, limit, or release this power in whole or in part by written instrument delivered to the trustee.**

No attempted exercise of this power shall be void if it can be construed or reformed to be limited as follows: If the donee attempts through the exercise of the power to create a trust that would continue for a period beyond 21 years after the death of the last survivor of the settlor's descendants and their spouses who were living when this trust was created, that trust shall terminate on the 21st anniversary of the last survivor's death and the entire principal of the trust shall be distributed to the person or persons then entitled to receive the income of that trust.

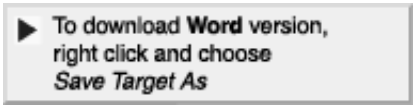
Comment: This form includes a clause to avoid the unintended violation of the rule against perpetuities. See Prob C §§21200-21225. In addressing the exercise of a power, however, the drafter should not rely on that clause but be careful to avoid violating the rule because it is not certain whether the provision would be effective in states without legislation similar to Prob C §21205.

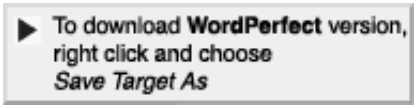
Note that if a special power is created, the permissible appointees should be carefully defined. See §10.134 for a definition of "issue" and "children." If the appointees constitute a class, the power should state whether gifts may be made to less than the entire class to avoid the common-law rule of some jurisdictions requiring each member of the class to receive part of the appointed property. See 1A Nossaman & Wyatt, Trust Administration and Taxation §36.18 (rev 2d ed 1966) (regarding exclusive and nonexclusive powers). But see Prob C §652 (allowing some members of class to be entirely excluded).

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/§20.64 b. Form: Choice of Law Governing Exercise of Power of Appointment

§20.64 b. Form: Choice of Law Governing Exercise of Power of Appointment





***Governing Law*. Questions regarding interpretation, scope, and validity of the exercise of this power shall be determined under the law of the state of _ _[*specify state*]_ _ as long as any question regarding the validity of the exercise of this power for real property shall be governed by the law of the state of its situs.**

Comment: See discussion in §20.62.

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§20.65 3. Application to Hypothetical Case

A power of appointment should not be drafted, exercised, or released without a careful review of the laws of all states having contact with the trust and the law of the situs of any real property subject to the power. In the hypothetical Jones case described in §20.6, the laws of New York, California, Oklahoma, and New Jersey (the donees' domicile) should be reviewed before drafting the power to ensure that the power can be exercised or released as provided by the trust. These laws should also be reviewed before any donee exercises or releases the power to ensure that the exercise or release is valid. The obvious complexity of such a task only emphasizes the wisdom of attempting to reduce problems by concentrating all the trust elements in one state.

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G. Charitable Trusts

§20.66 1. Nature of Problems

The creation of a multistate charitable trust raises several questions, discussed in §§20.67-20.70:

- Is the charitable purpose valid under the law of the state that governs the validity of the trust?
- Does the trust qualify for a tax exemption in the state that has the power to tax the trust?
- If the trust is revocable, does it violate any mortmain statutes of the settlors' domicile or of the state that governs the validity of the trust?
- Does the trust violate the rule against perpetuities of the state that governs the validity of the trust?
- Does the trust violate a spouse's marital rights?
- Is the trust subject to supervision by a state official?

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§20.67 a. Effect of State Law

The law of the state that governs the validity of the trust and of the state that has the power to tax the trust should be reviewed to ensure that the trust purposes are considered to be charitable and that a tax exemption under state law is available. For example, trusts for certain community projects may be considered as valid charitable purposes in some states but not in other states. See 1 Nossaman & Wyatt, Trust Administration and Taxation §§3.02-3.03 (rev 2d ed 1966) (reviewing cases describing valid charitable purposes). See also 1 Nossaman & Wyatt, Trust Admin and Tax §3.18 (reviewing conflicts cases dealing with multijurisdictional charitable dispositions). Some tax exemption statutes do not apply to charities situated in a foreign state unless the foreign state has a reciprocal exemption statute. The parties should review the Internal Revenue Code to ascertain whether and to what extent a federal tax exemption is available. See chap 17.

Although the settlors' domicile or the state that governs the validity of the trust may impose limitations on the amount of a testamentary bequest to charity, these limitations generally do not apply to living charitable gifts (*Rutherford v Ott* (1918) 37 CA 47, 51, 173 P 490; *Drew v Richards* (Ohio App 1960) 177 NE2d 631, 633; *Estate of Erney* (1953) 85 Pa D & C 349) even if the motive in creating the trust was to avoid the impact of such a statute (*Will of Frank* (App Div 1976) 383 NYS2d 777, 780). Accordingly, in most jurisdictions the mortmain statutes can apparently be avoided by the establishment of a living trust. See 1 Nossaman & Wyatt, Trust Admin and Tax §3.11[2]. However, because the California and New York mortmain statutes restricting charitable gifts have been repealed, the use of a living trust by a California resident to make charitable gifts is unnecessary.

In a state that still has mortmain laws, a settlor may create a living trust in a nondomiciliary state to avoid domiciliary statutes, reserving a testamentary power of appointment exercisable in favor of charities. See *In re Pratt's Trust* (App Div 1958) 172 NYS2d 965, aff'd (1960) 203 NYS2d 906, 168 NE2d 709 (Florida resident's testamentary exercise of reserved power of appointment in favor of charities under New York living trust held to be valid under New York law, which governed validity of exercise of power, although invalid under Florida's mortmain laws).

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§20.68 b. Rule Against Perpetuities

When the trust is to continue for an indefinite period of time, the rule against perpetuities in the state that governs the validity of the trust should be reviewed. The statutes of some states seem to exempt gifts to charities from operation of the rule. See, *e.g.,* Prob C §21225(e) (expressly exempting charitable gifts). For discussion of the perpetuities problem, see 1 Nossaman & Wyatt, Trust Administration and Taxation §3.10 (rev 2d ed 1966).

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§20.69 c. Marital Rights

A spouse's marital rights should be considered when establishing a living charitable trust. In some cases, a spouse's rights may be defeated by creating a trust in a jurisdiction that does not recognize a surviving spouse's right to take assets of a living trust. In other cases, the spouse's rights may be enlarged under the law governing the trust. For discussion of this problem, see §§20.50, 20.56-20.57, 20.59.

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§20.70 d. Administrative Problems

Administrative problems must also be considered with respect to a charitable trust. In some states, including California, special statutes relate to the supervision and enforcement of charitable trusts by the state attorney general or another state official. See Govt C §§12580-12599.5. These supervisory statutes generally require submission of trust documents and periodic reports and accountings. Although these requirements are absent from the California statute, the laws of some states permit the court to prohibit, limit, or authorize accumulations by charitable trusts. See, *e.g.*, NY Est Powers & Tr L §8-1.1(e). If the settlors wish to avoid supervision of a charitable trust, the trust should be established and administered in a state without these statutes.

Even without a statute, the state's attorney general may seek supervisory duties under general law relating to the sovereign's duty to care for the objects of charity. See *Brown v Memorial Nat'l Home Found.* (1958) 162 CA2d 513, 329 P2d 118, superseded by statute on other grounds in *Patton v Sherwood* (2007) 152 CA4th 339, 347, 61 CR3d 289 (statutory provisions for inspection and supervision of charitable trust records by attorney general do not affect that official's common-law powers); see also 1 Nossaman & Wyatt, Trust Administration and Taxation §3.14[1] (rev 2d ed 1966).

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§20.71 2. Application to Hypothetical Case

In the hypothetical Jones case described in §20.6, because Mr. Jones may be a resident of either New York or California, the laws of both states must be reviewed to determine the validity, tax effects, and supervisory problems of the charitable trust for the New York hospital.

The gift to the hospital, a nonprofit hospital for the poor that charges no fees, is considered to be a charitable transfer under both California and New York law. See *Dingwell v Seymour* (1928) 91 CA 483, 267 P 327; *Estate of Cohen* (Sur Ct 1945) 58 NYS2d 924. Note, however, that some hospitals will not be considered charitable organizations exempt from tax. See *In re La Societe Francaise de Bienfaisance Mutuelle* (1946) 75 CA2d 770, 171 P2d 544 (gift to hospital primarily for benefit of members held not exempt from inheritance tax).

Because California imposes an estate tax equal to the credit allowed against the federal estate tax, Mr. Jones's estate will not be subject to any California estate tax based on the value of a charitable gift, provided it qualifies as a charitable gift for federal transfer tax purposes.

Mrs. Jones's marital rights under both California and New York law will not be affected by the trust, because she will be receiving her statutory share outright. The trust will not violate a rule against perpetuities or mortmain statutes; the mortmain statutes of California and New York have both been repealed.

The primary problem for the Jones charitable trust is the supervisory statute of New York as the place of administration. If Mr. Jones wishes to avoid the New York statute and supervision over the trust, he should consider providing for the transfer of the charitable gift to a trust in another state (not California) without supervisory legislation.

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§20.72 IV. TAXATION OF MULTISTATE TRUSTS

A multistate trust presents death, gift, income, and property tax problems. The following discussion focuses on one of the most significant problems: double taxation. For further discussion of this subject, see Schmoker, *Minimizing State Death Taxes; Domicile; Tax Situs of Various Assets*, NYU 41st Inst Fed Tax, vol 2, chap 45 (1983); Gutierrez, *Oops! The State Income Taxation of Multi-Jurisdictional Trusts*, 25 U Miami Inst Est Plan, chap 12 (1991).

Tax planning opportunities are presented by use of a multistate trust because of the differing tax laws of each state. For example, Nevada has no death tax whatsoever, but all other states have some form of death tax, including the vestigial pick-up estate tax remaining in California. See Estate Planning for Special Assets, chap 5 (Cal CEB 2004). Florida constitutionally prohibits a personal income tax (see Fla Const art VII, §5), and California has a personal income tax with indexed rates that vary according to level of income and taxpayer.

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§20.73 A. State Death Taxes

The United States Supreme Court has, in a series of decisions in the first half of this century, outlined the constitutional limitations on the imposition of state death taxes. The guiding principle is that a state may not impose a death tax on property that is not subject to that state's jurisdiction. To do so is an unconstitutional taking of property without due process of law prohibited by the Fourteenth Amendment to the United States Constitution. See *Frick v Pennsylvania* (1925) 268 US 473, 69 L Ed 1058, 45 S Ct 603.

The state may, however, assess its death tax on every property interest under its jurisdiction. See 3 Nossaman & Wyatt, Trust Administration and Taxation §50.02[1]-[2] (rev 2d ed 1966). In applying this guiding principle, the courts have treated real property and tangible personal property differently from intangible personal property.

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§20.74 1. Real Property and Tangible Personal Property

Real property and tangible personal property generally can be taxed at death *only* by the state where the property is located. See, *e.g., Treichler v Wisconsin* (1949) 338 US 251, 94 L Ed 37, 70 S Ct 1 (real and tangible personal property owned by Wisconsin decedent, but located in Illinois and Florida, not subject to Wisconsin inheritance tax); *Frick v Pennsylvania* (1925) 268 US 473, 69 L Ed 1058, 45 S Ct 603 (tangible personal property of Pennsylvania decedent with situs in New York and in Massachusetts not subject to Pennsylvania estate tax).

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§20.75 2. Intangible Personal Property

Intangible personal property may be taxed at death by several states. See, *e.g., Graves v Elliott* (1939) 307 US 383, 83 L Ed 1356, 59 S Ct 913 (Colorado trustee and Colorado trust situs for bonds benefiting New York domiciliary subject to death taxes in both Colorado and New York); *Curry v McCanless* (1939) 307 US 357, 83 L Ed 1339, 59 S Ct 900 (Alabama trustee and Alabama trust situs for stocks and bonds benefiting Tennessee domiciliary subject to state death taxes in both Tennessee and Alabama). See also *Estate of Lincoln v Briggs* (Iowa 1972) 199 NW2d 337 (Iowa decedent's land-sale contract interest in Illinois real property held to be intangible personal property subject to Iowa inheritance tax; right of Illinois to tax same property interest specifically noted as not material to the court's ruling); *Estate of Plasterer* (Wash 1956) 301 P2d 539 (same result).

On examination of the cases in which multiple taxation of intangible personal property was allowed by the court in a trust situation, it appears that certain types of contact by a trust with a state reflect sufficient exercise by the state of its jurisdiction of the trust property to allow the state to impose a death tax. In order of priority, these types of contact are:

- The domicile of the decedent;
- The domicile of the trustee;
- The place in which the trust assets are kept; and
- The place where the business of the trust is carried on.

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§20.76 3. Exemption and Arbitration Statutes

Multiple death taxation problems have been reduced in some situations by statutes providing for exemption from death taxes of intangibles belonging to nonresidents. Almost all states have these statutes. The language of the applicable statutes should be carefully reviewed, however, because exemptions granted by one state may differ from those granted by another state. In some states, the exemption applies only if there is a reciprocal exemption for residents of the state where the intangible personal property is located.

The exemption statutes for intangible personal property owned by nonresidents have not solved two significant double taxation problems involving intangible personal property:

- Conflict-of-laws problems relating to the characterization of property; and
- Conflict-of-laws problems when two states claim the decedent as a domiciliary.

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§20.77 a. Characterization of Property

When the domicile of a decedent characterizes a property interest as intangible, and the situs state of the property characterizes it as tangible or real property, both states can then assess a death tax on the property interest. For example, a partnership interest, land subject to a contract for sale, and the interest of a beneficiary in a trust holding real property can be subject to such conflicting characterizations. See *Blodgett v Silberman* (1928) 277 US 1, 72 L Ed 749, 48 S Ct 410 (partnership interest was tangible personal property for New York death tax purposes, but intangible personal property for Connecticut death tax purposes); *Department of Revenue v Gruenwald* (Or App 1970) 467 P2d 660 (Oregon decedent's interest in trust property in Arizona held to be real property under Arizona law and personal property under Oregon law).

California considers secured and unsecured notes, bonds, partnership interests, and interests in Illinois land trusts to be intangible personal property. See 18 Cal Code Regs §13303.3. See also *Estate of Tutules* (1962) 204 CA2d 481, 22 CR 427 (beneficial interest in Illinois land trust held by California resident subject to California inheritance tax).

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§20.78 b. Multiple Domiciles

In addition to problems regarding the characterization of property, the exemption statutes have also failed to solve the problem of double taxation in cases when more than one state has claimed to be the domicile of the decedent. In those situations, each state claims to be the domicile of the decedent and seeks to tax all the decedent's intangible property, wherever situated.

Although an individual can theoretically have only one domicile at a time, this is not necessarily true when determining domicile for death tax purposes. See *Texas v Florida* (1939) 306 US 398, 83 L Ed 817, 59 S Ct 563 (four states claimed to be domicile of decedent).

The imposition of death taxes by more than one state, when each state has made its own judicial finding that the decedent was a domiciliary, has been held to be constitutional. See *Worcester County Trust Co. v Riley* (1937) 302 US 292, 82 L Ed 268, 58 S Ct 185. See also *California v Texas* (1982) 457 US 164, 72 L Ed 2d 755, 102 S Ct 2335 (reaffirming *Worcester* while simultaneously granting California leave to file federal interpleader action because of conflict between California and Texas in each claiming Howard Hughes was its domiciliary for inheritance tax purposes).

Thus, in multistate trust situations when a settlor has maintained contacts in several states, more than one state may claim to be his or her place of domicile and may attempt to impose death taxes on trusts of intangibles created by the settlor. To obviate double taxation because of domicile, some states have statutes authorizing (1) compromise of claims for death taxes when domicile is at issue or (2) the arbitration of domiciliary disputes. These statutes are generally permissive, however, and may not lead to equitable results. In addition, they may be inapplicable unless each of the states involved has a similar statute.

The determination of an individual's domicile is primarily a question of fact, *i.e.,* determining whether a factual basis exists for demonstrating the requisite intent and residence requirements that establish domicile. To facilitate such determinations, most tax authorities have developed questionnaires or affidavits that elicit detailed information about a broad range of possible contacts between a decedent and the state involved. These questionnaires generally focus on:

- Places and dates of actual residence;
- Time spent within the state;
- The ownership or leasing of a home or other real property or apartment within the state;
- The location of sources of income, including trusts;
- The location and nature of financial, business, and credit relationships;
- Memberships in religious and social organizations within the state;
- Voting history; and
- The existence of recitals of domicile consistent with the alleged domicile.

On the basis of the information obtained from these questionnaires, the taxing authority will usually make its determination about domicile. For a review of the steps to be taken to clearly establish a single state as one's domicile, see Zabel, *Domicile, Wills and Tax Problems of Migrating Clients Transplanted to Florida*, 10 U Miami Inst Est Plan ¶1402 (1976).

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§20.79 4. Computation of State Death Tax Credit or Deduction for Federal Estate Tax

The IRS has recognized the problem of double death taxation and has permitted the total amount of death taxes paid to two states that taxed the same property to be included in computing the state death tax credit allowable under former IRC §2011. See Rev Rul 70-272, 1970-1 Cum Bull 187 (relating to death taxes imposed by decedent's domicile and situs of corporate stock); Rev Rul 60-88, 1960-1 Cum Bull 365 (relating to death taxes imposed by two states claiming to be decedent's domicile). See §2.7. For decedents dying after 2004, similar principles should apply to the IRC §2058 deduction for state death taxes paid. However, under the "pick-up" estate tax, no state death taxes will be paid by California domiciliaries with respect to property situated in California. See §20.80.

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§20.80 5. Pick-Up Tax

California repealed its inheritance tax and gift tax laws, effective June 8, 1982, and replaced them with a "pick-up" estate tax (see Rev & T C §§13302-13304) intended to take maximum benefit of the credit allowed on the federal estate tax return for state death taxes paid. Under the terms of the initiative measure that enacted the repeal, no future estate or gift tax other than a pick-up tax may be imposed by California without approval of a majority of the electorate. Proposition 6, §5; Cal Const art II, §10(c).

When a trust is subject to multistate taxation, problems can arise with respect to payment of the pick-up tax. The state statutes vary with respect to apportionment of the former IRC §2011 state death tax credit amount, and in some cases, the levying of the pick-up tax by two or more states may result in a multistate trust paying a greater amount of pick-up tax than the total tax otherwise due. Under Rev & T C §13302, however, the California pick-up tax may not result in total (federal and California) tax liability in excess of the federal estate tax that would otherwise be due.

Moreover, under the marital deduction rules (see IRC §2056), many married persons, on the death of the first spouse, are likely to have no federal estate tax payable (either because of use of the unlimited marital deduction or by election for qualified terminable interest property status). In such a circumstance, no state death tax credit is applicable, and no pick-up tax is payable to the state. For decedents dying after 2004, repeal of the IRC §2011 state death credit will result in no pick-up tax payable in any event. See §2.84.

However, some states have an estate tax in the form of a pick-up tax with an exemption amount less than the IRC §2010(c) applicable exclusion amount, with the consequence that a state estate tax may apply to property situated in another state to the extent that the amount not eligible for the federal estate tax marital deduction exceeds the state estate tax exemption amount. One solution to this problem is to place additional assets in a trust (excess exemption QTIP trust) qualifying for the state estate tax marital deduction, but this may have the consequence of exposing those assets to federal estate tax in the estate of the surviving spouse. For decedents with property in New York, this may require making both a federal and state QTIP election for the additional assets and then seeking relief from the unnecessary federal election in the estate of the surviving spouse under Rev Proc 2001-38, 2001-1 Cum Bull 1335. For further discussion of this technique, see Graham, Gans & Blattmachr, *Quadpartite Will: Decoupling and the Next Generation of Instruments*, 32 Est Plan 3 (Apr. 2005); Graham, Gans & Blattmachr, *Quadpartite Will Redux: Coping With the Effects of Decoupling*, 32 Est Plan 15 (Oct. 2005). Another solution is to make an inter vivos gift of the assets if the other state has an estate tax but no gift tax. Often a better solution is to create an entity such as a limited partnership or limited liability company to hold the assets. Interests in the entity are intangible property and will be taxed in the state of decedent's domicile, not in the state where the assets owned by the entity are located. See Estate Planning for Special Assets, chap 5 (Cal CEB 2004).

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§20.81 6. Character of Decedent's Interest

In addition to the problems of multiple death taxation discussed in §20.80, there may be substantive law problems concerning taxation of the decedent's interest in the trust property if a trust situated in a common law state includes community property, or a trust situated in a community property state includes separate property.

Although in some states community or separate property will retain its original character for tax purposes (*People ex rel Dunbar v Bejarano* (Colo 1961) 358 P2d 866), in other states it may be treated differently (see *Estate of Kessler* (Ohio 1964) 203 NE2d 221; *Estate of Hunter* (Mont 1951) 236 P2d 94 (all community property taxed on husband's death)).

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B. Application to Hypothetical Case; Determining Settlors' Domicile

§20.82 1. Avoiding Multiple Domiciles

If state death taxes can be imposed by more than one state on the same items of property in a decedent's estate, and the total state inheritance tax exceeds the federal credit, the estate diminution from taxes may be substantially increased. It is a part of the job of estate planning to prevent, as much as feasible under the circumstances, the possibility of multiple state death taxation.

The hypothetical Jones trust described in §20.6 presents several state death tax problems. The question of Mr. Jones's domicile should be clearly resolved to prevent both New York and California from claiming him as a resident and subjecting his intangibles to double taxation, although with California's imposition of a "pick-up" tax (see §20.80), under the given facts any double taxation costs would be slight. California claims as estate tax only that share of the former IRC §2011 state death tax credit allocable to the share of the gross estate "having a situs in California." See Rev & T C §13304. Further, under current law, it is desirable to establish a California domicile if possible because the California estate tax is zero for all estates of decedents dying after December 31, 2004, whereas the New York estate tax continues to apply to estates in excess of $1 million. See §20.83.

The facts indicate that Mr. Jones might be considered a domiciliary of both New York and California. He has always voted and filed his tax returns in New York, but he has a California driver's license and California car registration. Although he owns his California home, he also owns the New York apartment building in which he stays when he is in New York. His personal property is situated in both New York and California. He has close family ties in New York and belongs to many organizations there, but he also has California relatives and is active in California clubs and a California church.

When resolving the question of domicile, the parties should review the income and inheritance tax laws and the marital rights laws of both California and New York to determine whether it is most advantageous for Mr. Jones to be considered a resident of New York or California. Once the decision on domicile has been made, Mr. Jones should be advised to take all steps necessary to prevent any ambiguities about his domicile. He should do the following:

- Consistently use the selected domicile as his address on all documents;
- Vote, file his tax returns, and obtain a driver's license in the selected domicile;
- Concentrate his organization and church activities in that domicile; and
- Transfer to that domicile any bank accounts or other intangibles that he may acquire and that are not a part of the trust.

Mr. Jones should also limit the amount of time he spends in the nondomiciliary state.

NOTE: For state income tax purposes, Mr. Jones is presumed to be a resident of California if he spends more than nine months a year in California, and he is considered to be a resident of New York if he spends more than 183 days a year there. See Rev & T C §17016 (rebuttable presumption of residence); NY Tax L §605(b) (defining "resident" and "nonresident").

Although a compromise procedure or negotiation with the taxing authorities might be necessary to avoid double taxation of the intangibles in the Jones case, unless the settlor's domicile is clearly established, the trust real property will only be taxed by the situs state. The Oklahoma oil interests could present a problem, because they might be categorized by Oklahoma as real property and by the domiciliary state as personal property, resulting in double taxation of the interests. However, Oklahoma currently has a "pick-up" tax that results in zero tax for decedents dying after December 31, 2004.

Mr. Jones's domicile at the time of his death can also affect the California taxation of his California real property and his intangibles. If he dies a resident of New York, the California real property will be treated by California as his separate property and the intangibles will be taxed by New York as his separate property. If he dies a resident of California, however, this property is considered to be quasi-community property because it was acquired with his

earnings during marriage. His change of domicile should not affect taxation of the New York real property by New York because the property will be considered as Mr. Jones's separate property in any event. Federal estate taxes will not be affected by a change in domicile because quasi-community property is taxed as separate property of the owner for federal estate tax purposes. *Estate of Frank Sbicca* (1960) 35 TC 96, 105.

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§20.83 2. Planning to Minimize State Death Taxation

Trust real property is taxed by the situs state. The only way to avoid this taxation is by making a completed gift of the property before death, by forming an entity and transferring the property to the entity (with the consequence that the decedent's interest in the entity is intangible property taxed in the state of domicile), or by selling the property and reinvesting the proceeds in another state. Any tax advantages realized by a disposition of the property may, however, be offset by the income tax on the sale of appreciated property (unless there is a tax-free exchange under IRC §1031) or, on a gift, by the lack of a stepped-up basis for the property in the hands of the donee for income tax purposes (see §2.43) and by possible liability for gift taxes. The optimum tax consequences can only be compared by computing the various alternatives under assumed conditions (*e.g.,* amount of expected appreciation, present and future tax rates) and comparing the results.

Problems of double state death taxation of a trust of intangibles can generally be minimized if the trust situs is located in the settlor's domicile or else in a state that exempts from taxation intangibles of a nonresident settlor or has only a "pick-up" estate tax, such as California. The problem may still arise, however, if the domiciliary state computes its estate tax by calculating the total value of the decedent's estate and reduces the tax only to the extent the nondomiciliary state taxes the decedent's estate. Although such a tax arguably violates the constitutional principles enunciated in *Frick v Pennsylvania* (1925) 268 US 473, 69 L Ed 1058, 45 S Ct 603, and other cases discussed in §§20.73-20.74, at least one state (Virginia) has continued to apply such a tax. For further discussion, see Estate Planning for Special Assets, chap 5 (Cal CEB 2004). See also Boyle & Flowers, *Modern State Death Tax Problems: The Supreme Court Has Spoken Long Ago*, 17 Prob Prac Rep 1 (Mar. 2005).

In the hypothetical Jones case described in §20.6, the settlor might consider disposing of the oil interests or forming an entity to hold the interests because they may be taxed as personal property by his domicile and as real property by Oklahoma. He might also consider the tax effects of a gift of the trust real property to his children or to charity, or a sale or exchange of the property if he wishes to avoid taxation of the real property by the situs states. With respect to the apartment building, New York has an estate tax in the form of a "pick-up" tax that was once limited to the amount of tax eligible for the state death tax credit under former IRC §2011 but that now results in payment of additional tax. See NY Tax L §952(a).

If Mr. Jones becomes a resident of California, New York will exempt the intangibles from death taxation. See NY Tax L §960(a). If he becomes a resident of New York, the intangibles will be situated in his domicile and will be subject to tax by New York only. Compare NY Tax L §954(a) with Rev & T C §13304 (California "pick-up" estate tax based on property "having a situs in California"). The settlor may wish to create an entity to hold the apartment building, because the settlor's interest in the entity is an intangible. No tax will be owed to California in any event. However, estate tax may still be owed to New York on estates of domiciliaries in excess of $1 million. NY Tax L §951(a).

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C. Payment of State Death Taxes and Apportionment

§20.84 1. Nature of Problem

Under federal law, the decedent's probate estate bears the burden of all federal estate taxes attributable to taxable property (excluding life insurance, property subject to the decedent's power of appointment, and certain marital deduction property), absent a state tax apportionment statute or an express clause by the decedent on payment of taxes. IRC §§2205-2207B.

Many states, including California, have apportionment statutes that provide for allocation of federal and state death taxes among the persons receiving interests in the decedent's taxable estate, unless the decedent has directed otherwise. See Prob C §§20100-20225; *Hoover v Hartman* (1982) 136 CA3d 1019, 186 CR 669 (when there was integrated estate plan including both will and living trust executed together to accomplish same purpose, testator's direction in will on apportionment of taxes may control taxation of assets contained in living trust). However, it is almost never appropriate to use an apportionment clause that indiscriminately charges the probate estate or trust estate with all estate or inheritance taxes—including taxes imposed on property not passing under the will or trust. See, *e.g.*, *Lurie v Commissioner* (7th Cir 2005) 425 F3d 1021 (revocable trust apportionment clause wiped out the marital deduction by compelling the trust to pay the tax burden that resulted when trusts established by decedent's mother were included in decedent's estate). If the settlor wants the settlor's estate or revocable trust to pay the taxes attributable to a particular transfer of property not included in the estate or trust, the apportionment clause should be drafted in a manner that avoids the risk that the clause will unexpectedly apply to other property. If a trust has been established, these laws generally provide that tax payments attributable to the trust property must be charged to corpus rather than to income. See, *e.g.,* Prob C §20113.

A few states (*e.g.,* Alabama) specifically provide against apportionment, and some states have no statutory provisions. In those states, absent a direction by the decedent, all taxes are generally paid from the residuary estate.

Tax apportionment questions may arise when (a) the trust situs differs from the settlor's domicile and the apportionment law of the two states differ, (b) one state requires apportionment and the other does not, or (c) a decedent dies leaving a taxable probate estate in one jurisdiction and nonprobate taxable assets in trust elsewhere. Under each of these circumstances, a question arises about which state's apportionment law governs the apportionment of death taxes: the state of the decedent's domicile or that of the trust situs. Problems of apportionment may also arise when the place of the decedent's domicile (and therefore the applicable apportionment law) is in dispute.

It is not clear whether the law of the settlor's domicile or the trust situs governs payment of taxes. The courts have reached different results. See *Doetsch v Doetsch* (7th Cir 1963) 312 F2d 323, 328 (in determining apportionment of tax, law of Arizona, as settlor's domicile, applied, rather than law of Illinois, as trust situs); *Isaacson v Boston Safe Deposit & Trust Co.* (Mass 1950) 91 NE2d 334 (law of trust situs rather than law of settlor's domicile governed apportionment). *Isaacson* and its progeny make it clear that, by refusing to apply the law of the decedent's domicile, the state of the trust's situs may have the last word on which jurisdiction's law of apportionment applies and that, if it wants to, that state can succeed in applying its own law. See Leflar, *Conflict of Laws (American Survey)*, 31 NYU L Rev 41, 58 (1956).

In more recent cases, however, the courts have favored the law of the domicile. This trend comports with the modern interest-analysis approach, *i.e.*, choosing which law to apply in a multijurisdictional problem on the basis of weighing each state's interest in applying its own law. See *Mazza v Mazza* (DC Cir 1973) 475 F2d 385, 388 (analyzing superior interest of decedent's domiciliary jurisdiction in protecting principal beneficiaries of his bounty).

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2. Planning for Payment of Death Taxes

§20.85 a. Problems and Solutions

To avoid problems relating to payment and charging of taxes imposed against property of a multistate trust, the parties must ensure that the decedent's will and the trust instrument expressly state how these taxes are to be paid and charged. The trust instrument and the will should be coordinated and should specify whether taxes on the trust property must be paid by the executor of the settlor's estate or by the trustee. In the latter case, the trust instrument should state whether the taxes should be charged against income or remainder interests or collected directly from the trust beneficiaries and how any penalties or interest should be charged.

Charging of taxes against trust interests is particularly important if there are marital or charitable bequests, because charging taxes against these bequests may endanger the amount of the marital or charitable deduction and thereby increase the amount of death and estate taxes payable. See *Estate of Herbert R. Penney* (1972) 59 TC 102, rev'd (6th Cir 1974) 504 F2d 37 (Ohio law differently construed by Tax Court and United States Court of Appeals). See also 3 Nossaman & Wyatt, Trust Administration and Taxation §§49.05-49.06 (rev 2d ed 1966) (discussion of divergent law of various states).

If a settlor's will provides for payment of all estate and inheritance taxes by the executor, it should state whether or not there is a right of contribution against the trust; if there is, the trust should authorize the trustee to reimburse the executor for taxes paid by him or her on trust property. The trust may also include a clause directing the trustee to reimburse the settlor's executor for all taxes paid on the settlor's death, whether or not attributable to trust property. For an example of such clauses, see 3 Nossaman & Wyatt, Trust Admin and Tax §§8.1.1 (providing the suggested reimbursement), 8.1.2 (protecting exempt assets).

CAVEAT: A direction for reimbursement of all taxes by the trustee may have significant federal income and estate tax consequences because it may shift taxable income from the trust to the estate and may also cause trust assets otherwise exempt from estate taxation (*e.g.,* life insurance proceeds) to be subject to taxation on the ground that they were used for the benefit of the settlor's estate.

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§20.86 b. Application to Hypothetical Case

In the hypothetical Jones case described in §20.6, the trust should include a clause directing the trustee to pay all federal and state death taxes because substantially all the settlor's assets will be transferred to the trust during Mr. Jones's lifetime. Whether these taxes should be charged only against the nonmarital residuary trust for the children or against both the marital and nonmarital gifts depends on whether Mr. Jones intends to make the maximum gift to his children or to make greater use of the unlimited marital deduction. If Mr. Jones intends to make the former choice, the taxes should be charged against both shares; otherwise, they should be charged only against the nonmarital share going to the children. To avoid reducing the value of the charitable deduction, taxes should not be charged against the charitable gift.

CAVEAT: The effect of any apportionment or tax-pay direction should be calculated so that the settlor may see the effect of it on all his or her dispositive plans—whether, for example, favoring charity so disfavors individuals as to minimize the intended individual gift. Furthermore, these calculations should be tested from time to time as the shape and character of the settlor's family and fortune change.

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§20.87 D. State Death Taxation of Beneficiary's Interest

On a beneficiary's death, his or her domicile may be able to tax the beneficiary's interest in a trust of intangibles situated in another state if the interest is vested or if the beneficiary has a power of appointment over the trust property. See *Graves v Schmidlapp* (1942) 315 US 657, 86 L Ed 1097, 62 S Ct 870 (upholding validity of New York estate tax on New York decedent who exercised general power of appointment over intangibles in Massachusetts trust); *Estate of Johnson* (1965) 233 CA2d 785, 43 CR 913 (matter of Missouri law whether California beneficiary's remainder interest in Missouri trust was vested and, if vested, interest was subject to California inheritance tax).

When the power has not been exercised and assets pass under the default clause of the donor's trust, the non-California cases differ about whether the donee's domicile may tax intangibles in a trust situated in another state. In some cases, the donee's domicile has taxed such property, even though the power had been reduced from a general to a limited power. See *Estate of Mueller* (Wis 1970) 177 NW2d 60; *Colorado v Cooke* (Colo 1962) 370 P2d 896. In *Schneider v Laffoon* (Ohio 1965) 212 NE2d 801, 804, however, such property was not taxed by the donee's domicile. The court followed cases from Massachusetts (on which the Ohio statute had been based) and refused to follow *Colorado v Cooke, supra.*

In the hypothetical Jones case described in §20.6, the laws of New York, California, Oklahoma, and New Jersey must be reviewed to determine the tax effects of giving the settlor's children limited powers of appointment and the tax effects of the exercise or nonexercise of these powers.

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E. State Gift Taxation

§20.88 1. Taxation of Real Property and Tangibles

When a completed gift has been made, the transfer in trust of real property and tangible personal property permanently situated in another state is usually subject to gift taxation only by the situs state. The transfer in trust of tangible personal property temporarily located in another state is generally taxed only by the settlors' domicile.

The settlors' domicile has taxed the transfer of tangibles in a foreign state, which were purchased with intangibles as part of an overall plan to avoid gift taxation, on the ground that the transaction was essentially a transfer of intangibles. See *Van Dyke v Commissioner* (Wis 1940) 292 NW 313, aff'd (1940) 311 US 605, 85 L Ed 383, 61 S Ct 36 (Wisconsin taxed resident on "transfer" in trust of 7-1/2 tons of silver dollars purchased in Illinois even though trust agreement was executed in Illinois and trustee, a Wisconsin corporation, actually received trust corpus in Illinois).

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§20.89 2. Taxation of Intangibles

In general, only the settlors' domicile can impose a gift tax on a completed gift of intangibles situated in their domicile that are transferred to a trustee in another jurisdiction. In some cases, however, when the intangibles have acquired a situs in another state at the time of the transfer, or at the time of relinquishment by the settlors of retained trust rights that result in a completed gift, the transfer may also be subject to gift taxation by the situs state.

These general rules are subject to statutory variations. For example, some states exempt from gift tax a transfer by a resident of intangibles situated elsewhere; other states exempt transfer of intangibles by nonresidents; and some states exempt intangibles transferred by the residents of other states with reciprocal exemption statutes. See Bogert, The Law of Trusts and Trustees §300 (2d ed 1977).

With respect to the hypothetical Jones trust described in §20.6, because the settlor is establishing a revocable living trust for his benefit during his lifetime and is not making a completed gift, gift taxes will not be due on the transfer of either real or personal property to the trust.

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§20.90 3. Planning for Gift Taxes

Gift taxation by the situs state of a completed gift of real property in trust cannot be avoided. The settlors might, however, consider selling the real property and transferring the proceeds to a trust in another state, thereby eliminating a gift in the situs state. The disadvantages of this approach are that a capital gains tax on appreciated property would have to be paid and, if the sales proceeds are evidenced by a note secured by the real property, the situs state might consider the note to be real property.

If it is more advantageous to have movable personal property taxed by the situs state than by the settlors' domiciliary state, as many independent facts as possible should be marshaled to demonstrate that the situs is permanent. If it is more advantageous to have the property taxed by the settlors' domicile, facts indicating that the situs is only temporary should be gathered.

For example, in the hypothetical Jones case described in §20.6:

- Whichever situs is selected as permanent should be the place in which Mr. Jones is registered to vote and in which his club and church affiliations are denominated as permanent (as distinguished from visiting status in those at the "temporary" location); and
- His stays in the permanent residence should exceed the local limit for residence suggested by any local law rules of that jurisdiction, in contrast to his stays in the "temporary" abode, which should always stay below the level suggested by the law of that jurisdiction as indicating permanent residence.

It is usually difficult to avoid paying gift taxes to the settlors' domicile on a completed gift of intangibles, except when the domicile exempts from taxation the transfer of intangibles with a situs in another state. However, in cases in which both the settlors' domicile and the state in which the intangibles are located have exemption statutes, it may be possible to transfer assets completely free from gift taxation (*e.g.,* when the settlors' domicile exempts transfer of intangibles in another state, and when the situs state exempts the transfer of intangibles by nonresidents).

In the absence of exemption statutes, the parties may be able to avoid double payment of taxes to both the domiciliary state and the state in which the intangibles are located by ascertaining whether the intangibles have acquired a situs in the state of location, permitting it also to tax the transfer in trust. If the intangibles have acquired a situs in another state (*e.g.,* securities held in an agency account in a state that imposes a gift tax), the intangibles should be moved to the settlors' domicile before the transfer in trust is made.

Imposition of gift tax by the situs state may be difficult to prevent when the settlors relinquish rights in the trust after its establishment, resulting in a taxable gift at that time. Accordingly, relinquishment of all rights at the inception of the trust should be considered to avoid taxation by both the situs state and the domiciliary state at a later date. Settlors who have retained a power of revocation can, however, revoke the trust before relinquishing any rights that would result in a taxable gift. After revocation, the trust assets can be retransferred to the settlors' domicile, where an irrevocable transfer without the retention of rights can be made, effecting a completed dissociation from the former situs. The transfer will then be subject to taxation only by the settlors' domicile. See Land, Trusts in the Conflict of Laws 421 (1940).

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§20.91 4. Application to Hypothetical Case

California and New York gift taxes were repealed effective in 1982 and 2000, respectively, but assume for purposes of illustration that the taxes remain in effect. If, in the hypothetical Jones case described in §20.6, Mr. Jones were to release his power of revocation over the trust, gift taxes would be payable to each state, with respect to trust real property situated in that state, and possibly to Oklahoma if the oil interests are real property. Gift taxes would be payable to the domiciliary state on the completed gift of the securities.

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/ F. Income Taxes/§20.92 1. Taxation of Trusts and Beneficiaries

F. Income Taxes

§20.92 1. Taxation of Trusts and Beneficiaries

State taxation of trust income differs widely from state to state. Some states have no income tax laws, and the tax laws of the other states are far from uniform.

In general, most states with income tax laws, including California, tax all trust income derived from sources within the state regardless of whether the trustee, beneficiary, or settlor is a resident of the state. On federal and California taxation of trusts and beneficiaries, see chap 3.

What constitutes "income derived from sources within the state" is a complex question, and the law of each state must be reviewed to determine whether a particular item of income is derived from a source within the state. For example, the source of dividends on stock may be the situs of the corporate payor or the place of the owner's domicile. See *Miller v McColgan* (1941) 17 C2d 432, 438 110 P2d 419. Compare *Robinson v McColgan* (1941) 17 C2d 423, 424, 110 P2d 426 (situs of stock held in California revocable trust was in China, home of settlor-beneficiary, when sole duty of trustee was to collect and pay trust income to settlor), with *Henley v Franchise Tax Bd.* (1953) 122 CA2d 1, 4, 264 P2d 179 (dividends from Canadian corporation doing business only in Canada held not to be "sources within" California). With regard to the income of an S corporation, however, the source of the income (not the situs of the stock) determines whether a nonresident shareholder's pro rata share of the income is taxable by California. See *Valentino v Franchise Tax Bd.* (2001) 87 CA4th 1284, 105 CR2d 304.

In addition to taxing income derived from sources within the state, many states, including California, tax trust income derived from sources outside the state if the residence of the trustee, beneficiary, or settlor or the situs of the trust is within the state. Because a state may constitutionally tax trust income derived from sources within and outside the state, double taxation of trust income is not unusual and may be anticipated in a multistate trust as long as there is some contact with the trust. See Report of Committee on Taxation of Trust Income, *State Taxation of Trust Income*, 2 Real Prop, Prob & Tr J 141 (1967).

The method of levying a tax on trust income derived from sources outside the state varies among the states. For example, if the tax is based on the residence of a trustee within the state, the taxable income may:

- Be apportioned between resident and nonresident trustees;
- All be taxable within the state if a majority of the trustees are residents (*e.g.,* Mississippi); or
- Be taxable only if the settlor or a beneficiary also resides within the state (*e.g.,* Massachusetts).

If the tax is based on the residence of the beneficiary within the state, generally only income that is currently distributed or distributable to a resident beneficiary is taxed.

In California, all trust income, whether derived from sources within or outside the state, is taxable to the trust if either the trustee or a beneficiary, other than a contingent beneficiary, is a resident, subject to the apportionment rules described below. Rev & T C §17742(a). When the trustee and the beneficiary are nonresidents, only that income derived from sources within California is taxed to the trust. Rev & T C §17953. If the trust income is currently distributable (whether to a resident or a nonresident beneficiary), the trust is entitled to a deduction for amounts distributable—just as it is under federal law. Rev & T C §17731; IRC §651. Although a California beneficiary is taxed on all current distributions, a nonresident beneficiary is taxed by California only on income from sources within California. Rev & T C §17953.

When there are California and non-California trustees, accumulated income from sources outside California is taxable to the trust based on the proportionate number of California trustees. Rev & T C §17743. Similarly, when there are California and non-California beneficiaries, accumulated income from sources outside the state is taxable to the trust based on the proportionate number of California beneficiaries. Rev & T C §17744. Even if some of the trustees are nonresidents, that portion of the trust income otherwise exempt from taxation is subject to tax based on the proportion of resident beneficiaries to nonresident beneficiaries.

No general rules can be stated regarding taxation of accumulated income by other states because there are

considerable differences among the states. The trustee may be taxed on all accumulated income, on all accumulated income except that is held for a nonresident beneficiary with a vested interest, or only on accumulated income that is held for a resident beneficiary. The accumulated income may also be taxed to resident beneficiaries.

NOTE: This discussion relates to taxation of an irrevocable trust over which the settlors have retained no powers. If the settlors have retained the power to revoke the trust or other taxable powers, the trust income is generally taxed to them as under federal law. On grantor trusts, see §§3.22-3.44.

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§20.93 2. Tax Credit Statutes

Although most states have tax credit statutes allowing a resident a credit for income taxed by another state, many of these statutes were not designed specifically for trust problems and do not afford any relief for double taxation of trust income. These statutes generally apply to income taxed to the same person by two jurisdictions. In a multistate trust, however, trust income can be taxed to different persons by different states, *e.g.,* the trustee and the beneficiary may both be taxed on the same income by their respective domiciles. See Report of Committee on Taxation of Trust Income, *State Taxation of Trust Income*, 2 Real Prop, Prob & Tr J 141, 148 (1967) (suggesting possible *triple* tax: by "source" state, trustee's state, and beneficiary's state). In addition, some states (*e.g.,* Texas) that do not have income tax laws impose a property tax based on income produced by the trust. In such cases, tax credit statutes are ineffective in alleviating the burden of double taxation.

In California and a few other states having comprehensive statutes relating to taxation of trusts, there are express statutory provisions allowing tax credits to prevent double taxation of trust income. Subject to certain qualifications, California residents and trusts are permitted a credit for taxes paid to another state on trust income from sources within that state. Rev & T C §§18001-18005. Nonresident individuals and trusts are permitted a credit against California income taxes for income taxes paid to their state of residence if that state has a reciprocal statute for California residents. Rev & T C §18002. When a trust is considered to be a resident of both California and another state, it is entitled to a credit for taxes paid to the other state even without a reciprocity statute. Rev & T C §18004.

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§20.94 3. Application to Hypothetical Case

If, in the hypothetical Jones case described in §20.6, Mr. Jones is considered to be a resident of New York, all income of the trust will be taxed to him during his lifetime by New York, as it is for federal tax purposes, because he has retained the right to income and the right to revoke the trust. See NY Tax L §§601, 611-616. Oklahoma and California will impose a tax on Mr. Jones on the trust income from real or personal property situated within the state because Mr. Jones is technically the owner of this property for tax purposes. See Rev & T C §17734. Because New York grants a resident individual or trust a credit against New York taxes for taxes imposed by another state subject to certain limitations, double taxation of trust income is minimized.

Assuming that Mr. Jones has not changed his New York residence and that a resident of New York will act as trustee of real property outside New York (see §§20.43-20.44), the trust will be taxed on his death as follows: New York will tax all income from all sources as fully as it is taxed for federal income tax purposes. Oklahoma and California will continue to impose a tax on trust income derived from sources within the state, but double taxation by New York will be alleviated by the New York tax credit statute. NY Tax L §620.

Mr. Jones's children, residents of New Jersey and the beneficiaries of a portion of the trust on Mr. Jones's death, will be taxed by New York only on income distributions to them from sources within New York, to the same extent as they are subject to federal taxes, subject to some modification. See generally NY Tax L §§631-639. Had the children been residents of New York, they would have been subject to taxation by New York on all trust distributions to the same extent as under federal law, subject to certain modifications. See generally NY Tax L §§601, 611-616. Because New Jersey has no general income tax, trust distributions to the children will not be subject to income tax by New Jersey (as long as its law does not change). Income distributed to or accumulated for the benefit of the New York hospital will be exempt from taxation.

If Mr. Jones is considered to be a resident of California, the income tax aspects of the trust will be significantly changed during his lifetime. California will tax all the trust income to him as the owner of the trust property, subject to a credit for income taxes paid to another state. New York will tax only income to him from sources within the state. Although New York and Oklahoma will tax income from sources within the state, the California tax credit statute substantially eliminates double taxation. The California credit cannot exceed that proportion of the California tax attributable to income taxed by other states even though the total taxes paid may be greater. Rev & T C §18001.

Assuming that Mr. Jones was a California resident at the time the trust was established and that a New York individual cotrustee will act with respect to the California real property, on his death the trust will not be considered to be either a California or a New York resident trust. When neither the trustee nor the beneficiaries are residents, California will tax only income from sources within the state. See Rev & T C §§17734, 17742-17744, 17953. The trust will not be a New York resident because New York determines the residence of a trust by the domicile of the settlor at the time of his or her death if the trust was created at the time of his or her death, or at the time of creation of the trust if the trustor was then domiciled in New York, regardless of the residence of the trustee and place of administration. NY Tax L §605(b). Therefore, it appears that New York, California, and Oklahoma will tax only trust income derived from sources within the state and that income and capital gains of the intangibles will not be taxed by any state. Nontaxation of income and capital gain of the intangibles may be an important planning consideration in establishing Mr. Jones's residence in California.

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§20.95 4. Planning for Income Taxes

Before establishing a multistate trust, the parties should examine the income tax laws of the domiciles of the settlors, beneficiaries, and proposed trustee and of the trust situs to ascertain how the trust income will be taxed. When a state has no income tax laws, the property tax laws should be reviewed because in some states property taxes may be based on trust income. See §§20.92-20.94.

If convenient, the trust situs and trustee's domicile should be in a state that does not levy an income tax or a property tax based on income. If this cannot be accomplished, as a general rule most of the elements of the trust should be concentrated in one state to avoid multiple taxation by several states. For example, in the hypothetical Jones case described in §20.6, it would be better to have a resident of New York (rather than California) act as cotrustee with the New York corporate trustee to avoid having half the trust income taxed by California. If, however, the trust is situated in a state with a high rate of income tax and the tax is based on the residence of the trustee (*e.g.,* California), it may be advantageous to appoint additional trustees in other states that have no income tax laws or that have lower income tax rates, thus reducing the total taxes paid by the trust. In this connection, it is appropriate to include in the trust a specific clause authorizing the trustees (or a court with jurisdiction) to appoint additional trustees, because it is unclear whether trustees can be added, absent such a clause. See 1A Nossaman & Wyatt, Trust Administration and Taxation §26.09 (rev 2d ed 1966).

As noted in §20.94 with respect to the Jones trust, in some situations taxation of trust income after the settlors' deaths can be minimized by establishing a trust outside the settlors' domicile. Taxation of income of intangibles might be avoided if the trust situs bases residence on the settlors' domicile (*e.g.,* New York) and the settlors' domicile bases residence on the trustees and beneficiaries situated within the state (*e.g.,* California).

After the trust has been established, the trustee should be certain that all taxes on trust income owed to his or her domicile have been paid before making any distributions of trust income or principal. Otherwise, the trustee may be held personally liable for such taxes in certain instances. See Rev & T C §19516.

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G. Property Taxes

§20.96 1. Basic Principles

Real property and personal property with a permanent situs are subject to property taxation only by the situs states. See *Union Refrigerator Transit Co. v Kentucky* (1905) 199 US 194, 50 L Ed 150, 26 S Ct 36. Intangibles, however, may be taxed by more than one state. See *Curry v McCanless* (1939) 307 US 357, 83 L Ed 1339, 59 S Ct 900. Accordingly, a trust of intangibles may be subject to property taxation by the domiciles of the trustees as well as by the domiciles of the settlors and beneficiaries if they have certain rights of ownership. See *Greenough v Tax Assessors* (1947) 331 US 486, 91 L Ed 1621, 67 S Ct 1400 (upholding Rhode Island property tax on Rhode Island cotrustee based on his proportionate share of trust corpus, even though other cotrustee was New York resident and entire trust corpus, consisting of stock certificates, was situated in New York).

Several states, including California and New York, do not impose a property tax on intangibles. The problems of multiple taxation of trust intangibles are minimal for a trust having contacts only with such states.

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§20.97 2. Taxation of Intangibles by Settlors' Domicile

If the settlors retain no rights with respect to the trust, their domicile cannot tax trust intangibles unless other factors on which taxation can be based are present, *e.g.,* if the trust situs or the domicile of the trustee is within the state. See *Safe Deposit & Trust Co. v Virginia* (1929) 280 US 83, 74 L Ed 180, 50 S Ct 59; see also 3 Nossaman & Wyatt, Trust Administration and Taxation §50.24[2] (rev 2d ed 1966). If the settlors retain a power of revocation, however, the property may be considered to be owned by the settlors for property tax purposes and may be taxable by their domicile. In this event, if the trust situs and settlors' domicile differ, the trust property may be subject to property taxation by both states.

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§20.98 3. Taxation of Intangibles by Beneficiary's Domicile

The domicile of the beneficiary cannot tax trust intangibles unless certain elements of the trust are situated within the beneficiary's domicile or he or she has the right to possession or control of the trust assets. See *Brooke v Norfolk* (1928) 277 US 27, 72 L Ed 767, 48 S Ct 422. In the latter event, the beneficiary may be considered to be the owner of the property, and his or her domicile as well as the situs state may tax the trust property.

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§20.99 4. Application to Hypothetical Case

Real property in the hypothetical Jones case described in §20.6 will be taxed by the situs states. Accordingly, the New York apartment building will be taxed by New York, and the California real property will be taxed by California. The oil interests may be taxed by Oklahoma if they are considered to be real property by Oklahoma.

Intangibles of the trust will not be taxed regardless of Mr. Jones's residence because neither New York nor California imposes a property tax on intangibles.

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§20.100 5. Planning for Property Taxes

Multiple taxation of trusts of intangibles can be prevented by establishing the trust in a state that does not tax intangibles. If, however, the trust will be established in a state that taxes intangibles, multiple taxation can be eliminated if neither the settlors nor the beneficiaries have any rights with respect to the trust, which are considered to be equivalent to present ownership of the trust property. If the elimination of these rights is not feasible, it is advantageous to have all the trustees or a majority of the trustees reside in the domicile of the settlors or the beneficiaries to reduce the number of states that may impose a tax.

If the trust income is large, the trust property should not be situated in a state that levies a property tax based on income. In this event, despite the fact that the property tax is in effect an income tax, the income tax credit statutes (see §20.93) would not apply and would not alleviate the problems of double taxation.

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Source: Estate Planning/Drafting California Irrevocable Trusts/20 Multistate Trusts/§20.101 V. CHECKLIST: MULTISTATE TRUSTS

§20.101 V. CHECKLIST: MULTISTATE TRUSTS

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The following is a checklist of items that should be considered by an attorney in the initial planning, drafting, and implementing of a multistate trust. The checklist is designed to guide an attorney faced with (a) the problem of planning and drafting a trust with multistate contracts or (b) a problem after the trust has been created. This checklist is only a starting place, however; careful practitioners will devise their own checklist for specific problems.

The checklist need be no different from those commonly used by drafters, but it should deal with *every* state involved. The best way to tailor a checklist to individual needs is to test the trust against what may happen in the future.

A. Planning the Trust

- (1) Which state would be most favorable as the trust situs from the standpoint of its validity, construction, administration, and taxation?
- (2) Which state will be selected for concentration of the trust elements?
- (3) Review the laws of each state having contact with the trust for the matters set out below.

B. Validity of Trust

- (1) Does the trust violate rules against perpetuities, accumulations, testamentary dispositions, and charitable gifts?
- (2) Are the trust purposes valid?
- (3) Is the trust adequately funded?
- (4) Will a pourover from the settlors' wills be permitted under the laws of the settlors' domicile and the trust situs?
- (5) Who can act as trustee?
- (6) What are the results of total or partial invalidity of the trust?

C. Execution of Trust and Amendment to Trust

- (1) What are the formalities of execution?
- Is notarization or recordation necessary?
- Is execution with testamentary formalities necessary?
- Is acceptance by the trustee necessary?
- Is notification of the beneficiaries necessary?
- For a trust of community property, are the signatures of both spouses necessary?
- (2) What documents are necessary to transfer title to trust assets to the trustee?
- (3) Are there any particular requirements regarding the form of title to trust assets?
- (4) Must the trustee be identified as a trustee?
- (5) Can the trustee take title in the name of a nominee?
- (6) What procedures must be followed to amend the trust?
- (7) If the settlors' will provides for a pourover to the trust, does an amendment to the trust require codicils to the wills thereafter?

D. Rights of Settlor, Beneficiaries, and Their Creditors

- (1) Is a declaration regarding revocability or irrevocability necessary?
- (2) Does the settlor have the right to amend the trust?
- (3) Is a spendthrift clause valid?
- What are the rights of the creditors of the settlors?
- What are the rights of the creditors of the beneficiaries?
- (4) When do income payments begin?
- (5) What are the respective rights of life and remainder beneficiaries?

E. Trustee's Problems

- (1) What is the procedure for resignation and removal of the trustee and appointment of a successor or successor trustees?
- (2) Can trust assets be transferred to a new place of administration with a change of trustee?
- (3) What law governs administration and construction of the trust with a change of trustee?
- (4) How does the trustee account?
- Who has the right to demand an accounting?
- How conclusive is such an accounting?
- (5) Is joint action necessary (or only majority action) by multiple trustees?
- (6) What investments can be made by the trustee?
- (7) What are the requirements regarding bonding of the trustee?
- (8) How is the trustee's compensation determined?
- (9) How are trust assets distributable, *e.g.,* in cash, in kind, or on a nonprorata basis?
- (10) What are the trustee's liabilities?
- What are the effects of an unauthorized act?
- What is the effect of an exculpation clause?
- Are there any prohibitions against authorizing self-dealing?
- Are there particular rules of trustee liability?
- (11) What court has jurisdiction over the trustee in the event of a breach of trust?
- (12) Will the jurisdiction permit alternative forms of dispute resolution?
- (13) May the duties of the trustee be divided among different persons or entities?

F. Powers of Appointment

- (1) Is the power valid under the law governing the trust?
- (2) Can the power be exercised by a further appointment in trust?
- (3) Can appointed property be transferred to another jurisdiction?
- (4) Can the power be released and, if so, what procedure must be followed?

G. Marital Rights

- (1) What are the surviving spouse's dower, statutory share, quasi-community property, or community property rights to trust property?
- (2) What are the tax and substantive effects of a transfer of community property to a separate property jurisdiction or a transfer of separate property to a community property jurisdiction?
- (3) What are the consequences if the settlors subsequently become residents of the trust situs?

H. Charitable Trusts

- (1) Are the purposes valid?
- (2) Are any mortmain statutes or perpetuity statutes violated?
- (3) Are a spouse's rights violated?
- (4) Will the trust be exempt from income and death taxation?
- (5) To what extent will the trust be subject to state supervision?

I. Tax Problems

- (1) Is the settlors' domicile or residence clearly established under the tax laws?
- (2) What are the inheritance, gift, income, and property tax consequences of creating the trust—to the settlors as well as the beneficiaries?
- (3) Will exemption statutes avoid double taxation?
- (4) Can any trust property be categorized as both real or personal property? If so, should it be converted into other forms?
- (5) For death tax purposes, will the marital deduction be allowed, and will separate and community property be treated as such by the taxing state?
- (6) How will death taxes on trust property be paid?
- (7) Are there adequate provisions for payment in the settlors' wills and the trust?

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Source: Estate Planning/Drafting California Irrevocable Trusts/Appendix A Long-Term Family Pot Trust; Independent Trustee

Appendix A

Long-Term Family Pot Trust; Independent Trustee

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Description

The following form is appropriate for a trust that will be made exempt from the generation-skipping transfer (GST) tax as a result of allocation of the settlors' GST exemption. Because the gift tax annual exclusion does not apply for GST tax purposes if a trust has more than one beneficiary, the GST exemption must be allocated on timely filed gift tax returns each year there is a transfer to the trust. The trust must have an independent trustee during the lifetime of the settlors; otherwise, trust income will be taxed to the grantors under IRC §674. Family members can serve as trustees after the settlors are deceased, if the trust contains the form 10.26-1 prohibition included in Article Three. Annual withdrawal powers must be limited to $5000 per beneficiary unless other provisions address the possibility that a lapse of a larger power will result in a gift.

CAVEAT: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix.

The John and Mary Doe Irrevocable Family Trust No. 1

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUST

- **A. Transfer to Trust**
- **B. Name of Trust**
- **C. Additions to Trust**
- **D. Irrevocability of Trust**

ARTICLE TWO: WITHDRAWAL RIGHTS

- **A. Withdrawal Right Limited to $5000 or 5 Percent**
- **B. Notice of Withdrawal Rights**
- **C. Withdrawal Rights Cumulative**
- **D. Exercise of Withdrawal Rights**

ARTICLE THREE: DISTRIBUTIONS

- **A. Discretionary Distributions**
- **B. Termination of Trust**

C. Distribution to Charity if No Issue

D. Distributions to Minors or Disabled Persons

E. Special Trustee for Distributions to Trustee

ARTICLE FOUR: OFFICE OF TRUSTEE

A. Nomination of Successor Trustees

B. Trustee's Power to Designate Successor Trustee

C. Removal of Trustee

D. Compensation of Trustee

E. Accounting by Trustee

F. Trustee Powers

ARTICLE FIVE: MISCELLANEOUS

A. Perpetuities Savings Clause

B. Spendthrift Clause

C. Governing Law

D. Definition of "Spouse"

E. Definition of "Children" and "Issue"

F. No-Contest Clause

The John and Mary Doe Irrevocable Family Trust No. 1

8.2-1 Trust agreement

This agreement is made between _ _[*name(s) of settlor(s)*]_ _ (called the "settlors") and _ _[*name of trustee*]_ _, as trustee.

ARTICLE ONE
Creation of Trust

A. *Transfer to Trust*. The settlors hereby transfer and deliver to the trustee, without consideration, _ _[*ten dollars ($10) or more/the property described in Schedule A, attached to this trust*]_ _. This property, together with any other property subsequently becoming part of the trust, constitutes the trust estate and will be held, administered, and distributed by the trustee as provided in this agreement.

8.5-1 Name of trust

B. *Name of Trust*. This trust may be referred to as _ _[*e.g., The John and Mary Doe Irrevocable Family Trust No. 1*]_ _.

10.122-1 Authorization of additions to trust

C. *Additions to Trust*. Other property acceptable to the trustee may be added to this trust by any person, by the will or codicil of either settlor, by the proceeds of any life insurance, or otherwise.

8.7-1 Irrevocability of trust

D. *Irrevocability of Trust*. This trust is irrevocable, and the settlors have no powers of amendment.

ARTICLE TWO
Withdrawal Rights

12.97-1 *Crummey* clause with "5 or 5" limitations

A. *Withdrawal Right Limited to $5000 or 5 Percent*. At any time a gift is made by any donor to this trust, _ _[*specify beneficiaries or class of beneficiaries*]_ _ shall each have the immediate right to demand and receive immediate distribution of an amount equal to the amount specified in a writing signed by the donor and delivered to the trustee no later than the time of the gift. If no such amount is specified, the amount that may be withdrawn shall be the lesser of:

(1) The amount of the gift divided by the number of persons having a right to demand a distribution with respect to the gift; or

(2) The amount of the Internal Revenue Code §2503(b) annual gift tax exclusion remaining available to the donor at the time of the gift for gifts to the distribution right holder in the calendar year. For purposes of determining the identity of the donor(s) and the amount of available gift tax exclusion remaining, any gift of separate property made by a married person shall be deemed to have been made one-half by that person and one-half by the spouse of that person unless either of those persons is not a citizen of the United States or the gift is accompanied by a statement that this sentence does not apply; or

(3) The remaining "5 or 5" amount. The remaining 5 or 5 amount shall be determined by calculating a tentative 5 or 5 amount, which shall be the greater of $5000 or 5 percent of the aggregate value of the assets out of which, or the proceeds of which, an exercise of the withdrawal power could be satisfied, determined as of the date of the gift. The remaining 5 or 5 amount is the tentative 5 or 5 amount reduced by all demand rights held by the demand right holder with respect to this trust at any time during the calendar year to date, that have lapsed or might lapse during the calendar year. If more than one donor makes a gift to the trust at the same time, the remaining 5 or 5 amount shall be calculated based on the aggregate of the gifts, with the sum so determined then being divided by the number of donors making gifts at the same time for purposes of determining the annual gift tax exclusion to be allowed each donor. If as of the date of the gift the demand right holder has possessed or continues to possess any withdrawal rights under other trusts that have lapsed or might lapse during the calendar year, this and the other trusts subject to the holder's withdrawal powers shall be aggregated for purposes of computing the remaining 5 or 5 amount.

B. *Notice of Withdrawal Rights*. On receiving any gift to this trust that creates a distribution right under this article, the trustee shall immediately give written notice of the right to each person acquiring the right. If a right is acquired by a minor, notice also shall be given to a parent of the minor and any court-appointed guardian of the minor. If a right is acquired by an incompetent adult, notice also shall be given to all of the following then in existence: the adult's spouse, the adult's conservator, and the adult's attorney in fact. The donor may require additional notice by giving written notice to the trustee at the time of the gift.

C. *Withdrawal Rights Cumulative*. The withdrawal rights created by this article are cumulative. At the end of each calendar year, the withdrawal rights of each holder that have been in existence more than 45 days shall expire as to that portion of such rights that is equal to the "maximum expiration amount." In the case of a demand right holder having no general power of appointment under another instrument that has lapsed during the calendar year, the maximum expiration amount is the greater of (a) $5000, or (b) 5 percent of the aggregate value of the assets out of which the demand right holder's withdrawal rights could be satisfied, determined using the value of the trust estate on the last day of the year. In other cases, the maximum expiration amount shall be calculated as if this trust and all trusts with respect to which the holder has allowed a general power of appointment to lapse during the calendar year were a single trust, and by reducing the result by the amounts of the lapses under the other trusts. The purpose of this provision is to prevent the occurrence of a lapse that would be treated as a release under Internal Revenue Code §2514(e).

D. *Exercise of Withdrawal Rights*. A withdrawal right may only be exercised by delivering written notice to the trustee before the right expires. In the case of a minor or incompetent adult, the right may be exercised on behalf of the holder by the holder's guardian, natural guardian, conservator, or attorney in fact. The trustee

may, at the trustee's discretion, satisfy a distribution right holder's demand in cash or in kind using any trust assets. The distribution rights created by this article are superior to all other distribution rights created in this instrument, and provisions of this document providing for retention in further trust of assets otherwise distributable to persons under a specified age are not applicable.

ARTICLE THREE
Distributions

9.11-1 Sprinkling power exercised by special trustee

A. *Discretionary Distributions*. Income of the trust estate shall be added to and become principal, and the trustee shall from time to time pay to or apply for the benefit of the settlors' issue and their spouses, including surviving spouses whether or not remarried, of the settlors' issue or any of them, such amounts as the trustee determines to be appropriate for their health, education (including study at an institution of higher education and vocational training), support, and maintenance, taking into account such factors as the trustee deems relevant, including the generation-skipping transfer tax exemption status of the trust. It is the settlors' desire to provide the beneficiaries with a safety net, but the trustee is also cautioned to avoid subsidizing or encouraging lack of initiative.

B. *Termination of Trust*. The trust shall terminate when all grandchildren of the settlors now living are deceased. On termination, the trust estate shall be distributed to the then-living issue of the settlors, per capita at each generation.

Comment: This provision is derived from the form in §9.11, but has been modified to avoid suggesting that the children are the primary beneficiaries. From a GST tax perspective, it is preferable that the trust make most of its distributions to skip persons. Many long-term trusts contain distribution provisions that are far more elaborate than this example.

9.49-3 Distribution of remainder to charitable beneficiary

C. *Distribution to Charity if No Issue*. If at any time before full distribution of the trust estate all the settlors' issue are deceased and no other disposition of the property is directed by this instrument, the remaining portion of the trust shall then be distributed to _ _[*legal name and address of charitable entity*]_ _.

10.105-1 Payments to beneficiary under disability or to minor beneficiary

D. *Distributions to Minors and Disabled Persons*. If the trustee is authorized or directed under this article to make distributions to a minor, a person under any other legal disability, or a person not adjudicated to have limited legal capacity but who, by reason of illness or mental or physical disability, is in the trustee's judgment unable to manage the distributed property properly, the trustee may, at the trustee's discretion, apply the payment for the person's benefit or make the payment or distribution to:

(1) The beneficiary directly;

(2) A legally appointed guardian or conservator of the beneficiary's person or estate;

(3) A custodian for the minor beneficiary, up to the maximum age permitted, under the Uniform Transfers/Gifts to Minors Act of any state selected by the trustee;

(4) An adult relative or friend in reimbursement for amounts properly advanced for the beneficiary's benefit.

Such payments shall not be made to either settlor.

10.26-1 Special trustee to make payments to beneficiary-trustee other than settlor

E. *Special Trustee for Distributions to Trustee*. No trustee may participate in any decision to make discretionary distributions to himself or herself or any person he or she has an obligation to support. If circumstances justify any such distributions and there is no trustee qualified to act, the trustee shall apply to _ _[*name of special trustee*]_ _, who shall act as special trustee of this trust and make all decisions regarding

the requested distributions. The special trustee's responsibilities shall be limited to the exercise of discretion under this clause, and the special trustee shall not be concerned with any other aspects of trust administration. If _ _[*name of special trustee*]_ _ is unable or unwilling to serve as special trustee, _ _[*name of successor special trustee*]_ _ shall serve as special trustee. If _ _[*name of successor special trustee*]_ _ is also unable or unwilling to serve as special trustee, _ _[*name of corporate special trustee*]_ _ shall act as special trustee.

ARTICLE FOUR
Office of Trustee

10.33-1 Sole settlor's designation of successor trustees

A. *Nomination of Successor Trustees*. If at any time _ _[*person/institution*]_ _ ceases to act as trustee, the _ _[*persons/institutions*]_ _ listed below shall serve as successor trustees _ _[*in the order named*]_ _:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

If the nominated successor also fails to qualify or ceases to act, _ _[*name*]_ _ shall have the power to name a successor trustee.

10.36-1 Trustee's power to designate successor

B. *Trustee's Power to Designate Successor Trustee*. Any acting trustee, including special trustee, shall have the power to designate one or more individuals or corporate fiduciaries to succeed the trustee in the event a vacancy in the position of trustee would otherwise occur. Any designation and revocation of that designation shall be made in a written instrument signed by the trustee while acting as trustee. In exercising this power, the acting trustee shall consider any tax consequences of any designation, and the trustee shall not designate a settlor.

11.20-1 Power to remove and replace trustee

C. *Removal of Trustee*. The settlors and the survivor of them shall have the power to remove a trustee at any time. When a trustee is removed or at any other time a trustee ceases to act, the settlor(s) may appoint a substitute trustee who shall immediately serve as the trustee, with any otherwise-nominated successor trustee not taking office until the substitute trustee ceases to act. The substitute trustee may not be a settlor or any person or entity related to or subordinate to a settlor within the meaning of Internal Revenue Code §672(c).

10.51-1 Reasonable compensation (individual trustee)

D. *Compensation of Trustee*. The trustee _ _[*other than a settlor*]_ _ shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

10.118-1 Accounting by trustee

E. *Accounting by Trustee*. The trustee shall account to the adult beneficiaries of the trust created under this instrument and, to the extent permitted by law, the written approval of the adult beneficiaries shall bind minor and contingent remainder interests.

10.58-1 Trustee's powers

F. *Trustee Powers*. The trustee of each trust established under this instrument is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

(1) Each power enumerated in California Probate Code §§16047, 16052, 16200, 16220-16249, and any successor statutes as amended from time to time.

(2) The power to invest and reinvest in any kind of property or type of investment.

(3) The power to operate any business at the risk of the trust estate.

(4) The power to retain, purchase, or otherwise acquire unproductive property.

(5) The power to divide any trust created under this instrument into two or more trusts and to administer any addition to a trust as a separate trust.

(6) The power to exercise all rights, powers, and privileges of an owner of securities, insurance, or any other property owned by the trust.

(7) The power to lend money to persons not currently entitled to distributions from the trust as long as the loan is adequately secured and bears a reasonable rate of interest.

(8) The power to loan or advance the trustee's own funds to the trust for any trust purpose, with interest at current rates; to receive security for such loans; to purchase assets of the trust at their fair market value as determined by an independent appraisal of those assets; and to sell property to the trust at a price not in excess of its fair market value as determined by an independent appraisal.

(9) The power to make or decline to make any tax election affecting the trust or its beneficiaries.

(10) The power to borrow money and to encumber trust property.

(11) The power to partition, allot, and distribute trust assets on any prorata or nonprorata division or distribution of any trust, in undivided interests or in kind or partly in money and partly in kind. For such purposes, assets shall be valued as of the date they are distributed or otherwise allocated.

Comment: Because this type of trust may remain in effect for a century or more, many practitioners provide a substantially more detailed statement of trustee powers than that provided by form 10.58-1.

ARTICLE FIVE
Miscellaneous

9.59-1 Perpetuities savings clause

A. *Perpetuities Savings Clause*. Each trust created by this instrument shall terminate no later than 21 years after the death of the last survivor of the beneficiaries of the trust who are living on the date the trust becomes irrevocable. If a trust terminates by reason of the previous sentence, the remaining trust estate shall be distributed to the persons then entitled to the trust income in the proportions of their income entitlement unless the trustee has discretion to distribute income among a class, in which case the trustee shall have the same discretion to distribute the remaining trust estate among the members of that class. For purposes of this paragraph, a trust created by the exercise of a special power of appointment as defined in California Probate Code §611 is not a new trust.

10.124-1 Short-form spendthrift clause

B. *Spendthrift Clause*. No interest in the principal or income of any trust created under this instrument shall be voluntarily or involuntarily anticipated, assigned, encumbered, or subjected to creditor's claim or legal process before actual receipt by the beneficiary.

10.126-1 Specifying law to govern validity, construction, and administration of trust

C. *Governing Law*. The internal laws (and not the law of conflicts) of the State of California _ _[*in force*]_ _ _ _[*on the date of execution of this trust/from time to time*]_ _ shall govern the validity, construction, interpretation, and administration of _ _[*this trust/any trust created under this instrument*]_ _, except that all matters relating to real property shall be governed by the laws of the situs.

10.135-1 Spouse, husband, or wife

D. *Definition of "Spouse"*. All references in this trust to a person's spouse, husband, or wife shall mean any individual who is that person's then lawfully married spouse (determined by the laws of the jurisdiction in which the person then resides). An individual shall not be considered a spouse, husband, or wife unless that individual is actually residing with the person as husband or wife (disregarding temporary absences due to vacation, illness, or other emergency) when it is necessary to determine the individual's status as a spouse, husband, or wife. The term "spouse," "husband," or "wife" also shall include a widow or widower if that individual was residing at the time of the deceased person's death with the deceased as husband or wife (disregarding temporary absences due to vacation, illness, or other emergency). This determination shall be made at the trustee's discretion.

10.134-1 Issue and children (California law of intestate succession applies)

E. *Definition of "Children" and "Issue"*. The terms "child" and "children" refer to individuals entitled to take as such from a parent under the California law of intestate succession in effect on the date of this instrument. The term "issue" refers to lineal descendants of all generations, with the relationship of parent and child at each generation being determined in the same manner.

10.136-1 No-contest clause

F. *No-Contest Clause*. If any beneficiary under this trust, singly or in conjunction with any other person or persons, contests in any court the validity of this trust, of _ _[*a/the*]_ _ deceased _ _[*settlor's/settlors'*]_ _ last will, or _ _[*a/the*]_ _ deceased _ _[*settlor's/settlors'*]_ _ beneficiary designation for any retirement plans, or seeks to obtain an adjudication in any proceeding in any court that this trust or any of its clauses, that will or any of its clauses, or that beneficiary designation is void, or seeks otherwise to void, nullify, or set aside this trust or any of its clauses, then that person's right to take any interest given to him or her by this trust shall be determined as it would have been determined if the person had predeceased the execution of this trust instrument _ _[*without surviving issue*]_ _. This clause shall not apply to any disclaimer by any person of any benefit under this trust or under any will.

The trustee is authorized to defend, at the expense of the trust estate, any contest or other attack of any nature on this trust or any of its provisions.

8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

State of California)
)
County of _ _[*name of county*]_ _)
)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

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Appendix B

Trusts for Minors

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Description

Contributions made to this trust will qualify for the annual gift tax exclusion under the provisions of IRC §2503(c). The trust also satisfies the requirements of IRC §2642(c), with the result that contributions will be exempt from the generation-skipping transfer tax to the extent that they are exempt from gift tax. The primary advantage of this trust is that these tax results are achieved without the necessity of giving the beneficiary a *Crummey* withdrawal power. The primary disadvantage is that the beneficiary must be entitled to the trust estate at age 21. This trust satisfies that requirement by giving the beneficiary a power to terminate the trust at that age. Because this power lapses if not exercised, contributions made after the beneficiary attains age 21 will not qualify for the annual gift tax exclusion. For further discussion of advantages and disadvantages of IRC §2503(c) trusts compared to *Crummey* trusts, see chap 12. The form in App C can be used if it is preferable to use a *Crummey* trust.

CAVEAT: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix.

The John and Mary Doe Irrevocable Trust for Susan Doe

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUST

- **A. Transfer to Trust**
- **B. Name of Trust**
- **C. Additions to Trust**
- **D. Irrevocability of Trust**

ARTICLE TWO: DISTRIBUTIONS

- **A. Discretionary Distributions**
- **B. Beneficiary's Power to Terminate Trust**
- **C. Distribution if Trust Not Terminated**
- **D. Beneficiary's Power of Appointment**
- **E. Distribution if Power of Appointment Not Exercised**

ARTICLE THREE: OFFICE OF TRUSTEE

- **A. Nomination of Successor Trustees**
- **B. Substitution of Trustee**
- **C. Removal of Trustee**
- **D. Nonliability of Trustee**

E. Nonliability of Cotrustee

F. Nonliability of Successor Trustee

G. Compensation of Trustee

H. Waiver of Trustee Bond

ARTICLE FOUR: TRUSTEE POWERS

A. Broad Investment Powers

B. Power to Retain Trust Property

C. Power to Hold Unproductive Property

D. Power to Acquire or Dispose of Trust Property

E. Power to Lease Trust Property

F. Power to Manage Securities

G. Power to Register Shares

H. Power to Hold Property as Nominee

I. Power to Employ Agents

J. Power to Retain Investment Counsel

K. Power to Borrow

L. Power to Litigate and Compromise Claims

M. Power to Insure

N. Power to Consider Tax Consequences

O. Power to Purchase Bonds at Premium

P. Power to Purchase Bonds at Discount

Q. Power to Delay Distributions

R. Payment of Undistributed Income

S. Allocation of Taxes and Expenses

T. Trustee Prohibitions

ARTICLE FIVE: MISCELLANEOUS

A. Trustee Exculpation Clause

B. Perpetuities Savings Clause

C. Spendthrift Clause

D. Definition of "Education"

E. Definition of "Children" and "Issue"

F. Gender and Number

G. Governing Law

The John and Mary Doe Irrevocable Trust for Susan Doe

8.2-1 Trust agreement

This agreement is made between _ _[*names of settlors*]_ _ (called the "settlors") and _ _[*name of trustee*]_ _ , as trustee.

ARTICLE ONE
Creation of Trust

A. *Transfer to Trust*. The settlors hereby transfer and deliver to the trustee, without consideration, _ _[*ten dollars ($10) or more/the property described in Schedule A, attached to this trust*]_ _. All property subject to this trust from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.

8.5-1 Name of trust

B. *Name of Trust*. The beneficiary of this trust is _ _[*e.g., Susan Doe*]_ _ (called the beneficiary). This trust may be referred to as _ _[*e.g., The John and Mary Doe Irrevocable Family Trust for Susan Doe*]_ _.

10.122-1 Authorization of additions to trust

C. *Additions to Trust*. Other property acceptable to the trustee may be added to _ _[*this/these*]_ _ trust(s) by any person, by the will or codicil of _ _[*the/either*]_ _ settlor, by the proceeds of any life insurance, or otherwise.

8.7-1 Irrevocability of trust

D. *Irrevocability of Trust*. This trust is irrevocable, and the settlors have no powers of amendment.

ARTICLE TWO
Distributions

12.59-1 Discretionary payment of income and principal before beneficiary attains age 18 or 21

A. *Discretionary Distributions*. As long as the beneficiary is under age _ _[*18/21*]_ _, income of the trust shall be added to principal and the trustee may pay to or apply for the benefit of the beneficiary as much of the beneficiary's trust as the trustee, at the trustee's discretion, considers necessary for the beneficiary's support, care, education, comfort, and welfare. In determining the amount to be paid to the beneficiary, the trustee need not consider the beneficiary's other income or resources.

Comment: See §12.39 for effect of substantial restrictions on trustee's discretion.

12.61-1 Beneficiary's power to terminate trust after attaining specified age

B. *Beneficiary's Power to Terminate Trust*. The beneficiary shall have the power to terminate the trust by a written instrument delivered to the trustee within 60 days after attaining age _ _[*18/21*]_ _. On receipt of an instrument exercising the termination right, the trustee shall distribute to the beneficiary the entire undistributed balance of _ _[*his/her*]_ _ trust.

9.28-1 Distribution if beneficiary does not terminate trust at age 21

C. *Distribution if Trust Not Terminated*. If the beneficiary does not exercise the power of termination contained in paragraph B of this article, the trust shall remain in effect and shall be held and administered as follows:

The trustee shall pay to or apply for the benefit of the beneficiary the entire net income of the beneficiary's trust, quarterly or at more frequent intervals. In addition, the trustee _ _[*shall/may*]_ _ pay to or apply for the benefit of the beneficiary as much of the principal of the beneficiary's trust as the trustee, at the trustee's discretion, considers necessary for the beneficiary's proper support, health, maintenance, and education, after taking into consideration to the extent the trustee considers advisable any of the beneficiary's other income or resources known to the trustee.

When the beneficiary attains age _ _[*18/25/30*]_ _, the trustee shall distribute to the beneficiary _ _[*e.g., one half*]_ _ of the principal of the beneficiary's trust as then constituted. When the beneficiary attains age

_ _[*25/35/40*]_ _, the trustee shall distribute to the beneficiary the undistributed balance of his or her trust.

Comment: The clause above is a modified version of Form 9.28-1, to reflect that it is operative only if the beneficiary does not exercise his or her power to terminate the trust at age 18 or 21. The clause also eliminates the last paragraph of Form 9.28-1 directing distribution if the beneficiary dies before entitlement to distribution. Form 12.62A-1, below, is used instead.

12.62A-1 Distribution according to child's power of appointment if child dies before age 18 or 21

D. *Beneficiary's Power of Appointment*. If the beneficiary dies before attaining age _ _[*18/21*]_ _ or before receiving full distribution of the trust, the trustee shall distribute the undistributed balance of the trust (including both principal and any accrued or undistributed income) to one or more persons or entities (including the beneficiary's own estate) on terms and conditions (either outright or in trust) as the beneficiary shall appoint by a will or codicil specifically referring to and exercising this power of appointment. Any part of the beneficiary's trust not effectively appointed by the beneficiary in this manner shall be distributed, free of trust, to the beneficiary's then-living issue by right of representation or, if there is no living issue of the beneficiary, to the settlors' then-living issue by right of representation. If any part of that balance, however, would otherwise be distributed to a person for whose benefit a trust similar to this trust is then being administered, that part shall instead be added to that trust and shall thereafter be administered according to its terms.

E. *Distribution if Power of Appointment Not Exercised*. If the beneficiary dies before attaining age _ _[*18/21*]_ _ _ _[*or before receiving full distribution of _ _[his/her]_ _ trust,*]_ _, all the settlors' issue are deceased, and no other distribution of the property is directed by this instrument or by the beneficiary's exercise of a power of appointment as provided under paragraph D of this article, the trust estate or the portion of it then remaining shall be distributed _ _[*e.g., in equal shares to _ _[name]_ _ and _ _[name]_ _, who are living on the occurrence of the event requiring distribution. If either of them is not then living but leave then-living issue, that issue shall take, by right of representation, the share that their parent would have taken had the parent been then living/to the Regents of the University of California*]_ _.

Comment: It is important to avoid having a reversionary interest in the settlors. See IRC §2037. Therefore, the heirs or a charity should be the ultimate beneficiaries.

ARTICLE THREE
Office of Trustee

10.33-1 Designation of successor trustees

A. *Nomination of Successor Trustees*. If at any time _ _[*person/institution*]_ _ ceases to act as trustee, the _ _[*person(s)/institution(s)*]_ _ listed below shall serve as successor trustee(s) in the order named:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

If the nominated successor also fails to qualify or ceases to act, _ _[*name*]_ _ shall have the power to name a successor trustee.

9.15-1 Substitution of independent trustee

B. *Substitution of Trustee*. Any trustee may resign as trustee at any time and appoint a successor trustee as long as no trustee acting from time to time is a settlor _ _[*or a spouse not legally separated from the settlor*]_ _ and no more than half the number of trustees acting from time to time are related or subordinate parties to either settlor within the meaning of Internal Revenue Code §672(c) or any successor statute. This power may be exercised or relinquished by a written instrument delivered to each acting trustee and to each person to whom payment may then be made at the trustee's discretion.

Comment: See Caveat in §9.15 concerning substitution of trustees.

10.31-1 Trustee removal due to trustee incapacity or illness

C. *Removal of Trustee*. If the trustee is unable to serve because of physical or mental incapacity or illness, the successor trustee(s) named in this trust _ _[*in the order designated*]_ _ shall serve as trustee, having all rights and powers granted to the trustee by this trust. Physical or mental incapacity or illness shall be conclusively established if two physicians authorized to practice medicine in the State of California or any other place in which the trustee resides, who are unrelated to the settlor and the trustee by blood or marriage,

examine the trustee and issue written declarations under penalty of perjury that state that the trustee is unable to serve because of incapacity or illness that is more likely than not to continue for an additional _ _[*number*]_ _ days _ _[*and _ _[name(s) of particular physician _ _[and/or]_ _ trusted friend*]_ _ *concur(s) that the trustee is incapacitated*]_ _. By assuming the office of trustee, any individual shall be deemed to have waived the doctor-patient privilege to the extent necessary to implement this clause. In the absence of declarations of incapacity, the successor trustee designated in this trust _ _[*or one or more of the beneficiaries*]_ _ may petition the Court having jurisdiction over this trust to remove the then-serving trustee and replace _ _[*him/her*]_ _ with the designated successor trustee. The successor trustee or beneficiary who petitions the Court shall incur no liability to any beneficiary of the trust or to the substituted trustee as a result of this petition unless the petition is filed in bad faith or without a reasonable belief that the substituted trustee is physically or mentally incapacitated or otherwise unable to serve.

10.39-1 Nonliability of all trustees

D. *Nonliability of Trustee*. No trustee named in this trust _ _[*or designated as authorized in this trust*]_ _ _ _[*(other than a corporate trustee)*]_ _ shall be liable to any beneficiary or to any heir of either settlor for the trustee's acts or failure to act, except for willful misconduct or gross negligence.

10.40-1 Nonliability for cotrustee's acts

E. *Nonliability of Cotrustee*. No trustee shall be liable or responsible for any act, omission, or default of any other trustee _ _[*as long as the trustee has no knowledge of facts that might reasonably be expected to put the trustee on notice of it*]_ _.

10.41-1 Successor trustee's nonliability for predecessor's acts

F. *Nonliability of Successor Trustee*. No successor trustee shall be liable for any act, omission, or default of a predecessor trustee. The successor trustee may accept the accounting records of the predecessor trustee showing assets on hand without further investigation and without incurring any liability to any person claiming or having an interest in the trust.

10.51-1 Reasonable compensation (individual trustee)

G. *Trustee Compensation*. The trustee _ _[*other than a settlor*]_ _ shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

10.49-1 Trustee's bond

H. *Waiver of Trustee Bond*. No bond shall be required of any person named in this trust as trustee _ _[*or as special trustee*]_ _ or of any person appointed as trustee _ _[*or as special trustee*]_ _, in the manner specified in this trust, for the faithful performance of his or her duties as trustee.

ARTICLE FOUR

Trustee Powers

10.57-1 Introduction to trustee's powers

To carry out the purposes of the trusts created by this instrument, and subject to any limitations provided elsewhere in this instrument, the trustee shall have, without necessity of application to any Court, the following powers in addition to those conferred by California Trust Law.

10.60-1 Broad investment powers under prudent investor rule

A. *Broad Investment Powers*. The trustee may invest in any kind of property (real, personal, or mixed) or any kind of investment (specifically including, but not limited to, corporate obligations of every kind; preferred or common stocks; shares of investment trusts, investment companies, and mutual funds _ _[*including any common trust funds administered by the trustee*]_ _; life insurance policies; notes, real estate, bonds, debentures, mortgages, deeds of trusts, mortgage participations, market funds, and index funds appropriate under the then-prevailing circumstances) or engage in any course of action or investment strategy consistent with the standards of the Uniform Prudent Investor Act (UPIA) (Probate Code §§16002(a), 16003, 16045-16054).

10.63-1 Power to retain property (standard clause)

**B. *Power to Retain Trust Property*. The trustee may continue to hold any property _ _[*, including any shares of*

the trustee's own stock,]_ _ **and to operate at the risk of the trust estate any business that the trustee receives or acquires under the trust as long as the trustee, at the trustee's discretion, considers it advisable to do so.**

10.64-1 Power to retain unproductive or underproductive property

C. *Power to Hold Unproductive Property*. The trustee may retain, purchase, or otherwise acquire unproductive or underproductive property _ _[*subject to the provisions set out elsewhere in this trust*]_ _

10.68-1 Power to sell, exchange, manage, encumber, and grant options on property (standard clause)

D. *Power to Acquire or Dispose of Trust Property*. The trustee may acquire or dispose of trust property, at public or private sale, for cash or credit (including deferred payments extending beyond the duration of this trust); exchange trust property; manage, control, divide, develop, improve, exchange, partition, change the character of, repair, alter, or abandon trust property; encumber, mortgage, or pledge trust property for a term within or beyond the term of the trust in connection with the exercise of any power vested in the trustee; and grant options on trust property.

10.70-1 Power to lease, including oil and mineral development (standard clause)

E. *Power to Lease Trust Property*. The trustee may lease trust property for terms within or beyond the term of the trust for any purpose (including exploration for and removal of gas, oil, minerals, and geothermal energy) and enter into community oil leases and pooling and unitization agreements.

10.72-1 Power to manage securities (standard clause)

F. *Power to Manage Securities*. The trustee shall have all the rights, powers, and privileges of an owner of the securities held in the trust, including, but not limited to, the powers to:

(1) Vote, give proxies, and pay assessments;

(2) Participate in voting trusts and pooling agreements and enter into shareholders' agreements, including, but not limited to, buy-sell agreements, close corporation and S corporation shareholders' agreements, and limited liability company member agreements;

(3) Consent to foreclosures, reorganizations, consolidations, mergers, and liquidations;

(4) Deposit securities with and transfer title to any protective or other committee on any terms that the trustee, at the trustee's discretion, considers advisable; and

(5) Exercise or sell stock subscription or conversion rights.

10.73-1 Power to register shares for sale (closely held or controlled public corporation)

G. *Power to Register Shares*. The trustee may register, or qualify for exemption from registration, shares of stock in any corporation with any agency of any government (including, but not limited to, the United States Securities and Exchange Commission); participate in any such registration or exemption from registration; apply for and secure approval of the agency for sale of these shares; sell these shares or participate in the public or private sale of these shares; enter into any agreement for the sale with any broker, investment banker, or underwriter; incur and pay all expenses connected with the registration, qualification, or sale; execute any indemnification agreement or other instrument required to consummate the registration, underwriting, or sale; and take all other actions necessary or appropriate to consummate the registration, qualification, or sale.

Comment: This power should be inserted only when trust corpus includes shares of a closely held business or controlled public corporation and the trustee is likely to sell shares to the public.

10.75-1 Authority to hold trust property as nominee

H. *Power to Hold Property as Nominee*. The trustee may hold:

(1) Stocks and other securities in the trustee's name as trustee under this trust, in a nominee's name, with or without any express designation of the status of the person as nominee, or in the name of the broker who handled the asset purchase (what is commonly called "street name"). The trustee also may, at the trustee's discretion, hold unregistered securities in "bearer" form, which enables ownership of the shares to pass on delivery.

(2) The property of the trust in the name of the trustee individually, with or without disclosing the capacity as trustee, or as trustee, with or without designation of any beneficiary.

10.77-1 Power to employ agents

I. *Power to Employ Agents*. The trustee may employ any custodian, attorney, accountant, corporate fiduciary, or any other agent or agents to assist the trustee in the administration of this trust _ _[*and to rely on the advice given by these agents*]_ _. The power to employ agents includes the power to delegate management and investment functions according to Probate Code §16052. Any agent or adviser shall receive reasonable compensation for all services performed, which shall be paid from the trust estate from either income or principal, as the trustee, at the trustee's discretion, determines, and shall _ _[*not*]_ _ decrease the compensation to which the trustee is entitled.

10.78-1 Individual trustee's power to employ investment counsel

J. *Power to Retain Investment Counsel*. The trustee may retain professional investment counsel of the trustee's choice, regarding investments held by these trusts, as long as the selected counsel is currently handling _ _[*specify parameters, e.g., at least five other accounts of similar or greater size*]_ _. If investment counsel is retained, the trustee shall abide by the counsel's decision but shall not be held liable or otherwise surcharged for losses directly attributable to investments made on the investment counsel's advice. While investment counsel is retained by the trustee, the trustee shall not be required to review trust investments subject to the investment counsel's supervision unless the trustee is apprised of facts clearly indicating that counsel is not performing competently. The trustee need not take action on those investments unless the trustee receives written instructions from the investment counsel. If counsel is retained, the trustee's fees for the trustee's ordinary services while counsel is retained shall be _ _[*reduced to a sum equal to _ _[number]_ _ percent of the fee normally charged by the trustee for ordinary services to such property/reasonably reduced*]_ _. The trustee shall have the power exercisable at the trustee's discretion to discharge such counsel and to employ other counsel or to administer the trust without such counsel.

10.80-1 Power to borrow (standard clause)

K. *Power to Borrow*. The trustee may borrow money and encumber trust property by mortgage, deed of trust, pledge, or otherwise, for the debts of the trust or the joint debts of the trust and a co-owner

10.85-1 Power to initiate and defend litigation and power to compromise (standard clause)

L. *Power to Litigate and Compromise Claims*. The trustee may initiate or defend, at the expense of the trust, any litigation that the trustee considers advisable relating to the trust or any property of the trust estate, and compromise, submit to arbitration, abandon, or otherwise adjust any claims or litigation against or in favor of the trust, as long as the trustee determines, at the trustee's discretion, that such action will be beneficial to the trust. The trustee's powers under this clause shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no obligations or duties, however, for any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss connected with these matters.

10.87-1 Power to insure (standard clause)

M. *Power to Insure*. The trustee may carry, at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.

10.96-1 Power to consider tax consequences of distributions

N. *Power to Consider Tax Consequences*. When determining whether to distribute income or corpus authorized by this trust and the person to whom it is made, the trustee may consider the tax consequences to the trust and to the beneficiaries to whom distribution may be made.

19.28-1 Power to purchase bonds at premium

O. *Power to Purchase Bonds at Premium*. The trustee may purchase bonds and pay any premiums connected with the purchase that the trustee at the trustee's discretion considers advisable,

19.29-1 Power to purchase bonds at discount

P. *Power to Purchase Bonds at Discount*. The trustee may purchase bonds at such discount as the trustee at the trustee's discretion considers advisable.

10.109-1 Power to withhold payment if conflicting claims arise

Q. *Power to Delay Distributions*. When an event occurs on which the trustee is required to divide or distribute trust property, the trustee may delay the division or distribution of all or part of the property (without later payment of interest) for the period of time necessary to ascertain and provide for the payment of any tax claim or other liability, contingent or otherwise, against the property. During this period, the trustee may pay the net income of the trust to the beneficiaries entitled to it. Any income not distributed shall, on resolution of any tax claim or other liability, be payable to the person entitled to it immediately after income is received by the trustee. This clause shall not be deemed to postpone or defer the vesting of any interest created under the dispositive clauses of the trust.

10.114-1 Undistributed income payable to next beneficiaries

R. *Payment of Undistributed Income*. Income accrued or unpaid on trust property when received into the trust shall be treated as any other income. Income accrued or held undistributed by the trustee at the termination of any trust created under this instrument shall go to the next beneficiaries of the trust in proportion to their interest in it.

10.116-1 Allocation of expenses among successive beneficiaries

S. *Allocation of Taxes and Expenses*. The trustee shall prorate all taxes and current expenses among successive beneficiaries on a daily basis over the period to which these expenses relate.

10.100-1 Trustee prohibited from exercising certain powers

T. *Trustee Prohibitions*. The trustee is expressly prohibited from exercising any power vested in the trustee primarily for the benefit of the settlor(s) rather than for the benefit of the beneficiaries. Neither the settlor(s) nor any other person may:

(1) Purchase, exchange, or otherwise deal with or dispose of the income or principal of the trust estate for less than adequate and full consideration in money or money's worth;

(2) Borrow the income or principal of the trust estate, directly or indirectly, without adequate interest or without adequate security; or

(3) Vote, directly or indirectly, any securities of a controlled corporation (as defined by Internal Revenue Code §2036(b)(2) or any successor statute) transferred by the settlor(s) to the trust.

ARTICLE FIVE

Miscellaneous

10.120-1 Notice to trustee of births, deaths, and other events affecting interests

A. *Trustee Exculpation Clause*. Unless the trustee has received actual _ _[*written*]_ _ notice of the occurrence of an event affecting the beneficial interests of this trust, the trustee shall not be liable to any beneficiary of this trust for proceeding as though the event had not occurred. This clause shall not exculpate the trustee from liability arising from nonpayment of estate taxes or generation-skipping transfer taxes that may be payable by the trust on the occurrence of an event affecting the beneficial interests in this trust.

9.59-1 Perpetuities savings clause

B. *Perpetuities Savings Clause*. Each trust created by this instrument shall terminate no later than 21 years after the death of the last survivor of the beneficiaries of the trust who are living on the date the trust becomes irrevocable. If a trust terminates by reason of the previous sentence, the remaining trust estate shall be distributed to the persons then entitled to the trust income in the proportions of their income entitlement unless the trustee has discretion to distribute income among a class, in which case the trustee shall have the same discretion to distribute the remaining trust estate among the members of that class. For purposes of this paragraph, a trust created by the exercise of a special power of appointment as defined in California Probate Code §611 is not a new trust.

10.124-1 Short-form spendthrift clause

C. *Spendthrift Clause*. No interest in the income or principal of any trust created under this instrument shall be voluntarily or involuntarily anticipated, assigned, encumbered, or subjected to creditor's claim or legal

process before actual receipt by the beneficiary.

10.132-1 Education

D. *Definition of "Education."* Whenever provision is made in this trust to pay for the education of a beneficiary, the term "education" shall include tuition for vocational school, college, and postgraduate study _ _[*if the trustee determines that the beneficiary pursues this study to his or her advantage*]_ _ **at an institution of the beneficiary's choice. Payments for "education" shall also include expenses for books, supplies, and tutors.**

10.134A-1 Issue and children (lineal descendants)

E. *Definition of "Children" and "Issue."* All references in this trust to the term "issue" refer to lineal descendants of all degrees. The terms "child," "children," and "issue" _ _[*do not*]_ _ **include** _ _[*e.g., stepchildren/foster children/adopted children who* _ _[*were/need not have been*]_ _ *minors at the date of adoption*]_ _**. All references to the terms "issue," "child," and "children" include a child born out of wedlock if a parent-child relationship existed between the child and his or her deceased parent. Except as otherwise expressly provided in this trust, for purposes of this trust the existence of a parent-child relationship shall be determined by California law.**

10.128-1 Gender and number

F. *Gender and Number*. In all matters of interpretation necessary to give effect to any clause of this trust, the masculine includes the feminine and neuter, the singular includes the plural, and the plural includes the singular.

10.126-1 Specifying law to govern validity, construction, and administration of trust

G. *Governing Law*. The internal laws (and not the law of conflicts) of the State of California _ _[*in force*]_ _ _ _[*on the date of execution of this trust/from time to time*]_ _ **shall govern the validity, construction, interpretation, and administration of** _ _[*this trust/any trust created under this instrument*]_ _**, except that all matters relating to real property shall be governed by the laws of the situs of the real property. If any trust created under this instrument is administered outside California, a court with jurisdiction over the trustee of the trust may order that the law of that state governs the trust, as long as the change of governing law will not adversely affect the interests of the trust beneficiaries.**

8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _**, California, on** _ _[*date*]_ _**.**

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

State of California)
)
County of _ _[*name of county*]_ _)
)
_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

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Source: Estate Planning/Drafting California Irrevocable Trusts/Appendix C Separate Trusts for Children or Grandchildren (Skip Persons); Sensitive Trustee Permitted

Appendix C

Separate Trusts for Children or Grandchildren (Skip Persons); Sensitive Trustee Permitted

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Description

Although this trust can be used for children, it is particularly well suited for creating trusts for grandchildren and great grandchildren. The $13,000 (plus further cost-of-living adjustments after 2009) IRC §2503(b) gift tax annual exclusion does not apply for generation-skipping transfer tax purposes if a trust has more than one beneficiary. The following form addresses this limitation by using a single instrument to create as many separate trusts as may be desired for purposes of administering gifts to grandchildren and their issue. This strategy facilitates most aspects of trust administration, but does not eliminate the need for filing separate income tax returns for each trust in any year in which the trusts have taxable income. The general power of appointment provision is mandatory in order to satisfy the "one beneficiary" rule. It is not necessary to limit the *Crummey* power annual withdrawal amount to $5000, because no completed gifts can occur as a result of the lapse of the power.

Provided there is no modification of the distribution provisions, this trust can usually have a sensitive trustee unless the trust will own life insurance on the life of the trustee (creating a problem under IRC §2042) or the trust will be funded with controlled corporation stock (possibly creating a problem under IRC §2036(b)). Because the power to accumulate income terminates at age 21, there are no adverse income tax consequences resulting from use of a sensitive trustee. See IRC §674(b)(7). Transfer tax problems are addressed by using an ascertainable standard related to health, education, support and maintenance to limit distribution discretion, and by prohibiting distributions that would discharge another person's obligation to support the beneficiary. In theory it is even possible for a settlor to be the trustee under these circumstances, but most practitioners believe this is unnecessarily risky with respect to the possibility of the trust being included in the settlor's estate, particularly if the trust is funded with assets of a family business.

CAVEAT: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix.

The John and Mary Doe Grandchildren Trusts

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUSTS

A. Transfer to Trust

B. Name of Trust

C. Additions to Trust

D. Irrevocability of Trust

ARTICLE TWO: WITHDRAWAL RIGHTS

A. Right to Withdraw Annual Exclusion Amount

B. Notice of Withdrawal Rights

C. Exercise of Withdrawal Rights

ARTICLE THREE: DISTRIBUTIONS

A. Discretionary Distributions

B. Distribution of Income

C. Distribution of Principal

D. Beneficiary's Power of Appointment

ARTICLE FOUR: OFFICE OF TRUSTEE

A. Nomination of Successor Trustees

B. Trustee's Power to Designate Successor Trustee

C. Removal of Trustee

D. Compensation of Trustee

E. Trustee Powers

ARTICLE FIVE: MISCELLANEOUS

A. Perpetuities Savings Clause

B. Spendthrift Clause

C. Governing Law

D. Commingling of Undivided Interests

The John and Mary Doe Grandchildren Trusts

8.2-1 Trust agreement

This agreement is made between _ _[*name(s) of settlor(s)*]_ _ (called the "settlors") and _ _[*name of trustee*]_ _, as trustee.

ARTICLE ONE
Creation of Trusts

A. *Transfer to Trusts*. The settlors hereby create _ _[*number*]_ _ separate trusts, one for each beneficiary named below, transferring to the trustee in equal shares for each trust, without consideration, _ _[*ten dollars ($10) or more/the property described in Schedule A, attached to this trust*]_ _. The share of the transferred property allocated to each trust, together with any other property subsequently becoming part of any trust, constitutes the trust estate of that trust and will be held, administered, and distributed by the trustee as provided in this agreement. The initial trust beneficiaries are _ _[*names*]_ _. Additional separate trusts for additional beneficiaries may be established at any time.

8.5-1 Name of trust

**B. *Name of Trusts*. The trusts created by this instrument may be referred to collectively as the _ _[*e.g. The*

John and Mary Doe Grandchildren Trusts]_ _**. Each separate trust created by this instrument may be referred to by adding the name of its beneficiary to that name.**

10.122-1 Authorization of additions to trust

C. *Additions to Trust*. Other property acceptable to the trustee may be added to any trust created by this instrument by the will or codicil of either settlor, by the proceeds of any life insurance, or otherwise. Any transfer to the trustee that does not specify a different allocation shall be allocated in equal shares among the trusts then being administered under this agreement for the benefit of their original beneficiaries.

8.7-1 Irrevocability of trust

D. *Irrevocability of Trust*. This trust agreement is irrevocable, and the settlors have no powers of amendment.

ARTICLE TWO
Withdrawal Rights

12.96-1 *Crummey* clause without excess lapse protection

A. *Right to Withdraw Annual Exclusion Amount*. At any time a gift is made by any donor to this trust, _ _[*specify beneficiaries or class of beneficiaries*]_ _ shall each have the immediate right to demand and receive immediate distribution of an amount equal to the amount specified in a writing signed by the donor and delivered to the trustee no later than the time of the gift. If no such amount is specified, the amount that may be withdrawn shall be the lesser of:

(1) The amount of the gift divided by the number of persons having a right to demand a distribution with respect to the gift; or

(2) The amount of the Internal Revenue Code §2503(b) annual gift tax exclusion remaining available to the donor at the time of the gift for gifts to the distribution right holder in the calendar year. For purposes of determining the identity of the donor(s) and the amount of available gift tax exclusion remaining, any gift of separate property made by a married person shall be deemed to have been made one-half by that person and one-half by the spouse of that person unless either of those persons is not a citizen of the United States or the gift is accompanied by a statement that this sentence does not apply.

B. *Notice of Withdrawal Rights*. On receiving any gift to this trust that creates a distribution right under this article, the trustee shall immediately give written notice of the right to the beneficiary. If a right is acquired by a minor, notice also shall be given to a parent of the minor and any court-appointed guardian of the minor. If a right is acquired by an incompetent adult, notice also shall be given to all of the following then in existence: the adult's spouse, the adult's conservator, and the adult's attorney in fact. The donor may require additional notice by giving written notice to the trustee at the time of the gift.

C. *Exercise of Withdrawal Rights*. Each right to demand distribution shall expire unless it is exercised by delivering written notice to the trustee within 45 days following the date of the gift. In the case of a minor or incompetent adult, the right may be exercised on behalf of the holder by the holder's guardian, natural guardian, conservator, or attorney in fact. The trustee may, at the trustee's discretion, satisfy a distribution right holder's demand in cash or in kind using any trust assets. The distribution rights created by this article are superior to all other distribution rights created in this instrument, and provisions of this document providing for retention in further trust of assets otherwise distributable to persons under a specified age are not applicable.

ARTICLE THREE
Distributions

9.27-1 Distribution of income and principal or accumulation of income during child's minority

A. *Discretionary Distributions*. As long as the original trust beneficiary is under age 21, the trustee shall pay to or apply for the beneficiary's benefit as much of the net income and principal of the beneficiary's trust as the trustee, at the trustee's discretion, considers appropriate for the beneficiary's support, health, maintenance, and education, after taking into consideration to the extent the trustee considers advisable any of the beneficiary's

other income or resources known to the trustee. Any income not distributed shall be accumulated and added to principal. Income or principal of the beneficiary's trust shall not, however, be used to discharge in whole or in part any person's legal obligation to support the beneficiary.

9.28-1 Distribution after child reaches age 21

B. *Distribution of Income*. After a beneficiary has attained age 21, the trustee shall pay to or apply for the benefit of the beneficiary the entire net income of the beneficiary's trust, quarterly or at more frequent intervals. In addition, the trustee shall pay to or apply for the benefit of the beneficiary as much of the principal of the beneficiary's trust as the trustee, at the trustee's discretion, considers appropriate for the beneficiary's support, health, maintenance, and education, after taking into consideration to the extent the trustee considers advisable any of the beneficiary's other income or resources known to the trustee.

C. *Distribution of Principal*. When the beneficiary attains age _ _[*25/30/35*]_ _, the trustee shall distribute to the beneficiary _ _[*e.g., one-half*]_ _ of the principal of the beneficiary's trust as then constituted. When the beneficiary attains age _ _[*25/35/40*]_ _, the trustee shall distribute to the beneficiary the undistributed balance of his or her trust.

D. *Beneficiary's Power of Appointment*. If a beneficiary dies before becoming entitled to receive distribution of his or her entire trust, the trustee shall distribute the entire balance then remaining, if any, of the beneficiary's trust to the one or more persons and entities, including the beneficiary's estate, on terms and conditions (either outright or in trust) appointed by the beneficiary in a will or codicil specifically referring to and exercising this power of appointment. In the event this power is not exercised, the remaining trust estate shall be distributed, free of trust, to the beneficiary's then-living issue per capita at each generation. If there are no issue, the trust estate shall be distributed to the settlors' then-living issue per capita at each generation. However, if any part of the balance to be distributed would otherwise be distributed to a person for whose benefit a trust is then being administered under this instrument, that part shall instead be added to that trust and shall thereafter be administered according to its terms, except that any addition to a partially distributed trust shall augment proportionally the distributed and undistributed portions of that trust.

ARTICLE FOUR
Office of Trustee

10.33-1 Sole settlor's designation of successor trustees

A. *Nomination of Successor Trustees*. If at any time the _ _[*person/institution*]_ _ ceases to act as trustee, the _ _[*persons/institutions*]_ _ listed below shall serve as successor trustees _ _[*in the order named*]_ _:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

If the nominated successor also fails to qualify or ceases to act, _ _[*name*]_ _ shall have the power to name a successor trustee.

10.36-1 Trustee's power to designate successor

B. *Trustee's Power to Designate Successor Trustee*. Any acting trustee, including special trustee, shall have the power to designate one or more individuals or corporate fiduciaries to succeed the trustee in the event a vacancy in the position of trustee would otherwise occur. Any designation and revocation of that designation shall be made in a written instrument signed by the trustee while acting as trustee. In exercising this power, the acting trustee shall consider any tax consequences of any designation, and the trustee shall not designate a settlor. Different trusts may have different trustees.

11.20-1 Power to remove and replace trustee

C. *Removal of Trustee*. The settlors and the survivor of them shall have the power to remove a trustee at any time. When a trustee is removed or at any other time a trustee ceases to act, the settlors may appoint a substitute trustee who shall immediately serve as the trustee, with any otherwise-nominated successor trustee not taking office until the substitute trustee ceases to act. The substitute trustee may not be a settlor or any

person or entity related to or subordinate to a settlor within the meaning of Internal Revenue Code §672(c).

10.51-1 Reasonable compensation (individual trustee)

D. *Compensation of Trustee*. The trustee shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

10.58-1 Trustee's powers

E. *Trustee Powers*. The trustee of each trust established under this instrument is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

(1) Each power enumerated in California Probate Code §§16047, 16052, 16200, 16220-16249, and any successor statutes as amended from time to time.

(2) The power to invest and reinvest in any kind of property or type of investment.

(3) The power to operate any business at the risk of the trust estate.

(4) The power to retain, purchase, or otherwise acquire unproductive property.

(5) The power to divide any trust created under this instrument into two or more trusts and to administer any addition to a trust as a separate trust.

(6) The power to exercise all rights, powers, and privileges of an owner of securities, insurance, or any other property owned by the trust.

(7) The power to lend money to persons not currently entitled to distributions from the trust as long as the loan is adequately secured and bears a reasonable rate of interest.

(8) The power to loan or advance the trustee's own funds to the trust for any trust purpose, with interest at current rates; to receive security for such loans; to purchase assets of the trust at their fair market value as determined by an independent appraisal of those assets; and to sell property to the trust at a price not in excess of its fair market value as determined by an independent appraisal.

(9) The power to make or decline to make any tax election affecting the trust or its beneficiaries.

(10) The power to borrow money and to encumber trust property.

(11) The power to partition, allot, and distribute trust assets on any prorata or nonprorata division or distribution of any trust, in undivided interests or in kind or partly in money and partly in kind. For such purposes, assets shall be valued as of the date they are distributed or otherwise allocated.

ARTICLE FIVE
Miscellaneous

9.59-1 Perpetuities savings clause

A. *Perpetuities Savings Clause*. Each trust created by this instrument shall terminate no later than 21 years after the death of the last survivor of the beneficiaries of the trust who are living on the date the trust becomes irrevocable. If a trust terminates by reason of the previous sentence, the remaining trust estate shall be distributed to the persons then entitled to the trust income in the proportions of their income entitlement unless the trustee has discretion to distribute income among a class, in which case the trustee shall have the same discretion to distribute the remaining trust estate among the members of that class. For purposes of this paragraph, a trust created by the exercise of a special power of appointment as defined in California Probate Code §611 is not a new trust.

10.124-1 Short-form spendthrift clause

B. *Spendthrift Clause*. No interest in the principal or income of any trust created under this instrument shall be voluntarily or involuntarily anticipated, assigned, encumbered, or subjected to creditor's claim or legal process before actual receipt by the beneficiary.

10.126-1 Specifying law to govern validity, construction, and administration of trust

C. *Governing Law*. The internal laws (and not the law of conflicts) of the State of California shall govern the validity, construction, interpretation, and administration of the trusts created under this instrument.

10.43-1 Authorization of commingling of undivided interests

D. *Commingling of Undivided Interests*. The property belonging to the various trusts created under this instrument may be held in the form of undivided interests in property titled under the collective name of the trusts. The trustee must maintain proper books of account showing the property belonging to each trust.

8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _**, California, on** _ _[*date*]_ _**.**

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

State of California)
)
County of _ _[*name of county*]_ _ **)**

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

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Appendix D

Irrevocable Life Insurance Trust for Children

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Description

The following form is intended for use in situations in which the settlor will not make immediate allocation of the generation-skipping transfer tax exemption to the trusts because it is not anticipated that any distributions will ever be made to skip persons. In order to address the risk that one of the children might fail to survive the settlor, the form creates separate trusts for each child and gives the child a general power of appointment over his or her trust. It is usually desirable that grandchildren take in default of the exercise of the power of appointment. The settlor cannot serve as trustee of the trust. It is not necessary to limit the annual beneficiary withdrawal amount to $5000, because the beneficiary's general power of appointment avoids the possibility of a lapse causing a completed gift.

CAVEAT: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix.

The Mary Doe Irrevocable Life Insurance Trust No. 1

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUSTS

- **A. Transfer to Trust**
- **B. Name of Trust**
- **C. Additions to Trust**
- **D. Irrevocability of Trust**

ARTICLE TWO: WITHDRAWAL RIGHTS

- **A. Right to Withdraw Annual Exclusion Amount**
- **B. Notice of Withdrawal Rights**
- **C. Exercise of Withdrawal Rights**

ARTICLE THREE: DISTRIBUTIONS

- **A. Discretionary Distributions**
- **B. Distribution on Settlor's Death**
- **C. Beneficiary's Power of Appointment**

ARTICLE FOUR: OFFICE OF TRUSTEE

A. Nomination of Successor Trustees

B. Trustee's Power to Designate Successor Trustee

C. Removal of Trustee

D. Compensation of Trustee

E. Trustee Powers

ARTICLE FIVE: LIFE INSURANCE

ARTICLE SIX: MISCELLANEOUS

A. Perpetuities Savings Clause

B. Spendthrift Clause

C. Governing Law

D. Commingling of Undivided Interests

The Mary Doe Irrevocable Life Insurance Trust No. 1

8.2-1 Trust agreement

This agreement is made between _ _[*name of settlor*]_ _ (called the "settlor") and _ _[*name of trustee*]_ _, as trustee.

ARTICLE ONE
Creation of Trusts

A. *Transfer to Trust*. The settlors hereby create _ _[*number*]_ _ separate trusts, one for each beneficiary named below, transferring to the trustee in equal shares for each trust, without consideration, _ _[*ten dollars ($10) or more/the property described in Schedule A, attached to this trust*]_ _. The share of the transferred property allocated to each trust, together with any other property subsequently becoming part of any trust, constitutes the trust estate of that trust and will be held, administered, and distributed by the trustee as provided in this agreement. The initial trust beneficiaries are _ _[*Names*]_ _. Additional separate trusts for additional beneficiaries may be established at any time.

8.5-1 Name of trust

B. *Name of Trust*. The trusts created by this instrument may be referred to collectively as the _ _[*e.g. The Mary Doe Irrevocable Life Insurance Trust No. 1*]_ _. Each separate trust created by this instrument may be referred to by adding the name of its beneficiary to that name.

10.122-1 Authorization of additions to trust

C. *Additions to Trust*. Other property acceptable to the trustee may be added to any trust created by this instrument by the will or codicil of either settlor, by the proceeds of any life insurance, or otherwise. Any transfer to the trustee which does not specify a different allocation shall be allocated in equal shares among the trusts then being administered under this agreement.

8.7-1 Irrevocability of trust

D. *Irrevocability of Trust*. This trust agreement is irrevocable, and the settlor has no powers of amendment.

ARTICLE TWO
Withdrawal Rights

12.96-1 *Crummey* clause without excess lapse protection

A. *Right to Withdraw Annual Exclusion Amounts*. At any time a gift is made by any donor to a trust governed by this agreement, the beneficiary of that trust shall each have the immediate right to demand and receive immediate distribution of an amount equal to the amount specified in a writing signed by the donor and delivered to the trustee no later than the time of the gift. If no such amount is specified, the amount that may be withdrawn shall be the lesser of:

(1) The amount of the gift divided by the number of persons having a right to demand a distribution with respect to the gift; or

(2) The amount of the Internal Revenue Code §2503(b) annual gift tax exclusion remaining available to the donor at the time of the gift for gifts to the distribution right holder in the calendar year. For purposes of determining the identity of the donor(s) and the amount of available gift tax exclusion remaining, any gift of separate property made by a married person shall be deemed to have been made one-half by that person and one-half by the spouse of that person unless either of those persons is not a citizen of the United States or the gift is accompanied by a statement that this sentence does not apply.

B. *Notice of Withdrawal Rights*. On receiving any gift to this trust that creates a distribution right under this article, the trustee shall immediately give written notice of the right to each person acquiring the right. If a right is acquired by a minor, notice also shall be given to a parent of the minor and any court-appointed guardian of the minor. If a right is acquired by an incompetent adult, notice also shall be given to all of the following then in existence: the adult's spouse, the adult's conservator, and the adult's attorney in fact. The donor may require additional notice by giving written notice to the trustee at the time of the gift.

C. *Exercise of Withdrawal Rights*. Each right to demand distribution shall expire unless it is exercised by delivering written notice to the trustee within 45 days following the date of the gift. In the case of a minor or incompetent adult, the right may be exercised on behalf of the holder by the holder's guardian, natural guardian, conservator, or attorney in fact. The trustee may, at the trustee's discretion, satisfy a distribution right holder's demand in cash or in kind using any trust assets. The distribution rights created by this article are superior to all other distribution rights created in this instrument, and provisions of this document providing for retention in further trust of assets otherwise distributable to persons under a specified age are not applicable.

ARTICLE THREE
Distributions

9.27-1 Distribution of income and principal or accumulation of income during settlor's lifetime

A. *Discretionary Distributions*. As long as the settlor and beneficiary are both living, the trustee may pay to or apply for the beneficiary's benefit as much of the net income and principal of the beneficiary's trust as the trustee, at the trustee's discretion, considers appropriate for the beneficiary's proper support, health, maintenance, and education, after taking into consideration to the extent the trustee considers advisable any of the beneficiary's other income or resources known to the trustee. Any net income not distributed shall be accumulated and added to principal.

B. *Distribution on Settlor's Death*. On the death of the settlor, the trustee shall distribute the entire trust estate to the beneficiary if the beneficiary survives the settlor.

C. *Beneficiary's Power of Appointment*. In the event the beneficiary fails to survive the settlor, the trust shall terminate on the beneficiary's death and the entire trust estate shall be distributed to the one or more persons and entities, including the beneficiary's estate, on terms and conditions (either outright or in trust) appointed by the beneficiary in a will or codicil specifically referring to and exercising this power of appointment. In the event this power is not exercised, the remaining trust estate shall be distributed, free of trust, to the beneficiary's then-living issue by right of representation. If there are no issue, the trust estate shall be distributed to _ _[*e.g., trusts for the beneficiary's issue*]_ _.

ARTICLE FOUR
Office of Trustee

10.33-1 Sole settlor's designation of successor trustees

A. *Nomination of Successor Trustees*. If at any time the _ _[*person/institution*]_ _ ceases to act as trustee, the _ _[*persons/institutions*]_ _ listed below shall serve as successor trustees _ _[*in the order named*]_ _:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

If the nominated successor also fails to qualify or ceases to act, _ _[*name*]_ _ shall have the power to name a successor trustee.

10.36-1 Trustee's power to designate successor

B. *Trustee's Power to Designate Successor Trustee*. Any acting trustee, including special trustee, shall have the power to designate one or more individuals or corporate fiduciaries to succeed the trustee in the event a vacancy in the position of trustee would otherwise occur. Any designation and revocation of that designation shall be made in a written instrument signed by the trustee while acting as trustee. In exercising this power, the acting trustee shall consider any tax consequences of any designation, and the trustee shall not designate a settlor. Different trusts may have different trustees.

11.20-1 Power to remove and replace trustee

C. *Removal of Trustee*. The settlor shall have the power to remove a trustee at any time. When a trustee is removed or at any other time a trustee ceases to act, the settlor may appoint a substitute trustee who shall immediately serve as the trustee, with any otherwise-nominated successor trustee not taking office until the substitute trustee ceases to act. The substitute trustee may not be a settlor or any person or entity related to or subordinate to a settlor within the meaning of Internal Revenue Code §672(c).

10.51-1 Reasonable compensation (individual trustee)

D. *Compensation of Trustee*. The trustee _ _[*other than a settlor*]_ _ shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

10.58-1 Trustee's powers

E. *Trustee Powers*. The trustee of each trust established under this instrument is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

(1) Each power enumerated in California Probate Code §§16047, 16052, 16200, 16220-16249, and any successor statutes as amended from time to time.

(2) The power to invest and reinvest in any kind of property or type of investment.

(3) The power to operate any business at the risk of the trust estate.

(4) The power to retain, purchase, or otherwise acquire unproductive property.

(5) The power to divide any trust created under this instrument into two or more trusts and to administer any addition to a trust as a separate trust.

(6) The power to exercise all rights, powers, and privileges of an owner of securities, insurance, or any other property owned by the trust.

(7) The power to lend money to persons not currently entitled to distributions from the trust as long as the loan is adequately secured and bears a reasonable rate of interest.

(8) The power to loan or advance the trustee's own funds to the trust for any trust purpose, with interest at

current rates; to receive security for such loans; to purchase assets of the trust at their fair market value as determined by an independent appraisal of those assets; and to sell property to the trust at a price not in excess of its fair market value as determined by an independent appraisal.

(9) The power to make or decline to make any tax election affecting the trust or its beneficiaries.

(10) The power to borrow money and to encumber trust property.

(11) The power to partition, allot, and distribute trust assets on any prorata or nonprorata division or distribution of any trust, in undivided interests or in kind or partly in money and partly in kind. For such purposes, assets shall be valued as of the date they are distributed or otherwise allocated.

ARTICLE FIVE
Life Insurance

11.19-1 Power to invest in life insurance (trustee not obligated to pay premium)

Despite any requirements of prudent investing that otherwise apply, the trustee is authorized, but not required, to invest any or all of the trust estate in insurance on the life of any person. The trustee also has the power to exercise all options, benefits, rights, and privileges of an owner of any insurance owned by the trust, including the right to borrow against and to pledge the insurance, to surrender it for its cash value, to name and change beneficiaries, and to select and change settlement options for the exclusive benefit of the trust estate. The trustee is not obligated to take any action to pay any premium on any life insurance policy unless the trustee has actual notice that the premium has not been paid. No trustee, however, may acquire insurance on the life of that trustee or exercise any incident of ownership with respect to a policy on the trustee's life. If the trust estate includes insurance on the life of a trustee for any reason, the other trustees or, if there are none, the next successor trustee shall exercise all incidents of ownership with respect to that insurance.

ARTICLE SIX
Miscellaneous

9.59-1 Perpetuities savings clause

A. *Perpetuities Savings Clause*. Each trust created by this instrument shall terminate no later than 21 years after the death of the last survivor of the beneficiaries of the trust who are living on the date the trust becomes irrevocable. If a trust terminates by reason of the previous sentence, the remaining trust estate shall be distributed to the persons then entitled to the trust income in the proportions of their income entitlement unless the trustee has discretion to distribute income among a class, in which case the trustee shall have the same discretion to distribute the remaining trust estate among the members of that class. For purposes of this paragraph, a trust created by the exercise of a special power of appointment as defined in California Probate Code §611 is not a new trust.

10.124-1 Short-form spendthrift clause

B. *Spendthrift Clause*. No interest in the principal or income of any trust created under this instrument shall be voluntarily or involuntarily anticipated, assigned, encumbered, or subjected to creditor's claim or legal process before actual receipt by the beneficiary.

10.126-1 Specifying law to govern validity, construction, and administration of trust

C. *Governing Law*. The internal laws (and not the law of conflicts) of the State of California _ _[*in force*]_ _ _ _[*on the date of execution of this trust/from time to time*]_ _ shall govern the validity, construction, interpretation, and administration of _ _[*this trust/any trust created under this instrument*]_ _, except that all matters relating to real property shall be governed by the laws of the situs.

10.43-1 Authorization of commingling of undivided interests

D. *Commingling of Undivided Interests*. The property belonging to the various trusts created under this instrument may be held in the form of undivided interests in property titled under the collective name of the trusts. The trustee must maintain proper books of account showing the property belonging to each trust.

8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _**, California, on** _ _[*date*]_ _**.**

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

State of California)
)
County of _ _[*name of county*]_ _ **)**
)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

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Appendix E

Life Insurance Trust for Spouse and Issue

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Description

The following form is appropriate for a trust which will not be exempt from the generation-skipping transfer (GST) tax because it is anticipated that no distributions will be made to skip persons. The trust should be funded with the separate property of the insured. Funding with community property would cause the beneficiary spouse to make a transfer with a retained interest, resulting in one half of the trust being includable in the survivor's estate. See chap 11. If the trust will be funded with an existing insurance policy, it may be desirable to provide that the trust estate will be distributed to the spouse if the trust is included in the insured's estate as a result of the insured failing to survive the transfer by three years. The spouse's annual *Crummey* withdrawal power is limited to the IRC §2514 "5 or 5" amount in order to minimize the risk that a portion of the trust will be included in the spouse's estate. It is preferable that the spouse not be given a *Crummey* power unless the power is necessary in order to provide sufficient annual gift tax exclusions to shield the annual transfers to the trust that are necessary to pay the policy premiums. The power will create an estate tax inclusion period (ETIP) for GST tax purposes and make it difficult to effectively allocate the GST exemption to the trust if this becomes appropriate because of the death or serious illness of a child. See chap 4.

The settlor cannot be trustee of this trust. Naming the spouse as trustee will result in the trust being a grantor for income tax purposes, but most insurance trusts generate little taxable income before the death of the insured.

CAVEAT: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix.

The Mary Doe Irrevocable Life Insurance Trust No. 1

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUST

A. Transfer to Trust

B. Name of Trust

C. Additions to Trust

D. Irrevocability of Trust

ARTICLE TWO: WITHDRAWAL RIGHTS

A. Withdrawal Right Limited to $5000 or 5 Percent

B. Notice of Withdrawal Rights

C. Withdrawal Rights Cumulative

C. Exercise of Withdrawal Rights

ARTICLE THREE: DISTRIBUTIONS

A. Discretionary Distributions

B. Spouse's Power of Appointment

ARTICLE FOUR: OFFICE OF TRUSTEE

A. Nomination of Successor Trustees

B. Trustee's Power to Designate Successor Trustee

C. Removal of Trustee

D. Compensation of Trustee

E. Accounting by Trustee

F. Trustee Powers

ARTICLE FIVE: LIFE INSURANCE

ARTICLE SIX: MISCELLANEOUS

A. Perpetuities Savings Clause

B. Spendthrift Clause

C. Governing Law

D. Definition of "Spouse"

E. Definition of "Children" and "Issue"

F. No-Contest Clause

The Mary Doe Irrevocable Life Insurance Trust No. 1

8.2-1 Trust agreement

This agreement is made between _ _[*name of settlor*]_ _ (called the "settlor") and _ _[*name of trustee*]_ _, as trustee.

ARTICLE ONE
Creation of Trust

A. *Transfer to Trust*. The settlor hereby transfers and delivers to the trustee, without consideration, _ _[*ten dollars ($10) or more/the property described in Schedule A, attached to this trust*]_ _. This property, together with any other property subsequently becoming part of the trust, constitutes the trust estate and will be held, administered, and distributed by the trustee as provided in this agreement.

8.5-1 Name of trust

B. *Name of Trust*. This trust may be referred to as _ _[*e.g. The Mary Doe Irrevocable Life Insurance Trust No. 1*]_ _.

10.122-1 Authorization of additions to trust

C. *Additions to Trust*. Other property acceptable to the trustee may be added to this trust by any person, by

the will or codicil of the settlor, by the proceeds of any life insurance, or otherwise.

8.7-1 Irrevocability of trust

D. *Irrevocability of Trust*. This trust agreement is irrevocable, and the settlor has no powers of amendment.

ARTICLE TWO
Withdrawal Rights

12.97-1 *Crummey* clause with "5 or 5" limitations

A. *Withdrawal Right Limited to $5000 or 5 Percent*. At any time a gift is made by any donor to this trust, the settlor's spouse and each child of the settlor shall each have the immediate right to demand and receive immediate distribution of an amount equal to the amount specified in a writing signed by the donor and delivered to the trustee no later than the time of the gift. If no such amount is specified, the amount that may be withdrawn shall be the lesser of:

(1) The amount of the gift divided by the number of persons having a right to demand a distribution with respect to the gift; or

(2) The amount of the Internal Revenue Code §2503(b) annual gift tax exclusion remaining available to the donor at the time of the gift for gifts to the distribution right holder in the calendar year. For purposes of determining the identity of the donor(s) and the amount of available gift tax exclusion remaining, any gift of separate property made by a married person shall be deemed to have been made one-half by that person and one-half by the spouse of that person unless either of those persons is not a citizen of the United States or the gift is accompanied by a statement that this sentence does not apply; or

(3) The remaining "5 or 5" amount (spouse only). The remaining 5 or 5 amount shall be determined by calculating a tentative 5 or 5 amount, which shall be the greater of $5000 or 5 percent of the aggregate value of the assets out of which, or the proceeds of which, an exercise of the withdrawal power could be satisfied, determined as of the date of the gift. The remaining 5 or 5 amount is the tentative 5 or 5 amount reduced by all demand rights held by the demand right holder with respect to this trust at any time during the calendar year to date, that have lapsed or might lapse during the calendar year. If more than one donor makes a gift to the trust at the same time, the remaining 5 or 5 amount shall be calculated based on the aggregate of the gifts, with the sum so determined then being divided by the number of donors making gifts at the same time for purposes of determining the annual gift tax exclusion to be allowed each donor. If as of the date of the gift the demand right holder has possessed or continues to possess any withdrawal rights under other trusts that have lapsed or might lapse during the calendar year, this and the other trusts subject to the holder's withdrawal powers shall be aggregated for purposes of computing the remaining 5 or 5 amount. The remaining 5 or 5 amount limitation applies only to the withdrawal power of the settlor's spouse.

B. *Notice of Withdrawal Rights*. On receiving any gift to this trust that creates a distribution right under this article, the trustee shall immediately give written notice of the right to each person acquiring the right. If a right is acquired by a minor, notice also shall be given to a parent of the minor and any court-appointed guardian of the minor. If a right is acquired by an incompetent adult, notice also shall be given to all of the following then in existence: the adult's spouse, the adult's conservator, and the adult's attorney in fact. The donor may require additional notice by giving written notice to the trustee at the time of the gift.

C. *Withdrawal Rights Cumulative*. The withdrawal rights created by this article are cumulative. At the end of each calendar year, the withdrawal rights of each holder that have been in existence more than 45 days shall expire as to that portion of such rights that is equal to the "maximum expiration amount." In the case of a demand right holder having no general power of appointment under another instrument that has lapsed during the calendar year, the maximum expiration amount is the greater of (a) $5000, or (b) 5 percent of the aggregate value of the assets out of which the demand right holder's withdrawal rights could be satisfied, determined using the value of the trust estate on the last day of the year. In other cases, the maximum expiration amount shall be calculated as if this trust and all trusts with respect to which the holder has allowed a general power of appointment to lapse during the calendar year were a single trust, and by reducing the result by the amounts of the lapses under the other trusts. The purpose of this provision is to prevent the occurrence of a lapse that would be treated as a release under Internal Revenue Code §2514(e).

D. *Exercise of Withdrawal Rights*. A withdrawal right may only be exercised by delivering written notice to the trustee before the right expires. In the case of a minor or incompetent adult, the right may be exercised on behalf of the holder by the holder's guardian, natural guardian, conservator, or attorney in fact. The trustee may, at the trustee's discretion, satisfy a distribution right holder's demand in cash or in kind using any trust assets. The withdrawal rights created by this article are superior to all other distribution rights created in this instrument, and provisions of this document providing for retention in further trust of assets otherwise distributable to persons under a specified age are not applicable.

ARTICLE THREE
Distributions

9.11-1 Sprinkling distributions

A. *Discretionary Distributions*. As long as either the settlor or the settlor's spouse is living, income of the trust estate shall be added to and become principal, and the trustee shall from time to time pay to or apply for the benefit of the settlor's spouse, _ _[*name*]_ _, children, _ _[*names*]_ _, and issue of any deceased child (the beneficiaries) or any of them, such amounts as the trustee determines appropriate for the beneficiaries' health, education (including study at an institution of higher education and vocational training), support, and comfort. The primary purpose of this trust is to provide for the settlor's spouse in the event the spouse survives the settlor, and the trustee shall consider this purpose in exercising its discretion. Notwithstanding the foregoing, no distribution shall be made during the lifetime of the settlor to or for the benefit of a person whom the settlor has a legal obligation to support, and no trustee shall have the power to make a distribution to or for the benefit of a person whom the trustee has an obligation to support.

B. *Spouse's Power of Appointment*. On the death of the settlor or the settlor's spouse, whichever is the last to die, the trustee shall distribute all or any portion of the trust estate (including both principal and any accrued or undistributed income) to such one or more of the "permitted appointees" or trusts for their benefit, as the settlor's spouse directs by instrument in writing filed with the trustee. The "permitted appointees" are the settlor's issue, and the spouses and surviving spouses (whether or not remarried) of the settlor's issue. This power of appointment is nongeneral and cannot be exercised directly or indirectly for the benefit of the surviving spouse, _ _[*his/her*]_ _ estate, _ _[*his/her*]_ _ creditors, or the creditors of _ _[*his/her*]_ _ estate. In the event the power is not exercised, the trustee shall distribute the trust estate to the then living issue of the settlor per capita at each generation.

ARTICLE FOUR
Office of Trustee

10.33-1 Sole settlor's designation of successor trustees

A. *Nomination of Successor Trustees*. If at any time the _ _[*person/institution*]_ _ fails to qualify or ceases to act as trustee, the _ _[*persons/institutions*]_ _ listed below shall serve as successor trustees _ _[*in the order named*]_ _:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

If the nominated successor also fails to qualify or ceases to act, _ _[*name*]_ _ shall have the power to name a successor trustee.

B. *Trustee's Power to Designate Successor Trustee*. Any acting trustee, including special trustee, shall have the power to designate one or more individuals or corporate fiduciaries to succeed the trustee in the event a vacancy in the position of trustee would otherwise occur. Any designation and revocation of that designation shall be made in a written instrument signed by the trustee while acting as trustee. In exercising this power, the acting trustee shall consider any tax consequences of any designation, and the trustee shall not designate a settlor.

11.20-1 Power to remove and replace trustee

C. *Removal of Trustee*. The settlors and the survivor of them shall have the power to remove a trustee at

any time. When a trustee is removed or at any other time a trustee ceases to act, the settlor may appoint a substitute trustee who shall immediately serve as the trustee, with any otherwise-nominated successor trustee not taking office until the substitute trustee ceases to act. The substitute trustee may not be a settlor or any person or entity related to or subordinate to a settlor within the meaning of Internal Revenue Code §672(c).

10.51-1 Reasonable compensation (individual trustee)

D. *Compensation of Trustee*. The trustee _ _[*other than a settlor*]_ _ shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

10.118-1 Accounting by trustee

E. *Accounting by Trustee*. The trustee shall account to the adult beneficiaries of the trust created under this instrument and, to the extent permitted by law, the written approval of the adult beneficiaries shall bind minor and contingent remainder interests.

10.58-1 Trustee's powers

F. *Trustee Powers*. The trustee of each trust established under this instrument is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

(1) Each power enumerated in California Probate Code §§16047, 16052, 16200, 16220-16249, and any successor statutes as amended from time to time.

(2) The power to invest and reinvest in any kind of property or type of investment.

(3) The power to operate any business at the risk of the trust estate.

(4) The power to retain, purchase, or otherwise acquire unproductive property.

(5) The power to divide any trust created under this instrument into two or more trusts and to administer any addition to a trust as a separate trust.

(6) The power to exercise all rights, powers, and privileges of an owner of securities, insurance, or any other property owned by the trust.

(7) The power to lend money to persons not currently entitled to distributions from the trust as long as the loan is adequately secured and bears a reasonable rate of interest.

(8) The power to loan or advance the trustee's own funds to the trust for any trust purpose, with interest at current rates; to receive security for such loans; to purchase assets of the trust at their fair market value as determined by an independent appraisal of those assets; and to sell property to the trust at a price not in excess of its fair market value as determined by an independent appraisal.

(9) The power to make or decline to make any tax election affecting the trust or its beneficiaries.

(10) The power to borrow money and to encumber trust property.

(11) The power to partition, allot, and distribute trust assets on any prorata or nonprorata division or distribution of any trust, in undivided interests or in kind or partly in money and partly in kind. For such purposes, assets shall be valued as of the date they are distributed or otherwise allocated.

ARTICLE FIVE
Life Insurance

11.19-1 Power to invest in life insurance (trustee not obligated to pay premium)

Despite any requirements of prudent investing that otherwise apply, the trustee is authorized, but not

required, to invest any or all of the trust estate in insurance on the life of any person. The trustee also has the power to exercise all options, benefits, rights, and privileges of an owner of any insurance owned by the trust, including the right to borrow against and to pledge the insurance, to surrender it for its cash value, to name and change beneficiaries, and to select and change settlement options for the exclusive benefit of the trust estate. The trustee is not obligated to take any action to pay any premium on any life insurance policy unless the trustee has actual notice that the premium has not been paid. No trustee, however, may acquire insurance on the life of that trustee or exercise any incident of ownership with respect to a policy on the trustee's life. If the trust estate includes insurance on the life of a trustee for any reason, the other trustees or, if there are none, the next successor trustee shall exercise all incidents of ownership with respect to that insurance.

ARTICLE SIX
Miscellaneous

9.59-1 Perpetuities savings clause

A. *Perpetuities Savings Clause*. Each trust created by this instrument shall terminate no later than 21 years after the death of the last survivor of the beneficiaries of the trust who are living on the date the trust becomes irrevocable. If a trust terminates by reason of the previous sentence, the remaining trust estate shall be distributed to the persons then entitled to the trust income in the proportions of their income entitlement unless the trustee has discretion to distribute income among a class, in which case the trustee shall have the same discretion to distribute the remaining trust estate among the members of that class. For purposes of this paragraph, a trust created by the exercise of a special power of appointment as defined in California Probate Code §611 is not a new trust.

10.124-1 Short-form spendthrift clause

B. *Spendthrift Clause*. No interest in the principal or income of any trust created under this instrument shall be voluntarily or involuntarily anticipated, assigned, encumbered, or subjected to creditor's claim or legal process before actual receipt by the beneficiary.

10.126-1 Specifying law to govern validity, construction, and administration of trust

C. *Governing Law*. The internal laws (and not the law of conflicts) of the State of California _ _[*in force*]_ _ _ _[*on the date of execution of this trust/from time to time*]_ _ shall govern the validity, construction, interpretation, and administration of _ _[*this trust/any trust created under this instrument*]_ _, except that all matters relating to real property shall be governed by the laws of the situs.

10.135-1 Spouse, husband, or wife

D. *Definition of "Spouse"*. All references in this trust to a person's spouse, husband, or wife shall mean any individual who is that person's then lawfully married spouse (determined by the laws of the jurisdiction in which the person then resides). An individual shall not be considered a spouse, husband, or wife unless that individual is actually residing with the person as husband or wife (disregarding temporary absences due to vacation, illness, or other emergency) when it is necessary to determine the individual's status as a spouse, husband, or wife. The term "spouse," "husband," or "wife" also shall include a widow or widower if that individual was residing at the time of the deceased person's death with the deceased as husband or wife (disregarding temporary absences due to vacation, illness, or other emergency). This determination shall be made at the trustee's discretion.

10.134-1 Issue and children (California law of intestate succession applies)

E. *Definition of " Children" and "Issue"*. The terms "child" and "children" refer to individuals entitled to take as such from a parent under the California law of intestate succession in effect on the date of this instrument. The term "issue" refers to lineal descendants of all generations, with the relationship of parent and child at each generation being determined in the same manner.

10.136-1 No-contest clause

F. *No-Contest Clause*. If any beneficiary under this trust, singly or in conjunction with any other person or persons, contests in any court the validity of this trust, of _ _[*a/the*]_ _ deceased _ _[*settlor's/settlors'*]_ _ last

will, or _ _[*a/the*]_ _ deceased _ _[*settlor's/settlors'*]_ _ beneficiary designation for any retirement plans, or seeks to obtain an adjudication in any proceeding in any court that this trust or any of its clauses, that will or any of its clauses, or that beneficiary designation is void, or seeks otherwise to void, nullify, or set aside this trust or any of its clauses, then that person's right to take any interest given to him or her by this trust shall be determined as it would have been determined if the person had predeceased the execution of this trust instrument _ _[*without surviving issue*]_ _. This clause shall not apply to any disclaimer by any person of any benefit under this trust or under any will.

The trustee is authorized to defend, at the expense of the trust estate, any contest or other attack of any nature on this trust or any of its provisions.

8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor _ _[*and Trustee*]_ _

__[*Signature of individual trustee*]__
_ _[*Typed name*]_ _
Trustee

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

State of California)
)
County of _ _[*name of county*]_ _)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

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Appendix F

Charitable Remainder Unitrust

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Description

This is a joint and survivor charitable remainder unitrust funded with community property for the benefit of the settlors during their joint lifetimes and for the survivor during his or her lifetime. The settlors each will receive 5 percent of the annual value of the trust assets each year during their joint lifetimes, and the survivor of the settlors will receive 5 percent of the annual value of the trust assets each year during his or her lifetime. On the death of the last settlor to die, the remaining property in the trust will be transferred to a public charity. An institution will serve as the trustee. For a form of charitable remainder annuity trust, see Appendix O.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

NOTE: If a private foundation is or may be the remainder beneficiary at the time when any principal or income of the trust is to be distributed to it, omit the reference to IRC §170(b)(1)(A) in Article 3(A) and Article 7(D).

CAVEAT: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix.

The John and Mary Doe Charitable Remainder Unitrust

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUST

- **A. Transfer to Trust**
- **B. Purpose of Trust**
- **C. Name of Trust**
- **D. Irrevocability of Trust**

ARTICLE TWO: UNITRUST PAYMENTS

- **A. Payment of Unitrust Amount**
- **B. Time of Payment**
- **C. Proration of Unitrust Amount**
- **D. Adjustment for Incorrect Valuation**

ARTICLE THREE: DISTRIBUTION TO CHARITY

- **A. Disposition of Remainder**
- **B. Termination of Unitrust Payment**

C. Partial Distributions in Kind

ARTICLE FOUR: ADDITIONAL CONTRIBUTIONS

A. Additional Contributions Permitted

B. Determination of Unitrust Amount on Contributions

C. Payment Deferred for Contributions at Death

ARTICLE FIVE: LIMITED POWER TO AMEND

ARTICLE SIX: OFFICE OF TRUSTEE

A. Nomination of Successor Trustees

B. Resignation of Trustee

C. Removal of Trustee

D. Appointment of Successor Trustee

E. Waiver of Trustee Bond

F. Compensation of Trustee

G. Corporate Trustee

H. Nonliability of Trustee

ARTICLE SEVEN: TRUSTEE PROHIBITIONS

A. Trustee Self-Dealing

B. No Investment Restriction on Trustee

C. Payment of Estate and Gift Taxes

D. No Other Noncharitable Payments

ARTICLE EIGHT: TRUSTEE POWERS

ARTICLE NINE: MISCELLANEOUS

A. Calendar Year

B. Governing Law

ACCEPTANCE BY TRUSTEE

SCHEDULE A

The John and Mary Doe Charitable Remainder Unitrust

8.2-1 Trust agreement

This agreement is made between _ _[*names of settlors*]_ _ (called the "settlors") and _ _[*name of trustee*]_ _, as trustee.

ARTICLE ONE
Creation of Trust

A. *Transfer to Trust*. The settlors hereby transfer and deliver to the trustee, without consideration, the property described in Schedule A attached to this trust. All property subject to this trust from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this agreement.

B. *Purpose of Trust*. The settlors desire to establish a charitable remainder unitrust within the meaning of Section 664(d)(2) of the Internal Revenue Code of 1986 (hereinafter referred to as the "Code").

8.5-1 Name of trust

C. *Name of Trust*. This trust may be referred to as _ _[*e.g., The John and Mary Doe*]_ _ Charitable Remainder Unitrust.

8.7-1 Trust is irrevocable

D. *Irrevocability of Trust*. This trust is irrevocable and may not be altered or amended in any respect except as specifically authorized by this instrument and may not be terminated except through distributions permitted by this instrument.

ARTICLE TWO
Unitrust Payments

18.56-1 Joint and survivor recipients

A. *Payment of Unitrust Amount*. The trustee shall pay the following unitrust amount to the following persons in _ _[*an annual/equal* _ _[*semiannual/quarterly/monthly*]_ _]_ _ payment(s) in each taxable year of the trust:

(1) During the joint lifetimes of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _, to _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ in equal shares a unitrust amount equal to 5 percent of the net fair market value of the trust assets valued on the _ _[*first/last/some other specified combination*]_ _ day(s) of each taxable year of the trust.

(2) After the death of the first to die of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _, to the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ the entire unitrust amount.

18.57-1 Payment from income, then principal

B. *Time of Payment*. The unitrust amount shall be paid at the _ _[*beginning/end*]_ _ of each payment period from income and, to the extent that income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal.

18.63-1 Proration of unitrust amount

C. *Proration of Unitrust Amount*. In determining the unitrust amount, the trustee shall prorate the same on a daily basis for a short taxable year of the trust and for the taxable year of the trust in which the interest of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ terminates.

18.71-1 Adjustment for incorrect valuation in unitrust

D. *Adjustment for Incorrect Valuation*. If the net fair market value of the trust assets is incorrectly determined, then, within a reasonable period after the value is finally determined for federal tax purposes, the trustee shall pay to _ _[*name(s) of recipient(s)*]_ _ (in the case of an undervaluation) or receive from _ _[*name(s) of recipient(s)*]_ _ (in the case of an overvaluation) an amount equal to the difference between the annuity amount properly payable and the annuity amount actually paid.

ARTICLE THREE
Distribution to Charity

18.67-1 Charitable remainder beneficiaries and alternative remainder beneficiaries

A. *Disposition of Remainder*. (1) On the death of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _, the entire remaining principal and accumulated income of the trust estate, other than any payment due to that survivor, shall be distributed as provided in paragraph (2).

(2) Any portion of the trust estate directed to be disposed of under this paragraph shall be distributed to _ _[*name of charity*]_ _. If _ _[*name of charity*]_ _ is not an organization described in Internal Revenue Code §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) when any income or principal of the trust estate is to be distributed to it, the trustee shall distribute the income or principal to one or more organizations selected by the trustee, at the trustee's discretion, which are then so described.

B. *Termination of Unitrust Payment*. In the year in which the death of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ occurs, the trustee's obligation to pay the unitrust amount shall terminate with the regular payment immediately preceding _ _[*his/her*]_ _ death.

Comment: If a private foundation is or may be the remainder beneficiary at the time when any principal or income of the trust is to be distributed to it, omit the reference to IRC §170(b)(1)(A).

18.99A-1 Partial distributions to charitable organizations

C. *Partial Distributions in Kind*. The adjusted basis for federal income tax purposes of any trust assets distributed in kind shall be fairly representative of the adjusted basis of all trust assets available for distribution on the date of distribution. After any distribution under this paragraph, payment of the amount referred to in Article Two shall be calculated based on the remaining net fair market value of the trust assets as of the next succeeding valuation date.

ARTICLE FOUR
Additional Contributions

10.122-1 Authorization of additions to trust

A. *Additional Contributions Permitted*. Other property acceptable to the trustee may be added to this trust by any person, by the will or codicil of either settlor, by the proceeds of any life insurance, or otherwise.

18.77-1 If additional contributions are permitted

B. *Determination of Unitrust Amount on Contributions*. If any additional contributions are made to the trust after the initial contribution, the unitrust amount for the taxable year in which the additional contributions are made shall be determined as follows:

(1) If no valuation date occurs after the date of the contribution and during the taxable year in which the contribution is made, the additional contribution shall be valued at the time of the contribution; and

(2) The unitrust amount for such year shall be _ _[*specify applicable percentage*]_ _ of the sum of (a) the fair market value of trust assets (excluding the assets so added and any income from or appreciation on such assets), plus (b) that proportion of the value of the assets so added that was excluded under (a) which the number of days in the period that begins with the date of contribution and ends with the earlier of the last day of the taxable year of the trust or _ _[*name of recipient's*]_ _ death bears to the number of days in the period that begins on the first day of that taxable year and ends with the earlier of the last day in the taxable year or death of _ _[*name of recipient*]_ _.

18.78-1 Additional contributions at death

C. *Payment Deferred for Contributions at Death*. If any additional contribution is made by will or other testamentary device that causes an additional contribution to be transferred at death, the obligation to pay the unitrust amount with respect to that additional contribution shall begin as of the date of the decedent's death, but payment of that unitrust amount may be deferred until the end of the taxable year in which the complete funding of the additional contribution occurs. Within a reasonable period after that, the trustee shall pay (in the

case of an underpayment) or shall receive from the recipient(s) (in the case of an overpayment) the difference between:

(1) Any unitrust amounts actually paid, plus interest compounded annually, computed for any period at the rate of interest that the federal income tax regulations under Internal Revenue Code §664 prescribe for the trust for this computation for that period; and

(2) The unitrust amounts payable determined under the method described in Treasury Regulation §1.664-1(a)(5)(ii). The unitrust amounts payable shall be retroactively determined by using the trust's taxable year, valuation method, and valuation date, and following the rules for retroactively determining the amounts payable specified in Treasury Regulation §1.664-1(a)(5)(i)-(ii).

ARTICLE FIVE
Limited Power To Amend

18.43-1 Savings provision

The settlors intend that this trust shall qualify as a charitable remainder unitrust under Internal Revenue Code §664, and all clauses of this instrument shall be interpreted according to this intention. The trustee shall have the power to amend the terms of this instrument in writing without application to any court to the extent permitted by the Internal Revenue Code and applicable Treasury Regulations to qualify and continue to qualify the trust as a charitable remainder unitrust under Internal Revenue Code §664. The powers conferred by this paragraph include, but are not limited to, the power to treat contributions to this trust as separate trusts when the contributions are so treated under Internal Revenue Code §664(d)(4).

ARTICLE SIX
Office of Trustee

10.33-1 Designation of successor trustees

A. *Nomination of Successor Trustees*. If at any time the institution named as trustee fails to qualify or ceases to serve as trustee, the _ _[*person(s)/institution(s)*]_ _ listed below shall serve as successor trustee(s) in the order named:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

If the nominated successor also fails to qualify or ceases to act, _ _[*name*]_ _ shall have the power to name a successor trustee.

10.28-1 Resignation of Trustee

B. *Resignation of Trustee*. Any trustee may resign at any time on sixty (60) days written notice to the settlor(s). The trustee shall continue to act until a successor trustee accepts the trusteeship.

10.30-1 Trustee removal

C. *Removal of Trustee*. The settlors or the survivor of them may remove any trustee at any time on thirty (30) days written notice. On such removal, a successor trustee shall be appointed under the provisions in paragraphs A and D of this article.

Successor trustee if no trustee is acting

D. *Appointment of Successor Trustee*. If no trustee is acting, _ _[*e.g., the charitable remainder beneficiary* (*if more than one, specify which*)]_ _ shall appoint a successor trustee. If at any time no trustee is acting, and the charitable remainder beneficiary has failed to select a trustee, a successor trustee shall be appointed by a court of competent jurisdiction.

10.49-1 Trustee's bond

E. *Waiver of Trustee Bond*. No bond shall be required of any person named in this instrument as trustee, or of any person appointed as trustee in the manner specified in this trust, for the faithful performance of his or her duties as trustee.

10.51-1 Reasonable compensation (individual trustee)

F. *Compensation of Trustee*. The trustee shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

Trustee includes corporation or association or successor corporation

G. *Corporate Trustee*. Reference in this instrument to the trustee shall include any corporation or association that may become a successor trustee or any successor corporation that may succeed to a corporate trustee's business.

Comment: When an institutional trustee is being used, this provision should be included.

10.41-1 Successor trustee's nonliability for predecessor's acts

H. *Nonliability of Successor Trustee*. All rights, powers, authority, immunity and discretion herein granted or conferred on the original trustee shall survive to and may be exercised or applied in the same manner and to the same extent by or for any successor or substitute that may at any time be acting hereunder. No successor trustee shall be liable for any act, omission, or default of a predecessor trustee. The successor trustee may accept the accounting records of the predecessor trustee showing assets on hand without further investigation and without incurring any liability to any person claiming or having an interest in the trust.

ARTICLE SEVEN
Trustee Prohibitions

18.81-1 Private foundation prohibitions

A. *Prohibited Transactions*. Except for the payment of the unitrust amount to _ _[*name(s) of recipient(s)*]_ _, the trustee is prohibited from engaging in any act of self-dealing as defined in Internal Revenue Code §4941(d), from retaining any excess business holdings as defined in Internal Revenue Code §4943(c) that would subject the trust to tax under Internal Revenue Code §4943, from making any investments that would be subject to tax under Internal Revenue Code §4944 of the Code, and from making any taxable expenditures as defined in Internal Revenue Code §4945(d). The trustee shall make distributions at such time and in such manner so as not to subject the trust to tax under Internal Revenue Code §4942.

Comment: See discussion in §18.80 about leaving out references to IRC §§4943(c) and 4944.

18.83-1 Investment of trust assets

B. *No Investment Restriction on Trustee*. Nothing in this trust instrument shall be construed to restrict the trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

18.85-1 No taxes payable from trust

C. *Payment of Estate and Gift Taxes*. No gift, legacy, succession, inheritance, estate taxes, or generation-skipping transfer taxes that may be assessed against the property of the trust created by this instrument by reason of a settlor's transfer to the trust or a settlor's death shall be paid out of any property held in this trust. Each settlor agrees on behalf of himself or herself, his or her heirs, legal representatives, successors and assigns, to provide for payments of any such taxes from sources other than property held by this trust and to indemnify and hold harmless the trustee from any and all liability for such taxes. Each settlor agrees that the trustee shall not be liable for any federal or state death taxes or generation-skipping transfer taxes payable. Each settlor imposes an obligation on _ _[*his/her*]_ _ estate to pay all such taxes, and each settlor agrees to

provide for the payment of all such taxes from sources other than the trust estate.

Each settlor has provided for the payment of any death taxes and generation-skipping transfer taxes resulting from his or her death from sources other than this trust. Nevertheless, if for any reason, the charitable remainder unitrust becomes liable for such taxes on the death of the first settlor to die, the interest of _ _[*name of secondary recipient*]_ _ shall not take effect unless _ _[*name of secondary recipient*]_ _ agrees to pay and pays federal or state death and generation-skipping transfer taxes for which the trustee may be liable on the death of the first the settlor to die. If _ _[*name of secondary recipient*]_ _ fails to agree to pay and to pay all such taxes, _ _[*name of secondary recipient*]_ _ shall be considered to have predeceased the first settlor to die for all purposes of the part of this trust attributable to the deceased settlor's death.

18.86-1 No other noncharitable payments

D. *No Other Noncharitable Payments*. No amount other than the unitrust amount described in Article Two of this instrument or an amount transferred for full and adequate consideration may be paid to or for the use of any person other than an organization described in Internal Revenue Code sections 170(b)(1)(A), 170(c), 2055(a), and 2522(a).

Comment: If a private foundation is or may be the remainder beneficiary at the time when any principal or income of the trust is to be distributed to it, omit the reference to IRC §170(b)(1)(A).

ARTICLE EIGHT
Trustee Powers

10.58-1 Trustee's powers

The trustee is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

(1) Each power enumerated in California Probate Code sections 16047, 16052, 16200, 16220-16249, and any successor statutes as amended from time to time.

(2) The power to make or decline to make any tax election affecting the trust or its beneficiaries.

(3) The power to determine the market value of any investment of any trust for any purpose on the basis of such quotation, evidence, data, or information, as the trustee may deem pertinent and reliable; to make any division or distribution prorata or nonprorata, in undivided interests or in kind or partly in money and partly in kind on partial or final distribution.

(4) Notwithstanding any other provision of this instrument, the trustee's powers and discretions shall not include any power or discretion that is in conflict with Internal Revenue Code §664 and the regulations thereunder or any specific provision of this instrument.

ARTICLE NINE
Miscellaneous

18.87-1 Taxable year

A. *Calendar Year*. The taxable year of the trust shall be the calendar year.

18.88-1 Governing law

B. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state*]_ _. The trustee is prohibited, however, from exercising any power or discretion granted under those laws that would be inconsistent with the qualification of the trust under Internal Revenue Code §664 and the corresponding regulations.

8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]_
_ _[*Typed name*]_ _
Settlor

_ _[*Signature of settlor*]_ _
_ _[*Typed name*]_ _
Settlor

State of California)
)
County of _ _[*name of county*]_ _)
)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

ACCEPTANCE BY TRUSTEE

In consideration of the foregoing, the trustee accepts the trust thus committed to it and agrees to act in accordance with the terms stated above.

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

[*Acknowledgment; see §8.12*]

SCHEDULE A

Items:

1.

2.

Accepted by the trustee:

Dated: _ _ _ _ _ _ _ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

Comment: See discussion in the Note in §18.40 regarding the use of dated and signed Schedule A as proof of creation and funding of charitable remainder trust.

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Appendix G

IRS Charitable Remainder Unitrusts for One and Two Lives or a Term of Years

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Description

Revenue Procedures 2005-52—2005-55, 2005-2 Cum Bull 326, contain sample declarations of trusts that meet the requirements for inter vivos charitable remainder unitrusts for one and two lives or a term of years under IRC §664(d)(2). (Revenue Procedures 2005-56—2003-59, 2005-2 Cum Bull 383, contain sample testamentary charitable remainder unitrust forms.) The following four sample inter vivos trusts (including alternative provisions) are republished in this appendix:

1. Unitrust Payments During One Life;
2. Unitrust Payments for a Term of Years;
3. Unitrust Payments During Two Lives, Consecutive Interests;
4. Unitrust Payments During Two Lives, Concurrent and Consecutive Interests.

Revenue Procedures 2005-52—2005-55 provide that a trust that substantially follows one of the sample forms given will meet the requirements of charitable remainder unitrusts, if the trust otherwise operates in a manner consistent with the terms of the creating instrument and if it is a valid trust under local law.

This form meets the requirements for an inter vivos charitable remainder unitrust for one life under IRC §664(d)(2) and (d)(3). Rev Proc 2005-52, 2005-2 Cum Bull 326.

Unitrust Payments During One Life

On this _ _[*ordinal number*]_ _ day of _ _[*month*]_ _, _ _[*year*]_ _, I, _ _[*name of donor*]_ _ (hereinafter "the Donor"), desiring to establish a charitable remainder unitrust within the meaning of Rev Proc 2005-52 and Internal Revenue Code (hereinafter "IRC") §664(d)(2) _ _[*and §664(d)(3)*]_ _, hereby enter into this trust agreement with _ _[*name of trustee*]_ _ as the initial trustee (hereinafter "the Trustee"). This trust shall be known as the _ _[*name of trust*]_ _ Charitable Remainder Unitrust.

1. *Funding of Trust*. The Donor hereby transfers and irrevocably assigns, on the above date, to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property, and any property subsequently transferred, under the terms set forth in this trust instrument.

[*Add one of the following alternatives*]

[*Alternative 1a: Payment of unitrust amount to individual (fixed percentage method)*]

[*Alternative 1a: Fixed percentage method*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipient") a unitrust amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date"). The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Recipient's death.

[*Alternative 1b: Payment of unitrust amount to individual (net income method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall

pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipient") a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The valuation date is the first day of each taxable year of the trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Recipient's death.

[*Alternative 1c: Payment of unitrust amount to individual (net income with make-up method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipient") a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2, but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2 and (a) of paragraph 5. The valuation date is the first day of each taxable year of the trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Recipient's death.

[*Alternative 1d: Payment of unitrust amount to individual (combination of net income method and fixed-percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the Recipient the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations.

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the Recipient in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i).

(iii) *In general*. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Recipient's death. The valuation date is the first day of each taxable year of the trust.

[*Alternative 1e: Payment of unitrust amount to individual (combination of net income with make-up method and fixed-percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income with make-up method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the Recipient the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2(i)") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2(i), but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2(i) and (a) of paragraph 5(i).

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the Recipient in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i) and shall not pay any amount of trust income described in the second sentence of paragraph 2(i).

(iii) *In general*. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Recipient's death. The valuation date is the first day of each taxable year of the trust.

[*Alternative 2: Payment of part of unitrust amount to charity (fixed percentage method of calculating unitrust amount)*]

2. *Payment of Unitrust Amount*. The unitrust amount is equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date"). In each taxable year of the trust during the unitrust period, the Trustee shall pay _ _[*number*]_ _ percent of the unitrust amount to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipient") and _ _[*number*]_ _ percent of the unitrust amount to _ _[*name of charitable organization*]_ _ (hereinafter "the Charitable Recipient"). The first day of the unitrust period shall be the date the property is transferred to the trust and the last day of the unitrust period shall be the date of the Recipient's death. If the Charitable Recipient is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any unitrust payment is to be distributed to it, then the Trustee shall distribute that unitrust payment to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Continue*]

The unitrust amount shall be paid in equal quarterly installments at the end of each calendar quarter from income, and to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the correct value is finally determined, the Trustee shall pay to the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an undervaluation) or receive from the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.

[*Add one of the following alternatives*]

[*Alternative 1: Fixed percentage method*]

3. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in paragraph 2, or, if an additional contribution is made to the trust, the unitrust amount described in paragraph 5.

[*Alternative 2: Net income method*]

3. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2, or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 5. In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2 or in (a) of paragraph 5 to determine the unitrust amount payable for that year.

[*Alternative 3: Net income with make-up method*]

3. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2, or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 5. In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2 or in (a) of paragraph 5 to determine the unitrust amount payable for that year.

[*Alternative 4: Combination of net income method and fixed percentage method*]

3. *Proration of Unitrust Amount*.

(i) *Proration in years preceding effective date of triggering event*. For a short taxable year before the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2(i), or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 5(i). In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2(i) or in (a) of paragraph 5(i) to determine the unitrust amount payable for that year.

(ii) *Proration on and after effective date of triggering event*. For a short taxable year beginning on or after the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in (a) of paragraph 2(ii), or, if an additional contribution is made to the trust, the unitrust amount described in (a) of paragraph 5(ii).

[*Alternative 5: Combination of net income with make-up method and fixed percentage method*]

3. *Proration of Unitrust Amount*.

(i) *Proration in years preceding effective date of triggering event*. For a short taxable year before the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2(i), or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 5(i). In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2(i) or in (a) of paragraph 5(i) to determine the unitrust amount payable for that year.

(ii) *Proration on and after effective date of triggering event*. For a short taxable year beginning on or after the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in (a) of paragraph 2(ii), or, if an additional contribution is made to the trust, the unitrust amount described in (a) of paragraph 5(ii).

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Named charity as remainderman*]

4. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient _ _[*and the Charitable Recipient*]**_ _ under the provisions above) to _ _**[*name of designated remainderman*]**_ _ (hereinafter "the Charitable Organization").**

[*If applicable, add the following option*]

[*Option: Retained right to substitute remainderman*]

The donor reserves the right to designate, at any time and from time to time, in lieu of the Charitable Organization identified above, one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the charitable remainderman and shall make any such designation by giving written notice to the Trustee.

[*Continue*]

If the Charitable Organization is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Alternative 2: Recipient's power to appoint remainderman*]

4. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient _ _[*and the Charitable Recipient*]_ _ under the provisions above) to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Recipient shall appoint and direct by specific reference to this power of appointment by inter vivos or testamentary instrument. To the extent that the Recipient fails to effectively exercise this power of appointment, the principal and income not effectively appointed shall be distributed to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion. If an organization fails to qualify as an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Fixed percentage method*]

5. *Additional Contributions*. If any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be _ _[*same percentage used in paragraph 2*]_ _ percent of the sum of (a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

[*Alternative 2: Net income method*]

5. *Additional Contributions*. Notwithstanding paragraph 2, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of (a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2*]_ _ percent of the sum of (1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 5") or (b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

[*Alternative 3: Net income with make-up method*]

5. *Additional Contributions*. Notwithstanding paragraph 2, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of (a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2*]_ _ percent of the sum of (1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 5") or (b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations. The unitrust amount for that year shall also include any amount of the trust income for the year that is in excess of the fixed

percentage amount determined under (a) of this paragraph 5 for the year, but only to the extent that the aggregate of the amounts paid to Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of paragraph 2 and (a) of this paragraph 5.

[*Alternative 4: Combination of net income method and fixed-percentage method*]

5. *Additional Contributions*.

(i) *Additional contributions made before effective date of triggering event*. Notwithstanding paragraph 2(i), if any additional contributions are made to the trust after the initial contribution, and before the effective date of the triggering event, the unitrust amount for the year in which the additional contribution is made shall be equal to the lesser of:

(a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 5(i)"); or

(b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

(ii) *Additional contributions made on or after effective date of triggering event*. Notwithstanding paragraph 2(ii), if any additional contributions are made to the trust after the initial contribution, and on or after the effective date of the triggering event, the unitrust amount described in paragraph 2(ii) for the year in which the additional contribution is made shall be _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

Beginning on the effective date of the triggering event, the trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 5(i).

[*Alternative 5: Combination of net income with make-up method and fixed-percentage method*]

5. *Additional Contributions*.

(i) *Additional contributions made before effective date of triggering event*. Notwithstanding paragraph 2(i), if any additional contributions are made to the trust after the initial contribution, and before the effective date of the triggering event, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of:

(a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 5(i)"); or

(b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

The unitrust amount for that year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 5(i), but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of paragraph 2(i) and (a) of this paragraph 5(i).

(ii) *Additional contributions made on or after effective date of triggering event*. Notwithstanding paragraph 2(ii), if any additional contributions are made to the trust after the initial contribution, and on or after the effective date of the triggering event, the unitrust amount described in paragraph 2(ii) for the year in which the additional contribution is made shall be _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 5(i) and shall not pay any amount of income described in the second sentence of paragraph 5(i).

[*Continue*]

In a taxable year in which an additional contribution is made on or after the valuation date, the assets so added shall be valued as of the date of contribution, without regard to any post-contribution income or appreciation, rather than as of the valuation date.

6. *Deferral of Unitrust Payment Allocable to Testamentary Transfer*. All property passing to the trust by reason of the death of the Donor (hereinafter "the testamentary transfer") shall be considered to be a single contribution that is made on the date of the Donor's death. Notwithstanding the provisions of paragraphs 2 and 5 above, the obligation to pay the unitrust amount with respect to the testamentary transfer shall commence with the date of the Donor's death. Nevertheless, payment of the unitrust amount with respect to the testamentary transfer may be deferred from the date of the Donor's death until the end of the taxable year in which the funding of the testamentary transfer is completed. Within a reasonable time after the end of the taxable year in which the funding of the testamentary transfer is completed, the Trustee must pay to the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an underpayment) or receive from the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an overpayment) the difference between any unitrust amounts allocable to the testamentary transfer that were actually paid, plus interest, and the unitrust amounts allocable to the testamentary transfer that were payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under IRC §664 prescribe for this computation.

7. *Unmarketable Assets*. Whenever the value of a trust asset must be determined, the Trustee shall determine the value of any assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents (hereinafter "unmarketable assets"), by either (a) obtaining a current "qualified appraisal" from a "qualified appraiser," as defined in Treas Reg §1.170A-13(c)(3) and (c)(5), respectively, or (b) ensuring the valuation of these unmarketable assets is performed exclusively by an "independent trustee," within the meaning of Treas Reg §1.664-1(a)(7)(iii).

8. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of IRC §4941(d), as modified by IRC §4947(a)(2)(A), and shall not make any taxable expenditures within the meaning of IRC §4945(d), as modified by IRC §4947(a)(2)(A).

9. *Taxable Year*. The taxable year of the trust shall be the calendar year.

10. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state, e.g., California*]_ _. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder unitrust under IRC §664(d)(2) _ _[*and §664(d)(3)*]_ _ and the corresponding regulations.

11. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder unitrust within the meaning of IRC §664(d)(2) _ _[*and §664(d)(3)*]_ _.

12. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

13. *Definition of Recipient*. References to the Recipient in this trust instrument shall be deemed to include the estate of the Recipient with regard to all provisions in this trust instrument that describe amounts payable to and/or due from the Recipient. The prior sentence shall not apply to the determination of the last day of the unitrust period.

This form meets the requirements for an inter vivos charitable remainder unitrust for a term of years under IRC §664(d)(2) and (d)(3). Rev Proc 2005-53, 2005-2 Cum Bull 339.

Unitrust Payments for a Term of Years

On this _ _[*ordinal number*]_ _ day of _ _[*month*]_ _, _ _[*year*]_ _, I, _ _[*name of donor*]_ _ (hereinafter "the Donor"), desiring to establish a charitable remainder unitrust within the meaning of Rev Proc 2005-53 and Internal Revenue Code (hereinafter "IRC") §664(d)(2) _ _[*and §664(d)(3)*]_ _, hereby enter into this trust agreement with _ _[*name of trustee*]_ _ as the initial trustee (hereinafter "the Trustee"). This trust shall be known as the _ _[*name of trust*]_ _ Charitable Remainder Unitrust.

1. *Funding of Trust*. The Donor hereby transfers and irrevocably assigns, on the above date, to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property, and any property subsequently transferred, under the terms set forth in this trust instrument.

[*Add one of the following alternatives*]

[*Alternative 1a: Payment of unitrust amount to individual (fixed percentage method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipient") a unitrust amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date"). The unitrust period shall be a period of _ _[*number not more than 20*]_ _ years. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the day preceding the _ _[*ordinal number corresponding to the unitrust period*]_ _ anniversary of that date.

[*Alternative 1b: Payment of unitrust amount to individual (net income method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipient") a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The valuation date is the first day of each taxable year of the trust. The unitrust period shall be a period of _ _[*number not more than 20*]_ _ years. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the day preceding the _ _[*ordinal number corresponding to the unitrust period*]_ _ anniversary of that date.

[*Alternative 1c: Payment of unitrust amount to individual (net income with make-up method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipient") a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2, but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2 and (a) of paragraph 5. The valuation date is the first day of each taxable year of the trust. The unitrust period shall be a period of _ _[*number not more than 20*]_ _ years. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the day preceding the _ _[*ordinal number corresponding to the unitrust period*]_ _ anniversary of that date.

[*Alternative 1d: Payment of unitrust amount to individual (combination of net income method and fixed-percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the Recipient the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations.

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the Recipient in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i).

(iii) *In general*. The unitrust period shall be a period of _ _[*number not more than 20*]_ _ years. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the day preceding the _ _[*ordinal number corresponding to the unitrust period*]_ _ anniversary of that date. The valuation date is the first day of each taxable year of the trust.

[*Alternative 1e: Payment of unitrust amount to individual (combination of net income with make-up method and fixed-percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income with make-up method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the Recipient the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2(i)") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust

amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2(i), but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2(i) and (a) of paragraph 5(i).

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the Recipient in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i) and shall not pay any amount of trust income described in the second sentence of paragraph 2(i).

(iii) *In general*. The unitrust period shall be a period of _ _[*number not more than 20*]_ _ years. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the day preceding the _ _[*ordinal number corresponding to the unitrust period*]_ _ anniversary of that date. The valuation date is the first day of each taxable year of the trust.

[*Alternative 2: Payment of part of unitrust amount to charity (fixed percentage method of calculating unitrust amount)*]

2. *Payment of Unitrust Amount*. The unitrust amount is equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date"). In each taxable year of the trust during the unitrust period, the Trustee shall pay _ _[*number*]_ _ percent of the unitrust amount to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipient") and _ _[*number*]_ _ percent of the unitrust amount to _ _[*name of charitable organization*]_ _ (hereinafter "the Charitable Recipient"). The unitrust period shall be a period of _ _[*number not more than 20*]_ _ years. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the day preceding the _ _[*ordinal number corresponding to the unitrust period*]_ _ anniversary of that date. If the Charitable Recipient is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any unitrust payment is to be distributed to it, then the Trustee shall distribute that unitrust payment to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Continue*]

The unitrust amount shall be paid in equal quarterly installments at the end of each calendar quarter from income, and to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the correct value is finally determined, the Trustee shall pay to the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an undervaluation) or receive from the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.

[*Add one of the following alternatives*]

[*Alternative 1: Fixed percentage method*]

3. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in paragraph 2, or, if an additional contribution is made to the trust, the unitrust amount described in paragraph 5.

[*Alternative 2: Net income method*]

3. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2, or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 5. In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2 or in (a) of paragraph 5 to determine the unitrust amount payable for that year.

[*Alternative 3: Net income with make-up method*]

3. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2, or, if an additional contribution is made to the trust, the unitrust amount described in (a) of paragraph 5. In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2 or in (a) of paragraph 5 to determine the unitrust amount payable for that year.

[*Alternative 4: Combination of net income method and fixed percentage method*]

3. *Proration of Unitrust Amount*.

(i) *Proration in years preceding effective date of triggering event*. For a short taxable year before the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2(i), or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 5(i). In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2(i) or in (a) of paragraph 5(i) to determine the unitrust amount payable for that year.

(ii) *Proration on and after effective date of triggering event*. For a short taxable year beginning on or after the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in paragraph 2(ii), or, if an additional contribution is made to the trust, the unitrust amount described in paragraph 5(ii).

[*Alternative 5: Combination of net income with make-up method and fixed percentage method*]

3. *Proration of Unitrust Amount*.

(i) *Proration in years preceding effective date of triggering event*. For a short taxable year before the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2(i), or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 5(i). In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2(i) or in (a) of paragraph 5(i) to determine the unitrust amount payable for that year.

(ii) *Proration on and after effective date of triggering event*. For a short taxable year beginning on or after the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in (a) of paragraph 2(ii), or, if an additional contribution is made to the trust, the unitrust amount described in (a) of paragraph 5(ii).

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Named charity as remainderman*]

4. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient _ _[*and the Charitable Recipient*]**_ _ under the provisions above) to _ _**[*name of designated remainderman*]**_ _ (hereinafter "the Charitable Organization").**

[*If applicable, add the following option*]

[*Option: Retained right to substitute remainderman*]

The donor reserves the right to designate, at any time and from time to time, in lieu of the Charitable Organization identified above, one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the charitable remainderman and shall make any such designation by giving written notice to the Trustee.

[*Continue*]

If the Charitable Organization is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Alternative 2: Recipient's power to appoint remainderman*]

4. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient _ _[*and the Charitable Recipient*]**_ _ under the provisions above) to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Recipient shall appoint and direct by specific reference to this power of appointment by inter vivos or testamentary instrument. To the extent that the Recipient fails to effectively exercise this power of appointment, the principal and income not effectively appointed shall be distributed to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion. If an organization fails to qualify as an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.**

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Fixed percentage method*]

5. *Additional Contributions*. If any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be _ _[*same percentage used in paragraph 2*]**_ _ percent of the sum of (a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.**

[*Alternative 2: Net income method*]

5. *Additional Contributions*. Notwithstanding paragraph 2, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of (a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2*]**_ _ percent of the sum of (1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 5") or (b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.**

[*Alternative 3: Net income with make-up method*]

5. *Additional Contributions*. Notwithstanding paragraph 2, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of (a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2*]**_ _ percent of the sum of (1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (2) for each additional contribution during the year, the fair market value of the assets so**

added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 5") or (b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations. The unitrust amount for that year shall also include any amount of the trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 5 for the year, but only to the extent that the aggregate of the amounts paid to Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of paragraph 2 and (a) of this paragraph 5.

[*Alternative 4: Combination of net income method and fixed-percentage method*]

5. *Additional Contributions*.

(i) *Additional contributions made before effective date of triggering event*. Notwithstanding paragraph 2(i), if any additional contributions are made to the trust after the initial contribution, and before the effective date of the triggering event, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of:

(a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 5(i)"); or

(b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

(ii) *Additional contributions made on or after effective date of triggering event*. Notwithstanding paragraph 2(ii), if any additional contributions are made to the trust after the initial contribution, and on or after the effective date of the triggering event, the unitrust amount described in paragraph 2(ii) for the year in which the additional contribution is made shall be _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

Beginning on the effective date of the triggering event, the trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 5(i).

[*Alternative 5: Combination of net income with make-up method and fixed-percentage method*]

5. *Additional Contributions*.

(i) *Additional contributions made before effective date of triggering event*. Notwithstanding paragraph 2(i), if any additional contributions are made to the trust after the initial contribution, and before the effective date of the triggering event, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of:

(a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 5(i)"); or

(b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

The unitrust amount for that year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 5(i), but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of paragraph 2(i) and (a) of this paragraph 5(i).

(ii) *Additional contributions made on or after effective date of triggering event*. Notwithstanding paragraph 2(ii), if any additional contributions are made to the trust after the initial contribution, and on or after the effective date of the triggering event, the unitrust amount described in paragraph 2(ii) for the year in which the additional contribution is made shall be _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 5(i) and shall not pay any amount of income described in the second sentence of paragraph 5(i).

[*Continue*]

In a taxable year in which an additional contribution is made on or after the valuation date, the assets so added shall be valued as of the date of contribution, without regard to any post-contribution income or appreciation, rather than as of the valuation date.

6. *Deferral of Unitrust Payment Allocable to Testamentary Transfer*. All property passing to the trust by reason of the death of the Donor (hereinafter "the testamentary transfer") shall be considered to be a single contribution that is made on the date of the Donor's death. Notwithstanding the provisions of paragraphs 2 and 5 above, the obligation to pay the unitrust amount with respect to the testamentary transfer shall commence with the date of the Donor's death. Nevertheless, payment of the unitrust amount with respect to the testamentary transfer may be deferred from the date of the Donor's death until the end of the taxable year in which the funding of the testamentary transfer is completed. Within a reasonable time after the end of the

taxable year in which the funding of the testamentary transfer is completed, the Trustee must pay to the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an underpayment) or receive from the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an overpayment) the difference between any unitrust amounts allocable to the testamentary transfer that were actually paid, plus interest, and the unitrust amounts allocable to the testamentary transfer that were payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under IRC §664 prescribe for this computation.

7. *Unmarketable Assets*. Whenever the value of a trust asset must be determined, the Trustee shall determine the value of any assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents (hereinafter "unmarketable assets"), by either (a) obtaining a current "qualified appraisal" from a "qualified appraiser," as defined in Treas Reg §1.170A-13(c)(3) and (c)(5), respectively, or (b) ensuring the valuation of these unmarketable assets is performed exclusively by an "independent trustee," within the meaning of Treas Reg §1.664-1(a)(7)(iii).

8. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of IRC §4941(d), as modified by IRC §4947(a)(2)(A), and shall not make any taxable expenditures within the meaning of IRC §4945(d), as modified by IRC §4947(a)(2)(A).

9. *Taxable Year*. The taxable year of the trust shall be the calendar year.

10. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state, e.g., California*]_ _. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder unitrust under IRC §664(d)(2) _ _[*and §664(d)(3)*]_ _ and the corresponding regulations.

11. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder unitrust within the meaning of IRC §664(d)(2) _ _[*and §664(d)(3)*]_ _.

12. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

13. *Definition of Recipient*. References to the Recipient in this trust instrument shall be deemed to include the estate of the Recipient with regard to all provisions in this trust instrument that describe amounts payable to and/or due from the Recipient. The prior sentence shall not apply to the determination of the last day of the unitrust period.

This form meets the requirements for an inter vivos charitable remainder unitrust for two lives with consecutive interests under IRC §664(d)(2) and (d)(3). Rev Proc 2005-54, 2005-2 Cum Bull 353.

Unitrust Payments During Two Lives, Consecutive Interests

On this _ _[*ordinal number*]_ _ day of _ _[*month*]_ _, _ _[*year*]_ _, I, _ _[*name of donor*]_ _ (hereinafter "the Donor"), desiring to establish a charitable remainder unitrust within the meaning of Rev Proc 2005-54 and Internal Revenue Code (hereinafter "IRC") §664(d)(2) _ _[*and §664(d)(3)*]_ _, hereby enter into this trust agreement with _ _[*name of trustee*]_ _ as the initial trustee (hereinafter "the Trustee"). This trust shall be known as the _ _[*name of trust*]_ _ Charitable Remainder Unitrust.

1. *Funding of Trust*. The Donor hereby transfers and irrevocably assigns, on the above date, to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property, and any property subsequently transferred, under the terms set forth in this trust instrument.

[*Add one of the following alternatives*]

[*Alternative 1a: Payment of unitrust amount to individual (fixed percentage method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall

pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of another permissible recipient*]_ _ (hereinafter "the Successor Recipient"), a unitrust amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date"). The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the death of the survivor of the Initial Recipient and the Successor Recipient.

[*Alternative 1b: Payment of unitrust amount to individual (net income method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of another permissible recipient*]_ _ (hereinafter "the Successor Recipient"), a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The valuation date is the first day of each taxable year of the trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the date of the death of the survivor of the Initial Recipient and the Successor Recipient.

[*Alternative 1c: Payment of unitrust amount to individual (net income with make-up method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of another permissible recipient*]_ _ (hereinafter "the Successor Recipient"), a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2, but only to the extent that the aggregate of the amounts paid in prior years, whether to the Initial Recipient or to the Successor Recipient, was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2 and (a) of paragraph 6. The valuation date is the first day of each taxable year of the trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the death of the survivor of the Initial Recipient and the Successor Recipient.

[*Alternative 1d: Payment of unitrust amount to individual (combination of net income method and fixed-percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the _ _[*name of permissible recipient*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of another permissible recipient*]_ _ (hereinafter "the Successor Recipient") the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations.

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), in each remaining taxable year of the trust during the unitrust period, the Trustee shall pay to the Initial Recipient until his or her death, and thereafter to the Successor Recipient, a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i).

(iii) *In general*. The first day of the unitrust period shall be the date property is first transferred to the trust

and the last day of the unitrust period shall be the date of the death of the survivor of the Initial Recipient and the Successor Recipient. The valuation date is the first day of each taxable year of the trust.

[*Alternative 1e: Payment of unitrust amount to individual (combination of net income with make-up method and fixed-percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income with make-up method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the _ _[*name of permissible recipient*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of another permissible recipient*]_ _ (hereinafter "the Successor Recipient") the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2(i)") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2(i), but only to the extent that the aggregate of the amounts paid in prior years, whether to the Initial Recipient or to the Successor Recipient, was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2(i) and (a) of paragraph 6(i).

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year the immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the Initial Recipient until his or her death, and thereafter to the Successor Recipient, in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i) and shall not pay any amount of trust income described in the second sentence of paragraph 2(i).

(iii) *In general*. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the death of the survivor of the Initial Recipient and the Successor Recipient. The valuation date is the first day of each taxable year of the trust.

[*Alternative 2a: Payment of unitrust amount to donor with retained right to revoke interest of successor recipient (fixed percentage method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of donor*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of permissible recipient*]_ _ (hereinafter "the Successor Recipient"), a unitrust amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date"). The Donor hereby expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of the Successor Recipient under this trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the death of the survivor of the Initial Recipient and the Successor Recipient or, if the power to revoke the interest of the Successor Recipient is exercised by the Donor, the date of the Initial Recipient's death.

[*Alternative 2b: Payment of unitrust amount to donor with retained right to revoke interest of successor recipient (net income method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of donor*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of permissible recipient*]_ _ (hereinafter "the Successor Recipient"), a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The valuation date is the first day of each taxable year of the trust. The Donor hereby expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of the Successor Recipient under this trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be

the date of the death of the survivor of the Initial Recipient and the Successor Recipient or, if the power to revoke the interest of the Successor Recipient is exercised by the Donor, the date of the Initial Recipient's death.

[*Alternative 2c: Payment of unitrust amount to donor with retained right to revoke interest of successor recipient (net income with make-up method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of donor*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of permissible recipient*]_ _ (hereinafter "the Successor Recipient"), a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2, but only to the extent that the aggregate of the amounts paid in prior years, whether to the Initial Recipient or to the Successor Recipient, was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2 and (a) of paragraph 6. The valuation date is the first day of each taxable year of the trust. The Donor hereby expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of the Successor Recipient under this trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the death of the survivor of the Initial Recipient and the Successor Recipient or, if the power to revoke the interest of the Successor Recipient is exercised by the Donor, the date of the Initial Recipient's death.

[*Alternative 2d: Payment of unitrust amount to donor with retained right to revoke interest of successor recipient (combination of net income and fixed percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the _ _[*name of permissible recipient*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of another permissible recipient*]_ _ (hereinafter "the Successor Recipient") the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations.

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the Initial Recipient until his or her death, and thereafter to the Successor Recipient, in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i).

(iii) *In general*. The Donor hereby expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of the Successor Recipient under this trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the death of the survivor of the Initial Recipient and the Successor Recipient or, if the power to revoke the interest of the Successor Recipient is exercised by the Donor, the date of the Initial Recipient's death.

[*Alternative 2e: Payment of unitrust amount to donor with retained right to revoke interest of successor recipient (combination of net income with make-up method and fixed percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income with make-up method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the _ _[*name of permissible recipient*]_ _ (hereinafter "the Initial

Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of another permissible recipient*]_ _ (hereinafter "the Successor Recipient") the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2(i)") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2(i), but only to the extent that the aggregate of the amounts paid in prior years, whether to the Initial Recipient or to the Successor Recipient, was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2(i) and (a) of paragraph 6(i).

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year the immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the Initial Recipient until his or her death, and thereafter to the Successor Recipient, in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i) and shall not pay any amount of trust income described in the second sentence of paragraph 2(i).

(iii) *In general*. The Donor hereby expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of the Successor Recipient under this trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the death of the survivor of the Initial Recipient and the Successor Recipient or, if the power to revoke the interest of the Successor Recipient is exercised by the Donor, the date of the Initial Recipient's death.

[*Alternative 3: Payment of part of unitrust amount to charity (fixed percentage method of calculating unitrust amount)*]

2. *Payment of Unitrust Amount*. The unitrust amount is equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date"). In each taxable year of the trust during the unitrust period, the Trustee shall pay _ _[*number*]_ _ percent of the unitrust amount to _ _[*name of permissible recipient*]_ _ (hereinafter "the Initial Recipient"), until the Initial Recipient's death, and thereafter to _ _[*name of another permissible recipient*]_ _ (hereinafter "the Successor Recipient"). In each taxable year of the trust during the unitrust period, the Trustee shall pay _ _[*number*]_ _ percent of the unitrust amount to _ _[*name of charitable organization*]_ _ (hereinafter "the Charitable Recipient"). The first day of the unitrust period shall be the date the property is transferred to the trust and the last day of the unitrust period shall be the date of the death of the survivor of the Initial Recipient and the Successor Recipient. If the Charitable Recipient is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any unitrust payment is to be distributed to it, then the Trustee shall distribute that unitrust payment to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Continue*]

The unitrust amount shall be paid in equal quarterly installments at the end of each calendar quarter from income, and to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the correct value is finally determined, the Trustee shall pay to the Initial Recipient and/or the Successor Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an undervaluation) or receive from the Initial Recipient and/or the Successor Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.

3. *Payment of Federal Estate Taxes and State Death Taxes*. The lifetime unitrust interest of the Successor Recipient will take effect upon the death of the Initial Recipient only if the Successor Recipient furnishes the funds for payment of any federal estate taxes and state death taxes for which the Trustee may be liable on the death of the Initial Recipient. If the funds are not furnished by the Successor Recipient, the unitrust period shall terminate on the death of the Initial Recipient, notwithstanding any other provision in this instrument to

the contrary.

[*Add one of the following alternatives*]

[*Alternative 1: Fixed percentage method*]

4. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in paragraph 2, or, if an additional contribution is made to the trust, the unitrust amount described in paragraph 6.

[*Alternative 2: Net income method*]

4. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in paragraph 2, or, if an additional contribution is made to the trust, the fixed percentage amount described in paragraph 6. In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2 or in (a) of paragraph 6 to determine the unitrust amount payable for that year.

[*Alternative 3: Net income with make-up method*]

4. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2, or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 6. In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2 or in (a) of paragraph 6 to determine the unitrust amount payable for that year.

[*Alternative 4: Combination of net income method and fixed percentage method*]

4. *Proration of Unitrust Amount*.

(i) *Proration in years preceding effective date of triggering event*. For a short taxable year before the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2(i), or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 6(i). In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2(i) or in (a) of paragraph 6(i) to determine the unitrust amount payable for that year.

(ii) *Proration on and after effective date of triggering event*. For a short taxable year beginning on or after the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in (a) of paragraph 2(ii), or, if an additional contribution is made to the trust, the unitrust amount described in (a) of paragraph 6(ii).

[*Alternative 5: Combination of net income with make-up method and fixed percentage method*]

4. *Proration of Unitrust Amount*.

(i) *Proration in years preceding effective date of triggering event*. For a short taxable year before the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2(i), or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 6(i). In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2(i) or in (a) of paragraph 6(i) to determine the unitrust amount payable for that year.

(ii) *Proration on and after effective date of triggering event*. For a short taxable year beginning on or after the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in (a) of paragraph 2(ii), or, if an additional contribution is made to the trust, the unitrust amount described in (a) of paragraph 6(ii).

[*Continue*]

If the Successor Recipient survives the Initial Recipient, the Trustee shall prorate on a daily basis the next regular unitrust payment due after the death of the Initial Recipient between the estate of the Initial Recipient and the Successor Recipient.

[*Add one of the following alternatives*]

[*Alternative 1: Named charity as remainderman*]

5. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Initial Recipient and/or the Successor Recipient _ _[*and the Charitable Recipient*]_ _ under the under the terms of this trust) to _ _[*name of designated remainderman*]_ _ (hereinafter "the Charitable Organization").

[*If applicable, add the following option*]

[*Option: Retained right to substitute remainderman*]

The Donor reserves the right to designate, at any time and from time to time, in lieu of the Charitable Organization identified above, one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the charitable remainderman and shall make any such designation by giving written notice to the Trustee.

[*Continue*]

If the Charitable Organization is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Alternative 2: Recipient's power to appoint remainderman*]

5. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Initial Recipient and/or the Successor Recipient _ _[*and the Charitable Recipient*]_ _ under the under the terms of this trust) to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as _ _[*name of one noncharitable recipient*]_ _ shall appoint and direct by specific reference to this power of appointment by inter vivos or testamentary instrument. To the extent that this power of appointment is not effectively exercised, the principal and income not effectively appointed shall be distributed to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion. If an organization fails to qualify as an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Fixed percentage method*]

6. *Additional Contributions*. If any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be _ _[*same percentage used in paragraph 2*]_ _ percent of the sum of (a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

[*Alternative 2: Net income method*]

6. *Additional Contributions*. Notwithstanding paragraph 2, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of (a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2*]_ _ percent of the sum of (1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 6") or (b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

[*Alternative 3: Net income with make-up method*]

6. *Additional Contributions*. Notwithstanding paragraph 2, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of (a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2*]_ _ percent of the sum of (1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 6") or (b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations. The unitrust amount for that year shall also include any amount of the trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 6 for the year, but only to the extent that the aggregate of the amounts paid in prior years, whether to the Initial Recipient or to the Successor Recipient, was less than the aggregate of the amounts determined for all prior years under (a) of paragraph 2 and (a) of this paragraph 6.

[*Alternative 4: Combination of net income method and fixed-percentage method*]

6. *Additional Contributions*.

(i) *Additional contributions made before effective date of triggering event*. Notwithstanding paragraph 2(i), if any additional contributions are made to the trust after the initial contribution, and before the effective date of the triggering event, the unitrust amount for the year in which the additional contribution is made shall be equal to the lesser of:

(a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 6(i)"); or

(b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

(ii) *Additional contributions made on or after effective date of triggering event*. Notwithstanding paragraph 2(ii), if any additional contributions are made to the trust after the initial contribution, and on or after the effective date of the triggering event, the unitrust amount described in paragraph 2(ii) for the year in which the additional contribution is made shall be _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

Beginning on the effective date of the triggering event, the trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 6(i).

[*Alternative 5: Combination of net income with make-up method and fixed-percentage method*]

6. *Additional Contributions*.

(i) *Additional contributions made before effective date of triggering event*. Notwithstanding paragraph 2(i), if any additional contributions are made to the trust after the initial contribution, and before the effective date of the triggering event, the unitrust amount for the year in which the additional contribution is made shall be equal to the lesser of:

(a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 6(i)"); or

(b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

The unitrust amount for that year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 6(i), but only to the extent that the aggregate of the amounts paid in prior years, whether to the Initial Recipient or to the Successor Recipient, was less than the aggregate of the amounts determined for all prior years under (a) of paragraph 2(i) and (a) of this paragraph 6(i).

(ii) *Additional contributions made on or after effective date of triggering event*. Notwithstanding paragraph 2(ii), if any additional contributions are made to the trust after the initial contribution and on or after the effective date of the triggering event, the unitrust amount described in paragraph 2(ii) for the year in which the additional contribution is made shall be _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 6(i) and shall not pay any amount of income described in the second sentence of paragraph 6(i).

[*Continue*]

In a taxable year in which an additional contribution is made on or after the valuation date, the assets so added shall be valued as of the date of contribution, without regard to any post-contribution income or appreciation, rather than as of the valuation date.

7. *Deferral of the Unitrust Payment Allocable to Testamentary Transfer*. All property passing to the trust by reason of the death of the Donor (hereinafter "the testamentary transfer") shall be considered to be a single contribution that is made on the date of the Donor's death. Notwithstanding the provisions of paragraphs 2 and 6 above, the obligation to pay the unitrust amount with respect to the testamentary transfer shall commence with the date of the Donor's death. Nevertheless, payment of the unitrust amount with respect to the testamentary transfer may be deferred from the date of the Donor's death until the end of the taxable year in which the funding of the testamentary transfer is completed. Within a reasonable time after the end of the taxable year in which the funding of the testamentary transfer is completed, the Trustee must pay to the Initial Recipient and/or the Successor Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an underpayment) or receive from the Initial Recipient and/or the Successor Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an overpayment) the difference between any unitrust amounts allocable to the testamentary transfer that were actually paid, plus interest, and the unitrust amounts allocable to the testamentary transfer that were payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under IRC §664 prescribe for this computation.

8. *Unmarketable Assets*. Whenever the value of a trust asset must be determined, the Trustee shall determine the value of any assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents (hereinafter "unmarketable assets"), by either (a) obtaining a current "qualified appraisal" from a "qualified appraiser," as defined in Treas Reg §1.170A-13(c)(3) and (c)(5), respectively, or (b) ensuring the valuation of these unmarketable assets is performed exclusively by an "independent trustee," within the meaning of Treas Reg §1.664-1(a)(7)(iii).

9. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of IRC §4941(d), as modified by IRC §4947(a)(2)(A), and shall not make any taxable expenditures within the meaning of IRC §4945(d), as modified by IRC §4947(a)(2)(A).

10. *Taxable Year*. The taxable year of the trust shall be the calendar year.

11. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state, e.g., California*]_ _. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder unitrust under IRC §664(d)(2) _ _[*and §664(d)(3)*]_ _ and the corresponding regulations.

12. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder unitrust within the meaning of IRC §664(d)(2) _ _[*and §664(d)(3)*]_ _.

13. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

14. *Definition of Initial Recipient and Successor Recipient*. References to the Initial Recipient and/or the Successor Recipient in this trust instrument shall be deemed to include the estate of the Initial Recipient and/or the Successor Recipient with regard to all provisions in this trust instrument that describe amounts payable to and/or due from the Initial Recipient and/or the Successor Recipient. The prior sentence shall not apply to the determination of the last day of the unitrust period.

This form meets the requirements for an inter vivos charitable remainder unitrust for two lives with concurrent and consecutive interests under IRC §664(d)(2) and (d)(3). Rev Proc 2005-55, 2005-2 Cum Bull 367.

Unitrust Payments During Two Lives, Concurrent and Consecutive Interests

On this _ _[*ordinal number*]_ _ day of _ _[*month*]_ _, _ _[*year*]_ _, I, _ _[*name of donor*]_ _ (hereinafter "the Donor"), desiring to establish a charitable remainder unitrust within the meaning of Rev Proc 2005-55 and Internal Revenue Code (hereinafter "IRC") §664(d)(2) _ _[*and §664(d)(3)*]_ _, hereby enter into this trust agreement with _ _[*name of trustee*]_ _ as the initial trustee (hereinafter "the Trustee"). This trust shall be known as the _ _[*name of trust*]_ _ Charitable Remainder Unitrust.

1. *Funding of Trust*. The Donor hereby transfers and irrevocably assigns, on the above date, to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property, and any property subsequently transferred, under the terms set forth in this trust instrument.

[*Add one of the following alternatives*]

[*Alternative 1a: Payment of unitrust amount to individual (fixed percentage method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ and _ _[*name of another permissible recipient*]_ _ (hereinafter "the Recipients") in equal shares during their joint lives, a unitrust amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date") and, on the death of one (hereinafter "the Predeceasing Recipient"), the Trustee shall pay the entire amount to the survivor (hereinafter "the Survivor Recipient"). The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death.

[*Alternative 1b: Payment of unitrust amount to individual (net income method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ and _ _[*name of another permissible recipient*]_ _ (hereinafter "the Recipients") in equal shares during their joint lives, a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The valuation date is the first day of each taxable year of the trust. On the death of one (hereinafter "the Predeceasing Recipient"), the Trustee shall pay the entire amount to the survivor (hereinafter "the Survivor Recipient"). The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death.

[*Alternative 1c: Payment of unitrust amount to individual (net income with make-up method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ and _ _[*name of another permissible recipient*]_ _ (hereinafter "the Recipients") in equal shares during their joint lives, a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2, but only to the extent that the aggregate of the amounts paid to the Recipients in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2 and (a) of paragraph 6. The valuation date is the first day of each taxable year of the trust. On the death of one of the Recipients (hereinafter "the Predeceasing Recipient"), the Trustee shall pay the entire amount to the survivor (hereinafter

"the Survivor Recipient"). The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death.

[*Alternative 1d: Payment of unitrust amount to individual (combination of net income method and fixed-percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the Recipients the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2(i)") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations.

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the Recipients in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i).

(iii) *In general*. On the death of one of the Recipients (hereinafter "the Predeceasing Recipient"), the Trustee shall pay the entire amount to the survivor (hereinafter "the Survivor Recipient"). The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death. The valuation date is the first day of each taxable year of the trust.

[*Alternative 1e: Payment of unitrust amount to individual (combination of net income with make-up method and fixed-percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income with make-up method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the Recipients the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2(i)") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2(i), but only to the extent that the aggregate of the amounts paid to the Recipients in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2(i) and (a) of paragraph 6(i).

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the Recipients in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i) and shall not pay any amount of trust income described in the second sentence of paragraph 2(i).

(iii) *In general*. On the death of one of the Recipients (hereinafter "the Predeceasing Recipient"), the Trustee shall pay the entire amount to the survivor (hereinafter "the Survivor Recipient"). The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death. The valuation date is the first day of each taxable year of the trust.

[*Alternative 2a: Payment of unitrust amount to donor with retained right to revoke interest of successor recipient (fixed percentage method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient and donor*]_ _ and _ _[*name of another permissible recipient*]_ _ (hereinafter "the Recipients") in equal shares during their joint lives, a unitrust amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date"). The Donor hereby expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of _ _[*name of recipient who is not the donor*]_ _ under this trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death or, if the power to revoke the interest of _ _[*name of recipient who is not the donor*]_ _ is exercised by the Donor, the earlier date of the Donor's death.

[*Alternative 2b: Payment of unitrust amount to donor with retained right to revoke interest of successor recipient (net income method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient and donor*]_ _ and _ _[*name of another permissible recipient*]_ _ (hereinafter "the Recipients") in equal shares during their joint lives, a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The valuation date is the first day of each taxable year of the trust. The Donor hereby expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of _ _[*name of recipient who is not the donor*]_ _ under this trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death or, if the power to revoke the interest of _ _[*name of recipient who is not the donor*]_ _ is exercised by the Donor, the earlier date of the Donor's death.

[*Alternative 2c: Payment of unitrust amount to donor with retained right to revoke interest of successor recipient (net income with make-up method)*]

2. *Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to _ _[*name of permissible recipient and donor*]_ _ and _ _[*name of another permissible recipient*]_ _ (hereinafter "the Recipients") in equal shares during their joint lives, a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2, but only to the extent that the aggregate of the amounts paid to the Recipients in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2 and (a) of paragraph 6. The valuation date is the first day of each taxable year of the trust. The Donor hereby expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of _ _[*name of recipient who is not the donor*]_ _ under this trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death or, if the power to revoke the interest of _ _[*name of recipient who is not the donor*]_ _ is exercised by the Donor, the earlier date of the Donor's death.

[*Alternative 2d: Payment of unitrust amount to donor with retained right to revoke interest of successor recipient (combination of net income method and fixed percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the Recipients the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations.

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the

Recipients in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i).

(iii) *In general*. The Donor hereby expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of _ _[*name of recipient who is not the donor*]_ _ under this trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death or, if the power to revoke the interest of _ _[*name of recipient who is not the donor*]_ _ is exercised by the Donor, the earlier date of the Donor's death. On the death of one of the Recipients (hereinafter "the Predeceasing Recipient"), the Trustee shall pay the entire amount to the survivor (hereinafter "the Survivor Recipient").

[*Alternative 2e: Payment of unitrust amount to donor with retained right to revoke interest of successor recipient (combination of net income with make-up method and fixed percentage method)*]

2. *Payment of Unitrust Amount*.

(i) *Unitrust amount determined by net income with make-up method*. In each taxable year of the trust during the unitrust period, the Trustee shall pay to the Recipients the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph 2(i)") or (b) the trust income for the taxable year as defined in IRC §643(b) and the applicable regulations. The unitrust amount for a taxable year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 2(i), but only to the extent that the aggregate of the amounts paid to the Recipients in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph 2(i) and (a) of paragraph 6(i).

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding paragraph 2(i), on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ (hereinafter "the triggering event") and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the Trustee shall pay to the Recipients in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i) and shall not pay any amount of trust income described in the second sentence of paragraph 2(i).

(iii) *In general*. The Donor hereby expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of _ _[*name of recipient who is not the donor*]_ _ under this trust. The first day of the unitrust period shall be the date property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death or, if the power to revoke the interest of _ _[*name of recipient who is not the donor*]_ _ is exercised by the Donor, the earlier date of the Donor's death. On the death of one of the Recipients (hereinafter "the Predeceasing Recipient"), the Trustee shall pay the entire amount to the survivor (hereinafter "the Survivor Recipient").

[*Alternative 3: Payment of part of unitrust amount to charity (fixed percentage method of calculating unitrust amount)*]

2. *Payment of Unitrust Amount*. The unitrust amount is equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (hereinafter "the valuation date"). In each taxable year of the trust during the unitrust period, the Trustee shall pay _ _[*number*]_ _ percent of the unitrust amount to _ _[*name of permissible recipient*]_ _ and to _ _[*name of another permissible recipient*]_ _ (hereinafter "the Recipients") in equal shares during their joint lives, and, on the death of one (hereinafter "the Predeceasing Recipient"), the Trustee shall pay that entire percentage of the unitrust amount to the survivor (hereinafter "the Survivor Recipient"). In each taxable year of the trust during the unitrust period, the Trustee shall pay _ _[*number*]_ _ percent of the unitrust amount to _ _[*name of charitable organization*]_ _ (hereinafter "the Charitable Recipient"). The first day of the unitrust period shall be the date the property is first transferred to the trust and the last day of the unitrust period shall be the date of the Survivor Recipient's death. If the Charitable Recipient is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any unitrust payment is to be distributed to it, then the Trustee shall distribute that unitrust payment to one or more organizations described in IRC §§170(b)(1)(A),

170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Continue*]

The unitrust amount shall be paid in equal quarterly installments at the end of each calendar quarter from income, and to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the correct value is finally determined, the Trustee shall pay to the Predeceasing Recipient and/or the Survivor Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an undervaluation) or receive from the Predeceasing Recipient and/or the Survivor Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.

3. *Payment of Federal Estate Taxes and State Death Taxes*. The lifetime unitrust interest of the Survivor Recipient will take effect on the death of the Predeceasing Recipient only if the Survivor Recipient furnishes the funds for payment of any federal estate taxes and state death taxes for which the Trustee may be liable on the death of the Predeceasing Recipient. If the funds are not furnished by the Survivor Recipient, the unitrust period shall terminate on the death of the Predeceasing Recipient, notwithstanding any other provision in this instrument to the contrary.

[*Add one of the following alternatives*]

[*Alternative 1: Fixed percentage method*]

4. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in paragraph 2, or, if an additional contribution is made to the trust, the unitrust amount described in paragraph 6.

[*Alternative 2: Net income method*]

4. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in paragraph 2, or, if an additional contribution is made to the trust, the fixed percentage amount described in paragraph 6. In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2 or in (a) of paragraph 6 to determine the unitrust amount payable for that year.

[*Alternative 3: Net income with make-up method*]

4. *Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2, or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 6. In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2 or in (a) of paragraph 6 to determine the unitrust amount payable for that year.

[*Alternative 4: Combination of net income method and fixed percentage method*]

4. *Proration of Unitrust Amount*.

(i) *Proration in years preceding effective date of triggering event*. For a short taxable year before the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2(i), or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 6(i). In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2(i) or in (a) of paragraph 6(i) to determine the unitrust amount payable for that year.

(ii) *Proration on and after effective date of triggering event*. For a short taxable year beginning on or after the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in (a) of paragraph 2(ii), or, if an additional contribution is made to the trust, the unitrust amount described in (a) of paragraph 6(ii).

[*Alternative 5: Combination of net income with make-up method and fixed percentage method*]

4. *Proration of Unitrust Amount*.

(i) *Proration in years preceding effective date of triggering event*. For a short taxable year before the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph 2(i), or, if an additional contribution is made to the trust, the fixed percentage amount described in (a) of paragraph 6(i). In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph 2(i) or in (a) of paragraph 6(i) to determine the unitrust amount payable for that year.

(ii) *Proration on and after effective date of triggering event*. For a short taxable year beginning on or after the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the Trustee shall prorate on a daily basis the unitrust amount described in (a) of paragraph 2(ii), or, if an additional contribution is made to the trust, the unitrust amount described in (a) of paragraph 6(ii).

[*Continue*]

On the death of the Predeceasing Recipient, the Trustee shall prorate on a daily basis the next regular unitrust payment due after the death of the Predeceasing Recipient between the estate of the Predeceasing Recipient and the Survivor Recipient.

[*Add one of the following alternatives*]

[*Alternative 1: Named charity as remainderman*]

5. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Predeceasing Recipient and/or the Survivor Recipient _ _[*and the Charitable Recipient*]**_ _ under the under the terms of this trust) to _ _**[*name of designated remainderman*]**_ _ (hereinafter "the Charitable Organization").**

[*If applicable, add the following option*]

[*Option: Retained right to substitute remainderman*]

The Donor reserves the right to designate, at any time and from time to time, in lieu of the Charitable Organization identified above, one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the charitable remainderman and shall make any such designation by giving written notice to the Trustee.

[*Continue*]

If the Charitable Organization is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Alternative 2: Recipient's power to appoint remainderman*]

5. *Distribution to Charity*. At the termination of the unitrust period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Predeceasing Recipient and/or the Survivor Recipient _ _[*and the Charitable Recipient*]**_ _ under the under the terms of this trust) to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as _ _**[*name of one of the noncharitable recipients*]**_ _ shall appoint and direct by specific reference to this power of appointment by inter vivos or testamentary instrument. To the extent that this power of appointment is not effectively exercised, the principal and income not effectively appointed shall be distributed to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion. If an organization fails to qualify as an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.**

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Fixed percentage method*]

6. *Additional Contributions*. If any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be _ _[*same percentage used in paragraph 2*]_ _ percent of the sum of (a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

[*Alternative 2: Net income method*]

6. *Additional Contributions*. Notwithstanding paragraph 2, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of (a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2*]_ _ percent of the sum of (1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 6") or (b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

[*Alternative 3: Net income with make-up method*]

6. *Additional Contributions*. Notwithstanding paragraph 2, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of (a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2*]_ _ percent of the sum of (1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year) and (2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 6") or (b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations. The unitrust amount for that year shall also include any amount of the trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 6 for the year, but only to the extent that the aggregate of the amounts paid to Recipients in prior years was less than the aggregate of the amounts determined for all prior years under (a) of paragraph 2 and (a) of this paragraph 6.

[*Alternative 4: Combination of net income method and fixed-percentage method*]

6. *Additional Contributions*.

(i) *Additional contributions made before effective date of triggering event*. Notwithstanding paragraph 2(i), if any additional contributions are made to the trust after the initial contribution, and before the effective date of the triggering event, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of:

(a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 6(i)"); or

(b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

(ii) *Additional contributions made on or after effective date of triggering event*. Notwithstanding paragraph 2(ii), if any additional contributions are made to the trust after the initial contribution, and on or after the effective date of the triggering event, the unitrust amount described in paragraph 2(ii) for the year in which the additional contribution is made shall be _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

Beginning on the effective date of the triggering event, the trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 6(i).

[*Alternative 5: Combination of net income with make-up method and fixed-percentage method*]

6. *Additional Contributions*.

(i) *Additional contributions made before effective date of triggering event*. Notwithstanding paragraph 2(i), if any additional contributions are made to the trust after the initial contribution, and before the effective date of the triggering event, the unitrust amount for the year in which any additional contribution is made shall be equal to the lesser of:

(a) a fixed percentage amount equal to _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph 6(i)"); or

(b) the trust income for the taxable year as defined in IRC §643(b) and applicable regulations.

The unitrust amount for that year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph 6(i), but only to the extent that the aggregate of the amounts paid to the Recipients in prior years was less than the aggregate of the amounts determined for all prior years under (a) of paragraph 2(i) and (a) of this paragraph 6(i).

(ii) *Additional contributions made on or after effective date of triggering event*. Notwithstanding paragraph 2(ii), if any additional contributions are made to the trust after the initial contribution, and on or after the effective date of the triggering event, the unitrust amount described in paragraph 2(ii) for the year in which the additional contribution is made shall be _ _[*same percentage used in (a) of paragraph 2(i)*]_ _ percent of the sum of:

(a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any post-contribution income from, and appreciation on, such assets during that year); and

(b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any post-contribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

Beginning on the effective date of the triggering event, the trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 6(i) and shall not pay any amount of income described in the second sentence of paragraph 6(i).

[*Continue*]

In a taxable year in which an additional contribution is made on or after the valuation date, the assets so added shall be valued as of the date of contribution, without regard to any post-contribution income or appreciation, rather than as of the valuation date.

7. *Deferral of the Unitrust Payment Allocable to Testamentary Transfer*. All property passing to the trust by reason of the death of the Donor (hereinafter "the testamentary transfer") shall be considered to be a single contribution that is made on the date of the Donor's death. Notwithstanding the provisions of paragraphs 2 and 6 above, the obligation to pay the unitrust amount with respect to the testamentary transfer shall commence with the date of the Donor's death. Nevertheless, payment of the unitrust amount with respect to the testamentary transfer may be deferred from the date of the Donor's death until the end of the taxable year in which the funding of the testamentary transfer is completed. Within a reasonable time after the end of the taxable year in which the funding of the testamentary transfer is completed, the Trustee must pay to the Predeceasing Recipient and/or the Survivor Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an underpayment) or receive from the Predeceasing Recipient and/or the Survivor Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an overpayment) the difference between any unitrust amounts allocable to the testamentary transfer that were actually paid, plus interest, and the unitrust amounts allocable to the testamentary transfer that were payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under IRC §664 prescribe for this computation.

8. *Unmarketable Assets*. Whenever the value of a trust asset must be determined, the Trustee shall determine the value of any assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents (hereinafter "unmarketable assets"), by either (a) obtaining a current "qualified appraisal" from a "qualified appraiser," as defined in Treas Reg §1.170A-13(c)(3) and (c)(5), respectively, or (b) ensuring the valuation of these unmarketable assets is performed exclusively by an "independent trustee," within the meaning of Treas Reg §1.664-1(a)(7)(iii).

9. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of IRC §4941(d), as modified by IRC §4947(a)(2)(A), and shall not make any taxable expenditures within the meaning of IRC §4945(d), as modified by IRC §4947(a)(2)(A).

10. *Taxable Year*. The taxable year of the trust shall be the calendar year.

11. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state, e.g., California*]_ _. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder unitrust under IRC §664(d)(2) _ _[*and §664(d)(3)*]_ _ and the corresponding regulations.

12. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder unitrust within the meaning of IRC §664(d)(2) _ _[*and §664(d)(3)*]_ _.

13. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

14. *Definition of Predeceasing Recipient and Survivor Recipient*. References to the Predeceasing Recipient and/or the Survivor Recipient in this trust instrument shall be deemed to include the estate of the Predeceasing Recipient and/or the Survivor Recipient with regard to all provisions in this trust instrument that describe amounts payable to and/or due from the Predeceasing Recipient and/or the Survivor Recipient. The prior sentence shall not apply to the determination of the last day of the unitrust period.

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Appendix H

IRS Charitable Remainder Annuity Trusts for One and Two Lives or a Term of Years

▶ To download **Word** version, right click and choose *Save Target As*

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Description

Revenue Procedures 2003-53—2003-56, 2003-2 Cum Bull 230, contain sample declarations of trusts that meet the requirements for inter vivos charitable remainder annuity trusts for one and two lives or a term of years under IRC §664(d)(1). (Revenue Procedures 2003-57—2003-60, 2003-2 Cum Bull 257, contain sample testamentary charitable remainder annuity trust forms.) The following four sample inter vivos trusts (including alternative provisions) are republished in this appendix:

1. Annuity Trust Payments During One Life;
2. Annuity Trust Payments for a Term of Years;
3. Annuity Trust Payments During Two Lives, Consecutive Interests;
4. Annuity Trust Payments During Two Lives, Concurrent and Consecutive Interests.

Revenue Procedures 2003-53—2003-56 provide that a trust that substantially follows one of the sample forms given will meet the requirements of charitable remainder annuity trusts, if the trust otherwise operates in a manner consistent with the terms of the creating instrument and if it is a valid trust under local law.

This form meets the requirements for an inter vivos charitable remainder annuity trust for one life under IRC §664(d)(1). Rev Proc 2003-53, 2003-2 Cum Bull 230.

Annuity Trust Payments During One Life

On this _ _[*ordinal number*]_ _ **day of** _ _[*month*]_ _, _ _[*year*]_ _, **I,** _ _[*name of donor*]_ _ **(hereinafter "the Donor"), desiring to establish a charitable remainder annuity trust, within the meaning of Rev Proc 2003-53 and Internal Revenue Code (hereinafter "IRC") §664(d)(1), hereby enter into this trust agreement with** _ _[*name of trustee*]_ _ **as the initial trustee (hereinafter "the Trustee"). This trust shall be known as the** _ _[*name of trust*]_ _ **Charitable Remainder Annuity Trust.**

1. *Funding of Trust*. On the above date, the Donor hereby transfers and irrevocably assigns to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property under the terms set forth in this trust instrument.

[*Add one of the following alternatives*]

[*Alternative 1: Payment of annuity amount to individual*]

2. *Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ **(hereinafter "the Recipient") an annuity amount equal to** _ _[*dollar amount/*_ _[*number no less than 5 and no more than 50*]_ _ *percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _**. The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of the Recipient's death.**

[*Alternative 2: Payment of part of annuity amount to charity*]

2. *Payment of Annuity Amount*. The annuity amount is equal to _ _[*dollar amount/*_ _[*number no less than 5 and no more than 50*]_ _ *percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _**. In each taxable year of the trust during the annuity period, the Trustee shall pay** _ _[*number*]_ _ **percent of the annuity amount to** _ _[*name of permissible recipient*]_ _

(hereinafter "the Recipient") and _ _[*number*]_ _ percent of the annuity amount to _ _[*name of charitable organization*]_ _ (hereinafter "the Charitable Recipient"). The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of the Recipient's death. If the Charitable Recipient is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any annuity payment is to be distributed to it, then the Trustee shall distribute that annuity payment to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Continue*]

The annuity amount shall be paid in equal quarterly installments at the end of each calendar quarter from income, and to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal.

[*Add if annuity amount stated as a percentage*]

If the initial net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the Trustee shall pay to the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an undervaluation) or receive from the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

[*Continue*]

3. *Proration of Annuity Amount*. The Trustee shall prorate the annuity amount on a daily basis for any short taxable year.

[*Add one of the following alternatives*]

[*Alternative 1: Proration of annuity amount when recipient dies*]

In the taxable year of the trust during which the annuity period ends, the Trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

[*Alternative 2: Termination of annuity payment when recipient dies*]

In the taxable year of the trust during which the annuity period ends, the obligation of the Trustee to pay the annuity amount shall terminate with the regularly quarterly installment next preceding the death of the Recipient.

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Named charity as remainderman*]

4. *Distribution to Charity*. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient or the Recipient's estate _ _[*and the Charitable Recipient*]_ _ under the provisions above) to _ _[*name of designated remainderman*]_ _ (hereinafter "the Charitable Organization").

[*If applicable, add the following option*]

[*Option: Retained right to substitute remainderman*]

The donor reserves the right to designate, at any time and from time to time, in lieu of the Charitable Organization identified above, one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the charitable remainderman and shall make any such designation by giving written notice to the Trustee.

[*Continue*]

If the Charitable Organization is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the

Trustee's sole discretion.

[*Alternative 2: Recipient's power to appoint remainderman*]

4. *Distribution to Charity*. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient or the Recipient's estate _ _[*and the Charitable Recipient*]_ _ under the provisions above) to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the recipient shall appoint and direct by specific reference to this power of appointment by inter vivos or testamentary instrument. To the extent that the Recipient fails to effectively exercise this power of appointment, the principal and income not effectively appointed shall be distributed to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion. If an organization fails to qualify as an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Continue*]

5. *Additional Contributions*. No additional contributions shall be made to the trust after the initial contribution.

6. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of IRC §4941(d), as modified by IRC §4947(a)(2)(A), and shall not make any taxable expenditures within the meaning of IRC §4945(d), as modified by IRC §4947(a)(2)(A).

7. *Taxable Year*. The taxable year of the trust shall be the calendar year.

8. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state, e.g., California*]_ _. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder annuity trust under IRC §664(d)(1) and the corresponding regulations.

9. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder annuity trust within the meaning of IRC §664(d)(1).

10. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

This form meets the requirements for an inter vivos charitable remainder annuity trust for a term of years under IRC §664(d)(1). Rev Proc 2003-54, 2003-2 Cum Bull 236.

Annuity Trust Payments for a Term of Years

On this _ _[*ordinal number*]_ _ day of _ _[*month*]_ _, _ _[*year*]_ _, I, _ _[*name of donor*]_ _ (hereinafter "the Donor"), desiring to establish a charitable remainder annuity trust, within the meaning of Rev Proc 2003-54 and Internal Revenue Code (hereinafter "IRC") §664(d)(1), hereby enter into this trust agreement with _ _[*name of trustee*]_ _ as the initial trustee (hereinafter "the Trustee"). This trust shall be known as the _ _[*name of trust*]_ _ Charitable Remainder Annuity Trust.

1. *Funding of Trust*. The Donor hereby transfers and irrevocably assigns, on the above date, to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property under the terms set forth in this trust instrument.

[*Add one of the following alternatives*]

[*Alternative 1: Payment of annuity amount to individual*]

2. *Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the Trustee shall

pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipient") an annuity amount equal to _ _[*dollar amount/_ _[number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _. The annuity period is a term of _ _[*number not more than 20*]_ _ years. The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the day preceding the _ _[*ordinal number*]_ _ anniversary of that date.

[*Alternative 2: Payment of part of annuity amount to charity*]

2. *Payment of Annuity Amount*. The annuity amount is equal to _ _[*dollar amount/_ _[number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _. In each taxable year of the trust during the annuity period, the Trustee shall pay _ _[*number*]_ _ percent of the annuity amount to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipient") and _ _[*number*]_ _ percent of the annuity amount to _ _[*name of charitable organization*]_ _ (hereinafter "the Charitable Recipient"). The annuity period is a term of _ _[*number not more than 20*]_ _ years. The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the day preceding the _ _[*ordinal number*]_ _ anniversary of that date. If the Charitable Recipient is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any annuity payment is to be distributed to it, then the Trustee shall distribute that annuity payment to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Alternative 3: Apportionment of annuity amount among members of a named class in the discretion of trustee*]

2. *Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the Trustee shall pay to a member or members of a class of persons comprised of _ _[*designated members of class*]_ _ (hereinafter "the Recipient") an annuity amount equal to _ _[*dollar amount/_ _[number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _. The trustee may pay the annuity amount to one or more members of the class, in equal or unequal shares, as the Trustee, in the Trustee's sole discretion, may from time to time deem advisable. The Trustee may not, however, apply the payment for the Trustee's own benefit, or in satisfaction of any support or other legal obligation of the Trustee. The annuity period is a term of _ _[*number not more than 20*]_ _ years. The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the day preceding the _ _[*ordinal number*]_ _ anniversary of that date.

[*Continue*]

The annuity amount shall be paid in equal quarterly installments at the end of each calendar quarter from income, and to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal.

[*Add if annuity amount stated as a percentage*]

If the initial net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the Trustee shall pay to the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an undervaluation) or receive from the Recipient _ _[*and the Charitable Recipient*]_ _ (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

[*Continue*]

3. *Proration of Annuity Amount*. The Trustee shall prorate the annuity amount on a daily basis for any short taxable year. In the taxable year of the trust during which the annuity period ends, the Trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

[*Add one of the following alternatives*]

[*Alternative 1: Named charity as remainderman*]

4. *Distribution to Charity*. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient or the Recipient's estate _ _[*and the Charitable Recipient*]_ _ under the provisions above) to _ _[*name of designated remainderman*]_ _ (hereinafter "the Charitable Organization").

[*If applicable, add the following option*]

[*Option: Retained right to substitute remainderman*]

The donor reserves the right to designate, at any time and from time to time, in lieu of the Charitable Organization identified above, one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the charitable remainderman and shall make any such designation by giving written notice to the trustee.

[*Continue*]

If the Charitable Organization is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Alternative 2: Recipient's power to appoint remainderman*]

4. *Distribution to Charity*. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient or the Recipient's estate _ _[*and the Charitable Recipient*]**_ _ under the provisions above) to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the recipient shall appoint and direct by specific reference to this power of appointment by inter vivos or testamentary instrument. To the extent that the Recipient fails to effectively exercise this power of appointment, the principal and income not effectively appointed shall be distributed to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion. If an organization fails to qualify as an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.**

[*Continue*]

5. *Additional Contributions*. No additional contributions shall be made to the trust after the initial contribution.

6. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of IRC §4941(d), as modified by IRC §4947(a)(2)(A), and shall not make any taxable expenditures within the meaning of §4945(d), as modified by IRC §4947(a)(2)(A).

7. *Taxable Year*. The taxable year of the trust shall be the calendar year.

8. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state, e.g., California*]**_ _. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder annuity trust under IRC §664(d)(1) and the corresponding regulations.**

9. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder annuity trust within the meaning of IRC §664(d)(1).

10. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

This form meets the requirements for an inter vivos charitable remainder annuity trust for two lives with consecutive interests under IRC §664(d)(1). Rev Proc 2003-55, 2003-2 Cum Bull 242.

Annuity Trust Payments During Two Lives, Consecutive Interests

On this _ _[*ordinal number*]_ _ day of _ _[*month*]_ _, _ _[*year*]_ _, I, _ _[*name of donor*]_ _ (hereinafter "the Donor"), desiring to establish a charitable remainder annuity trust, within the meaning of Rev Proc 2003-55 and Internal Revenue Code (hereinafter "IRC") §664(d)(1), hereby enter into this trust agreement with _ _[*name of trustee*]_ _ as the initial trustee (hereinafter "the Trustee"). This trust shall be known as the _ _[*name of trust*]_ _ Charitable Remainder Annuity Trust.

1. *Funding of Trust*. The Donor hereby transfers and irrevocably assigns, on the above date, to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property under the terms set forth in this trust instrument.

[*Add one of the following alternatives*]

[*Alternative 1: Payment of annuity amount to individuals*]

2. *Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of permissible recipient*]_ _ (hereinafter "the Successor Recipient") (subject to any proration in paragraph 4) an annuity amount equal to _ _[*dollar amount/_ _[number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _. The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of death of the Initial Recipient and the Successor Recipient.

[*Alternative 2: Payment of part of annuity amount to charity*]

2. *Payment of Annuity Amount*. The annuity amount is equal to _ _[*dollar amount/_ _[number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _. In each taxable year of the trust during the annuity period, the Trustee shall pay _ _[*number*]_ _ percent of the annuity amount to _ _[*name of permissible recipient*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of permissible recipient*]_ _ (hereinafter "the Successor Recipient") (subject to any proration in paragraph 4), and _ _[*number*]_ _ percent of the annuity amount to _ _[*name of charitable organization*]_ _ (hereinafter "the Charitable Recipient"). The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of death of the Initial Recipient and the Successor Recipient. If the Charitable Recipient is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any annuity payment is to be distributed to it, then the Trustee shall distribute that annuity payment to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Alternative 3: Retained right to revoke successor interest*]

2. *Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the Trustee shall pay to _ _[*name of donor*]_ _ (hereinafter "the Initial Recipient") until the Initial Recipient's death, and thereafter to _ _[*name of permissible recipient*]_ _ (hereinafter "the Successor Recipient") (subject to any proration in paragraph 4) an annuity amount equal to _ _[*dollar amount/_ _[number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _. The Donor hereby reserves expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of the Successor Recipient under this trust. The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of death of the survivor of the Initial Recipient and the Successor Recipient or, if the Donor revokes the interest of the Successor Recipient, the date of the Initial Recipient's death.

[*Continue*]

The annuity amount shall be paid in equal quarterly installments at the end of each calendar quarter from income, and to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal.

[*Add if annuity amount stated as a percentage*]

If the initial net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the Trustee shall pay to the Initial Recipient and/or

Successor Recipient _ _[*and the Charitable Recipient*]**_ _ (in the case of an undervaluation) or receive from the Initial Recipient and/or Successor Recipient _ _**[*and the Charitable Recipient*]**_ _ (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.**

[*Continue*]

3. *Payment of Federal Estate Taxes and State Death Taxes*. The lifetime annuity interest of the Successor Recipient will take effect on the death of the Initial Recipient only if the Successor Recipient furnishes the funds for payment of any federal estate taxes and state death taxes for which the Trustee may be liable on the death of the Initial Recipient. If the funds are not furnished by the Successor Recipient, the annuity period shall terminate on the death of the Initial Recipient, notwithstanding any other provision in this instrument to the contrary.

[*Add one of the following alternatives*]

[*Alternative 1: Proration of annuity amount when recipient dies*]

4. *Proration of Annuity Amount*. The Trustee shall prorate the annuity amount on a daily basis for any short taxable year. If the Successor Recipient survives the Initial Recipient, the Trustee shall prorate on a daily basis the next regular annuity payment due after the death of the Initial Recipient between the estate of the Initial Recipient and the Successor Recipient. In the taxable year of the trust during which the annuity period ends, the Trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

[*Alternative 2: Termination of annuity payment when initial recipient dies*]

4. *Proration of Annuity Amount*. Except as provided below, the Trustee shall prorate the annuity amount on a daily basis for any short taxable year. The obligation of the Trustee to pay the annuity amount to the Initial Recipient shall terminate with the regularly quarterly installment next preceding the Initial Recipient's death. In the taxable year of the trust in which the annuity period ends, the Trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

[*Alternative 3: Termination of annuity payment when successor recipient dies*]

4. *Proration of Annuity Amount*. Except as provided below, the Trustee shall prorate the annuity amount on a daily basis for any short taxable year. If the Successor Recipient survives the Initial Recipient, the Trustee shall prorate on a daily basis the next regular annuity payment due after the death of the Initial Recipient between the estate of the Initial Recipient and the Successor Recipient. In the taxable year of the trust during which the annuity period ends, the obligation of the Trustee to pay the annuity amount to the Successor Recipient shall terminate with the regularly quarterly installment next preceding the Successor Recipient's death.

[*Alternative 4: Termination of annuity payment when initial or successor recipient dies*]

4. *Proration of Annuity Amount*. Except as provided below, the Trustee shall prorate the annuity amount on a daily basis for any short taxable year. The obligation of the Trustee to pay the annuity amount to the Initial Recipient shall terminate with the regularly quarterly installment next preceding the Initial Recipient's death. In the taxable year of the trust during which the annuity period ends, the obligation of the Trustee to pay the annuity amount to the Successor Recipient shall terminate with the regularly quarterly installment next preceding the Successor Recipient's death.

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Named charity as remainderman*]

5. *Distribution to Charity*. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipients or their estates _ _[*and the Charitable Recipient*]**_ _ under the provisions above) to _ _**[*name of designated remainderman*]**_ _ (hereinafter "the Charitable Organization").**

[*If applicable, add the following option*]

[*Option: Retained right to substitute remainderman*]

The donor reserves the right to designate, at any time and from time to time, in lieu of the Charitable Organization identified above, one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the charitable remainderman and shall make any such designation by giving written notice to the trustee.

[*Continue*]

If the Charitable Organization is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Alternative 2: Recipient's power to appoint remainderman*]

5. *Distribution to Charity*. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipients or their estates _ _[*and the Charitable Recipient*]**_ _ under the provisions above) to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as _ _**[*name of one of the permissible recipients*]**_ _ shall appoint and direct by specific reference to this power of appointment by inter vivos or testamentary instrument. To the extent that this power of appointment is not effectively exercised, the principal and income not effectively appointed shall be distributed to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion. If an organization fails to qualify as an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.**

[*Continue*]

6. *Additional Contributions*. No additional contributions shall be made to the trust after the initial contribution.

7. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of IRC §4941(d), as modified by IRC §4947(a)(2)(A), and shall not make any taxable expenditures within the meaning of IRC §4945(d), as modified by IRC §4947(a)(2)(A).

8. *Taxable Year*. The taxable year of the trust shall be the calendar year.

9. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state, e.g., California*]**_ _. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder annuity trust under IRC §664(d)(1) and the corresponding regulations.**

10. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder annuity trust within the meaning of IRC §664(d)(1).

11. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

This form meets the requirements for an inter vivos charitable remainder annuity trust for two lives with concurrent and consecutive interests under IRC §664(d)(1). Rev Proc 2003-56, 2003-2 Cum Bull 249.

Annuity Trust Payments During Two Lives, Concurrent and Consecutive Interest

On this _ _[*ordinal number*]**_ _ day of _ _**[*month*]**_ _, _ _**[*year*]**_ _, I, _ _**[*name of donor*]**_ _ (hereinafter "the Donor"), desiring to establish a charitable remainder annuity trust, within the meaning of Rev Proc 2003-56 and**

Internal Revenue Code (hereinafter "IRC") §664(d)(1), hereby enter into this trust agreement with _ _[*name of trustee*]_ _ as the initial trustee (hereinafter "the Trustee"). This trust shall be known as the _ _[*name of trust*]_ _ Charitable Remainder Annuity Trust.

1. *Funding of Trust*. The Donor hereby transfers and irrevocably assigns, on the above date, to the Trustee the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property under the terms set forth in this trust instrument.

[*Add one of the following alternatives*]

[*Alternative 1: Payment of annuity amount to individuals*]

2. *Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the Trustee shall pay to _ _[*name of permissible recipient*]_ _ and to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipients") in equal shares during their lifetimes an annuity amount equal to _ _[*dollar amount/_ _[number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _, and on the death of one (hereinafter "the Predeceasing Recipient") the Trustee shall pay the entire annuity amount (subject to any proration in paragraph 4) to the survivor (hereinafter "the Survivor Recipient"). The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the Survivor Recipient's death.

[*Alternative 2: Payment of part of annuity amount to charity*]

2. *Payment of Annuity Amount*. The annuity amount is equal to _ _[*dollar amount/_ _[number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _. In each taxable year of the trust during the annuity period, the Trustee shall pay _ _[*number*]_ _ percent of the annuity amount to _ _[*name of permissible recipient*]_ _ and to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipients") in equal shares during their lifetimes, and on the death of one (hereinafter "the Predeceasing Recipient") the Trustee shall pay that entire percentage of the annuity amount (subject to any proration in paragraph 4) to the survivor (hereinafter "the Survivor Recipient"). In each taxable year of the trust during the annuity period, the Trustee shall pay _ _[*number*]_ _ percent of the annuity amount to _ _[*name of charitable organization*]_ _ (hereinafter "the Charitable Recipient"). The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of Survivor Recipient's death. If the Charitable Recipient is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any annuity payment is to be distributed to it, then the Trustee shall distribute that annuity payment to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Alternative 3: Retained right to revoke successor interest*]

2. *Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the Trustee shall pay to _ _[*name of donor*]_ _ and to _ _[*name of permissible recipient*]_ _ (hereinafter "the Recipients) in equal shares during their lifetimes an annuity amount equal to _ _[*dollar amount/_ _[number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of all property transferred to the trust, valued as of the above date (that is, the date of the transfer)*]_ _, and on the death of one (hereinafter "the Predeceasing Recipient") the Trustee shall pay the entire annuity amount (subject to any proration in paragraph 4) to the survivor (hereinafter "the Survivor Recipient"). The Donor hereby reserves expressly reserves the power, exercisable only by the Donor's last will and testament, to revoke and terminate the interest of _ _[*name of permissible recipient who is not the donor*]_ _ under this trust. The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of death of the Survivor Recipient, or on the earlier death of the Donor if the power to revoke _ _[*name of permissible recipient who is not the donor*]_ _'s interest is exercised.

[*Continue*]

The annuity amount shall be paid in equal quarterly installments at the end of each calendar quarter from income, and to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal.

[*Add if annuity amount stated as a percentage*]

If the initial net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the Trustee shall pay to the Recipients _ _[*and the Charitable Recipient*]_ _ (in the case of an undervaluation) or receive from the Recipients _ _[*and the Charitable Recipient*]_ _ (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

[*Continue*]

3. *Payment of Federal Estate Taxes and State Death Taxes*. The lifetime annuity interest of the Survivor Recipient will take effect on the death of the Predeceasing Recipient only if the Survivor Recipient furnishes the funds for payment of any federal estate taxes and state death taxes for which the Trustee may be liable on the death of the Predeceasing Recipient. If the funds are not furnished by the Survivor Recipient, the annuity period shall terminate on the death of the Predeceasing Recipient, notwithstanding any other provision in this instrument to the contrary.

[*Add one of the following alternatives*]

[*Alternative 1: Proration of annuity amount when recipient dies*]

4. *Proration of Annuity Amount*. The Trustee shall prorate the annuity amount on a daily basis for any short taxable year. On the death of the Predeceasing Recipient, the Trustee shall prorate on a daily basis the Predeceasing Recipient's share of the next regular annuity payment due after the death of the Initial Recipient between the estate of the Predeceasing Recipient and the Survivor Recipient. In the taxable year of the trust during which the annuity period ends, the Trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

[*Alternative 2: Termination of annuity payment when predeceasing recipient dies*]

4. *Proration of Annuity Amount*. Except as provided below, the Trustee shall prorate the annuity amount on a daily basis for any short taxable year. The obligation of the Trustee to pay a share of the annuity amount to the Predeceasing Recipient shall terminate with the regularly quarterly installment next preceding the Predeceasing Recipient's death. In the taxable year of the trust in which the annuity period ends, the Trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

[*Alternative 3: Termination of annuity payment when survivor recipient dies*]

4. *Proration of Annuity Amount*. The Trustee shall prorate the annuity amount on a daily basis for any short taxable year. On the death of the Predeceasing Recipient, the Trustee shall prorate on a daily basis the Predeceasing Recipient's share of the next regular annuity payment due between the estate of the Predeceasing Recipient and the Survivor Recipient. In the taxable year of the trust during which the annuity period ends, the obligation of the Trustee to pay the annuity amount to the Survivor Recipient shall terminate with the regularly quarterly installment next preceding the Survivor Recipient's death.

[*Alternative 4: Termination of annuity payment when predeceasing or survivor recipient dies*]

4. *Proration of Annuity Amount*. Except as provided below, the Trustee shall prorate the annuity amount on a daily basis for any short taxable year. The obligation of the Trustee to pay a share of the annuity amount to the Predeceasing Recipient shall terminate with the regularly quarterly installment next preceding the Predeceasing Recipient's death. In the taxable year of the trust in which the annuity period ends, the Trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Named charity as remainderman*]

5. *Distribution to Charity*. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipients or their estates _ _[*and the Charitable Recipient*]_ _ under the provisions above) to _ _[*name of designated remainderman*]_ _ (hereinafter "the Charitable Organization").

[*If applicable, add the following option*]

[*Option: Retained right to substitute remainderman*]

The donor reserves the right to designate, at any time and from time to time, in lieu of the Charitable Organization identified above, one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the charitable remainderman and shall make any such designation by giving written notice to the trustee.

[*Continue*]

If the Charitable Organization is not an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Alternative 2: Recipient's power to appoint remainderman*]

5. *Distribution to Charity*. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipients or their estates _ _[*and the Charitable Recipient*]_ _ under the provisions above) to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as _ _[*name of one of the permissible recipients*]_ _ shall appoint and direct by specific reference to this power of appointment by inter vivos or testamentary instrument. To the extent that this power of appointment is not effectively exercised, the principal and income not effectively appointed shall be distributed to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion. If an organization fails to qualify as an organization described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time when any principal or income is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in IRC §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

[*Continue*]

6. *Additional Contributions*. No additional contributions shall be made to the trust after the initial contribution.

7. *Prohibited Transactions*. The Trustee shall not engage in any act of self-dealing within the meaning of IRC §4941(d), as modified by IRC §4947(a)(2)(A), and shall not make any taxable expenditures within the meaning of IRC §4945(d), as modified by IRC §4947(a)(2)(A).

8. *Taxable Year*. The taxable year of the trust shall be the calendar year.

9. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state, e.g., California*]_ _. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the trust as a charitable remainder annuity trust under IRC §664(d)(1) and the corresponding regulations.

10. *Limited Power of Amendment*. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder annuity trust within the meaning of IRC §664(d)(1).

11. *Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

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Appendix I

Inter Vivos QTIP Trust

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

Description

Contributions to this trust qualify for the gift tax marital deduction under the qualified terminable interest property (QTIP) provisions of IRC §2523(f). The trust is primarily used in situations in which one spouse (the donor) has substantial property and the other spouse (the less wealthy spouse) has very little property. Under these circumstances adverse tax consequences could result if the less wealthy spouse were to die first. Assuming the taxable estate of the less wealthy spouse is worth less than the full IRC §2010 applicable exclusion amount ($2 million in 2006-2008, $3.5 million in 2009), there would be a failure to take maximum advantage of the right to the less wealthy spouse to transfer the full applicable exclusion amount free of tax. Similarly there would be a failure take full advantage of the IRC §2631 GST exemption of the less wealthy spouse. Further, if the less wealthy spouse dies first, relatively little of the aggregate property interests of both spouses will receive a new income tax basis at the time of that death under IRC §1014 (IRC §1022 if the spouse dies in 2010). See §2.39A.

An inter vivos QTIP trust should always be funded exclusively with the donor's separate property. A contribution of community property would result in the beneficiary making a contribution to a trust for the beneficiary's own benefit. The many complex tax issues and administrative problems which could result include the possibility of a completed gift by the beneficiary adversely valued under the special valuation rules of IRC §2702. Although the following form permits additions by persons other than the settlor, the tax consequences of any such contributions must be carefully analyzed.

CAVEAT: To make an effective QTIP election for an inter vivos trust it is imperative to make the election on a timely filed gift tax return. Treas Reg §25.2523(f)-1(b)(4). If contributions are made to the trust in more than one year, the election must be made on timely returns for each contribution.

The Mary Doe Irrevocable QTIP Trust for John Doe

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUST

- **A. Transfer to Trust**
- **B. Name of Trust**
- **C. Additions to Trust**
- **D. Irrevocability of Trust**

ARTICLE TWO: DISTRIBUTIONS

- **A. Mandatory Distribution of Income and Discretionary Distributions of Principal**
- **B. Distribution of Remainder**

ARTICLE THREE: OFFICE OF TRUSTEE

- **A. Nomination of Successor Trustees**
- **B. Substitution of Trustee**
- **C. Removal of Trustee**
- **D. Nonliability of Successor Trustee**
- **E. Compensation of Trustee**

ARTICLE FOUR: TRUSTEE POWERS

A. Broad Investment Powers

B. Power to Retain Trust Property

C. Power to Hold Unproductive Property

D. Power to Acquire or Dispose of Trust Property

E. Power to Lease Trust Property

F. Power to Manage Securities

G. Power to Register Shares

H. Power to Hold Property as Nominee

I. Power to Employ Agents

J. Power to Retain Investment Counsel

K. Power to Borrow

L. Power to Litigate and Compromise Claims

M. Power to Insure

N. Power to Consider Tax Consequences

O. Power to Purchase Bonds at Premium

P. Power to Purchase Bonds at Discount

Q. Power to Delay Distributions

R. Payment of Undistributed Income

S. Allocation of Expenses

T. Trustee Prohibitions

ARTICLE FIVE: MISCELLANEOUS

A. Trustee Exculpation Clause

B. Perpetuities Savings Clause

C. Spendthrift Clause

D. Definition of "Education"

E. Definition of "Children" and "Issue"

F. Gender and Number

G. Governing Law

The Mary Doe Irrevocable QTIP Trust for John Doe

8.2-1 Trust agreement

This agreement is made between _ _[*name of settlor*]_ _ (called the "settlor") and _ _[*name of trustee*]_ _, as trustee.

ARTICLE ONE
Creation of Trust

A. *Transfer to Trust*. The settlor hereby transfers and delivers to the trustee, without consideration, _ _[*ten dollars ($10) or more/the property described in Schedule A, attached to this trust*]_ _. All property subject to this trust from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.

8.5-1 Name of trust

B. *Name of Trust*. The primary beneficiary of this trust is _ _[*e.g., John Doe*]_ _ (called the primary beneficiary). This trust may be referred to as _ _[*e.g., The Mary Doe Irrevocable QTIP Trust for John Doe*]_ _.

10.122-1 Authorization of additions to trust

C. *Additions to Trust*. Other property acceptable to the trustee may be added to _ _[*this/these*]_ _ trust(s) by any person, by the will or codicil of _ _[*the/either*]_ _ settlor, by the proceeds of any life insurance, or otherwise.

8.7-1 Irrevocability of trust

D. *Irrevocability of Trust*. This trust is irrevocable, and the settlor has no power of amendment.

ARTICLE TWO
Distributions

2.39A-1 Mandatory distribution of income and discretionary distribution of principal

A. *Mandatory Distribution of Income and Discretionary Distributions of Principal*. During the lifetime of the primary beneficiary, the Trustee shall pay to or apply for the benefit of the primary beneficiary all of the net income of this trust in quarter-annual or more frequent installments. If the income is insufficient, the Trustee shall pay to or apply for the benefit of the primary beneficiary, at quarter-annual or more frequent intervals, as much of the principal of the QTIP Trust as the Trustee in its discretion determines is appropriate for the primary beneficiary's health, education, and support. In exercising its discretion the Trustee may take into account other income and resources available to the primary beneficiary to such extent, if any, as the trustee deems appropriate. Income earned between the last distribution date and the date of the primary beneficiary's death shall be distributed to the persons entitled to distribution of income earned immediately following the primary beneficiary's death. The primary beneficiary, including any attorney-in-fact or Conservator authorized to act on behalf of the primary beneficiary, may compel the trustee to invest the trust estate in income producing assets.

Comment: The clause above is intended to satisfy the IRC §2523(f) requirements for a QTIP trust.

2.39A-2 Distribution of remainder

B. *Distribution of Remainder*. On the death of the primary beneficiary the remaining trust estate shall be distributed as follows: _ _[*e.g., to the then-living issue of the donor, per stirpes*]_ _

Comment: The provisions for distribution of the trust following the death of the primary beneficiary can provide for establishing a second QTIP trust for the benefit of the original donor. See the introduction to this form. If this is desired, the original donor must be entitled to all trust income from the time of the death of the less wealthy spouse until the donor's death and no person can have a power to appoint the trust assets to anyone other than the donor during that period. IRC §2523(f).

ARTICLE THREE
Office of Trustee

10.33-1 Designation of successor trustees

A. *Nomination of Successor Trustees*. If at any time _ _[*person/institution*]_ _ ceases to act as trustee, the _ _[*person(s)/institution(s)*]_ _ listed below shall serve as successor trustee(s) in the order named:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

If the nominated successor also fails to qualify or ceases to act, _ _[*name*]_ _ shall have the power to name a successor trustee.

9.15-2 Trustee may resign and appoint substitute trustee

B. *Substitution of Trustee*. Any trustee may resign as trustee at any time and appoint a successor trustee as long as no trustee acting from time to time is settlor _ _[*or a spouse not legally separated from the settlor*]_ _ and no more than half the number of trustees acting from time to time are related or subordinate parties to either settlor within the meaning of Internal Revenue Code §672(c) or any successor statute. This power may be exercised or relinquished by a written instrument delivered to each acting trustee and to each person to whom payment may then be made at the trustee's discretion.

Comment: See Caveat in §9.15 concerning substitution of trustees. In most cases the settlor or the spouse can be the trustee of an inter vivos QTIP trust. See the introduction to this form. In such cases the prohibition against naming such successors can be deleted.

10.31-1 Trustee removal due to trustee incapacity or illness

C. *Removal of Trustee*. If the trustee is unable to serve because of physical or mental incapacity or illness, the successor trustee(s) named in this trust _ _[*in the order designated*]_ _ shall serve as trustee, having all rights and powers granted to the trustee by this trust. Physical or mental incapacity or illness shall be conclusively established if two physicians authorized to practice medicine in the State of California or any other place in which the trustee resides, who are unrelated to the settlor and the trustee by blood or marriage, examine the trustee and issue written declarations under penalty of perjury that state that the trustee is unable to serve because of incapacity or illness that is more likely than not to continue for an additional _ _[*number*]_ _ days _ _[*and _ _[name(s) of particular physician _ _[and/or*]_ _ *trusted friend*]_ _ *concur(s) that the trustee is incapacitated*]_ _. By assuming the office of trustee, any individual shall be deemed to have waived the doctor-patient privilege to the extent necessary to implement this clause. In the absence of declarations of incapacity, the successor trustee designated in this trust _ _[*or one or more of the beneficiaries*]_ _ may petition the Court having jurisdiction over this trust to remove the then-serving trustee and replace _ _[*him/her*]_ _ with the designated successor trustee. The successor trustee or beneficiary who petitions the Court shall incur no liability to any beneficiary of the trust or to the substituted trustee as a result of this petition unless the petition is filed in bad faith or without a reasonable belief that the substituted trustee is physically or mentally incapacitated or otherwise unable to serve.

10.41-1 Successor trustee's nonliability for predecessor's acts

D. *Nonliability of Successor Trustee*. No successor trustee shall be liable for any act, omission, or default of a predecessor trustee. The successor trustee may accept the accounting records of the predecessor trustee showing assets on hand without further investigation and without incurring any liability to any person claiming or having an interest in the trust.

10.51-1 Reasonable compensation (individual trustee)

E. *Compensation of Trustee*. The trustee _ _[*other than a settlor*]_ _ shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

ARTICLE FOUR
Trustee Powers

10.57-1 Introduction to trustee's powers

To carry out the purposes of the trusts created by this instrument, and subject to any limitations provided elsewhere in this instrument, and expressly subject to the power of the primary beneficiary to compel the trustee to make the trust estate productive and the right of the primary beneficiary to receive that income, the trustee shall have, without necessity of application to any Court, the following powers in addition to those conferred by California Trust Law.

Comment: The clause above has been modified to further clarify that the spouse has the right to compel the trustee to make the trust property productive. This avoids a potential contention that the trustee's powers to hold unproductive property could be used to defeat the spouse's income interest. If such a contention was successful the trust likely would fail to qualify for the marital deduction. Treas Reg §20.2056(b)-5(f)(4).

10.60-1 Broad investment powers under prudent investor rule

A. *Broad Investment Powers*. The trustee may invest in any kind of property (real, personal, or mixed) or any kind of investment (specifically including, but not limited to, corporate obligations of every kind; preferred or common stocks; shares of investment trusts, investment companies, and mutual funds _ _[*including any common trust funds administered by the trustee*]_ _; life insurance policies; notes, real estate, bonds, debentures, mortgages, deeds of trusts, mortgage participations, market funds, and index funds appropriate under the then-prevailing circumstances) or engage in any course of action or investment strategy consistent with the standards of the Uniform Prudent Investor Act (UPIA) (Probate Code §§16002(a), 16003, 16045-16054).

10.63-1 Power to retain property (standard clause)

B. *Power to Retain Trust Property*. The trustee may continue to hold any property _ _[*, including any shares of the trustee's own stock,*]_ _ and to operate at the risk of the trust estate any business that the trustee receives or acquires under the trust as long as the trustee, at the trustee's discretion, considers it advisable to do so.

10.64-1 Power to retain unproductive or underproductive property

C. *Power to Hold Unproductive Property*. The trustee may retain, purchase, or otherwise acquire unproductive or underproductive property _ _[*subject to the provisions set out elsewhere in this trust*]_ _

10.68-1 Power to sell, exchange, manage, encumber, and grant options on property (standard clause)

D. *Power to Acquire or Dispose of Trust Property*. The trustee may acquire or dispose of trust property, at public or private sale, for cash or credit (including deferred payments extending beyond the duration of this trust); exchange trust property; manage, control, divide, develop, improve, exchange, partition, change the character of, repair, alter, or abandon trust property; encumber, mortgage, or pledge trust property for a term within or beyond the term of the trust in connection with the exercise of any power vested in the trustee; and grant options on trust property.

10.70-1 Power to lease, including oil and mineral development (standard clause)

E. *Power to Lease Trust Property*. The trustee may lease trust property for terms within or beyond the term of the trust for any purpose (including exploration for and removal of gas, oil, minerals, and geothermal energy) and enter into community oil leases and pooling and unitization agreements.

10.72-1 Power to manage securities (standard clause)

F. *Power to Manage Securities*. The trustee shall have all the rights, powers, and privileges of an owner of the securities held in the trust, including, but not limited to, the powers to:

(1) Vote, give proxies, and pay assessments;

(2) Participate in voting trusts and pooling agreements and enter into shareholders' agreements, including, but not limited to, buy-sell agreements, close corporation and S corporation shareholders' agreements, and limited liability company member agreements;

(3) Consent to foreclosures, reorganizations, consolidations, mergers, and liquidations;

(4) Deposit securities with and transfer title to any protective or other committee on any terms that the trustee, at the trustee's discretion, considers advisable; and

(5) Exercise or sell stock subscription or conversion rights.

10.73-1 Power to register shares for sale (closely held or controlled public corporation)

G. *Power to Register Shares*. The trustee may register, or qualify for exemption from registration, shares of stock in any corporation with any agency of any government (including, but not limited to, the United States Securities and Exchange Commission); participate in any such registration or exemption from registration; apply for and secure approval of the agency for sale of these shares; sell these shares or participate in the public or private sale of these shares; enter into any agreement for the sale with any broker, investment banker, or underwriter; incur and pay all expenses connected with the registration, qualification, or sale; execute any indemnification agreement or other instrument required to consummate the registration, underwriting, or sale; and take all other actions necessary or appropriate to consummate the registration, qualification, or sale.

Comment: This power should be inserted only when trust corpus includes shares of a closely held business or

controlled public corporation and the trustee is likely to sell shares to the public.

10.75-1 Authority to hold trust property as nominee

H. *Power to Hold Property as Nominee*. The trustee may hold:

(1) Stocks and other securities in the trustee's name as trustee under this trust, in a nominee's name, with or without any express designation of the status of the person as nominee, or in the name of the broker who handled the asset purchase (what is commonly called "street name"). The trustee also may, at the trustee's discretion, hold unregistered securities in "bearer" form, which enables ownership of the shares to pass on delivery.

(2) The property of the trust in the name of the trustee individually, with or without disclosing the capacity as trustee, or as trustee, with or without designation of any beneficiary.

10.77-1 Power to employ agents

I. *Power to Employ Agents*. The trustee may employ any custodian, attorney, accountant, corporate fiduciary, or any other agent or agents to assist the trustee in the administration of this trust _ _[*and to rely on the advice given by these agents*]_ _. The power to employ agents includes the power to delegate management and investment functions according to Probate Code §16052. Any agent or adviser shall receive reasonable compensation for all services performed, which shall be paid from the trust estate from either income or principal, as the trustee, at the trustee's discretion, determines, and shall _ _[*not*]_ _ decrease the compensation to which the trustee is entitled.

10.78-1 Individual trustee's power to employ investment counsel

J. *Power to Retain Investment Counsel*. The trustee may retain professional investment counsel of the trustee's choice, regarding investments held by these trusts, as long as the selected counsel is currently handling _ _[*specify parameters, e.g., at least five other accounts of similar or greater size*]_ _. If investment counsel is retained, the trustee shall abide by the counsel's decision but shall not be held liable or otherwise surcharged for losses directly attributable to investments made on the investment counsel's advice. While investment counsel is retained by the trustee, the trustee shall not be required to review trust investments subject to the investment counsel's supervision unless the trustee is apprised of facts clearly indicating that counsel is not performing competently. The trustee need not take action on those investments unless the trustee receives written instructions from the investment counsel. If counsel is retained, the trustee's fees for the trustee's ordinary services while counsel is retained shall be _ _[*reduced to a sum equal to _ _[number]_ _ percent of the fee normally charged by the trustee for ordinary services to such property/reasonably reduced*]_ _. The trustee shall have the power exercisable at the trustee's discretion to discharge such counsel and to employ other counsel or to administer the trust without such counsel.

10.80-1 Power to borrow (standard clause)

K. *Power to Borrow*. The trustee may borrow money and encumber trust property by mortgage, deed of trust, pledge, or otherwise, for the debts of the trust or the joint debts of the trust and a co-owner

10.85-1 Power to initiate and defend litigation and power to compromise (standard clause)

L. *Power to Litigate and Compromise Claims*. The trustee may initiate or defend, at the expense of the trust, any litigation that the trustee considers advisable relating to the trust or any property of the trust estate, and compromise, submit to arbitration, abandon, or otherwise adjust any claims or litigation against or in favor of the trust, as long as the trustee determines, at the trustee's discretion, that such action will be beneficial to the trust. The trustee's powers under this clause shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no obligations or duties, however, for any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss connected with these matters.

10.87-1 Power to insure (standard clause)

M. *Power to Insure*. The trustee may carry, at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.

10.96-1 Power to consider tax consequences of distributions

N. *Power to Consider Tax Consequences*. When determining whether to distribute income or corpus

authorized by this trust and the person to whom it is made, the trustee may consider the tax consequences to the trust and to the beneficiaries to whom distribution may be made.

19.28-1 Power to purchase bonds at premium

O. *Power to Purchase Bonds at Premium*. The trustee may purchase bonds and pay any premiums connected with the purchase that the trustee at the trustee's discretion considers advisable.

19.29-1 Power to purchase bonds at discount

P. *Power to Purchase Bonds at Discount*. The trustee may purchase bonds at such discount as the trustee at the trustee's discretion considers advisable.

10.109-1 Power to withhold payment if conflicting claims arise

Q. *Power to Delay Distributions*. When an event occurs on which the trustee is required to divide or distribute trust property, the trustee may delay the division or distribution of all or part of the property (without later payment of interest) for the period of time necessary to ascertain and provide for the payment of any tax claim or other liability, contingent or otherwise, against the property. During this period, the trustee may pay the net income of the trust to the beneficiaries entitled to it. Any income not distributed shall, on resolution of any tax claim or other liability, be payable to the person entitled to it immediately after income is received by the trustee. This clause shall not be deemed to postpone or defer the vesting of any interest created under the dispositive clauses of the trust.

10.114-1 Undistributed income payable to next beneficiaries

R. *Payment of Undistributed Income*. Income accrued or unpaid on trust property when received into the trust shall be treated as any other income. Income accrued or held undistributed by the trustee at the termination of any trust created under this instrument shall go to the next beneficiaries of the trust in proportion to their interest in it.

10.116-1 Allocation of expenses among successive beneficiaries; proration required

S. *Allocation of Expenses*. The trustee shall prorate all taxes and current expenses among successive beneficiaries on a daily basis over the period to which these expenses relate.

10.100-1 Trustee prohibited from exercising certain powers

T. *Trustee Prohibitions*. The trustee is expressly prohibited from exercising any power vested in the trustee primarily for the benefit of the settlor rather than for the benefit of the beneficiaries. Neither the settlor nor any other person may:

(1) Purchase, exchange, or otherwise deal with or dispose of the income or principal of the trust estate for less than adequate and full consideration in money or money's worth;

(2) Borrow the income or principal of the trust estate, directly or indirectly, without adequate interest or without adequate security; or

(3) Vote, directly or indirectly, any securities of a controlled corporation (as defined by Internal Revenue Code §2036(b)(2) or any successor statute) transferred by the settlor to the trust.

ARTICLE FIVE
Miscellaneous

10.120-1 Notice to trustee of births, deaths, and other events affecting interests

A. *Trustee Exculpation Clause*. Unless the trustee has received actual _ _[*written*]_ _ notice of the occurrence of an event affecting the beneficial interests of this trust, the trustee shall not be liable to any beneficiary of this trust for proceeding as though the event had not occurred. This clause shall not exculpate the trustee from liability arising from nonpayment of estate taxes or generation-skipping transfer taxes that may be payable by the trust on the occurrence of an event affecting the beneficial interests in this trust.

9.59-1 Perpetuities savings clause

B. *Perpetuities Savings Clause*. Each trust created by this instrument shall terminate no later than 21 years

after the death of the last survivor of the beneficiaries of the trust who are living on the date the trust becomes irrevocable. If a trust terminates by reason of the previous sentence, the remaining trust estate shall be distributed to the persons then entitled to the trust income in the proportions of their income entitlement unless the trustee has discretion to distribute income among a class, in which case the trustee shall have the same discretion to distribute the remaining trust estate among the members of that class. For purposes of this paragraph, a trust created by the exercise a special power of appointment as defined in California Probate Code §611 is not a new trust.

10.124-1 Short-form spendthrift clause

C. *Spendthrift Clause*. No interest in the income or principal of any trust created under this instrument shall be voluntarily or involuntarily anticipated, assigned, encumbered, or subjected to creditor's claim or legal process before actual receipt by the beneficiary.

10.132-1 Education

D. *Definition of "Education"*. Whenever provision is made in this trust to pay for the education of a beneficiary, the term "education" shall include tuition for vocational school, college, and postgraduate study _ _[*if the trustee determines that the beneficiary pursues this study to his or her advantage*]_ _ **at an institution of the beneficiary's choice. Payments for "education" shall also include expenses for books, supplies, and tutors.**

10.134A-1 Issue and children (lineal descendants)

E. *Definition of "Children" and "Issue"*. All references in this trust to the term "issue" refer to lineal descendants of all degrees. The terms "child," "children," and "issue" _ _[*do not*]_ _ **include** _ _[*e.g., stepchildren/foster children/adopted children who* _ _[*were/need not have been*]_ _ *minors at the date of adoption*]_ _**. All references to the terms "issue," "child," and "children" include a child born out of wedlock if a parent-child relationship existed between the child and his or her deceased parent. Except as otherwise expressly provided in this trust, for purposes of this trust the existence of a parent-child relationship shall be determined by California law.**

10.128-1 Gender and number

F. *Gender and Number*. In all matters of interpretation necessary to give effect to any clause of this trust, the masculine includes the feminine and neuter, the singular includes the plural, and the plural includes the singular.

10.126-1 Specifying law to govern validity, construction, and administration of trust

G. *Governing Law*. The internal laws (and not the law of conflicts) of the State of California _ _[*in force*]_ _ _ _[*on the date of execution of this trust/from time to time*]_ _ **shall govern the validity, construction, interpretation, and administration of** _ _[*this trust/any trust created under this instrument*]_ _**, except that all matters relating to real property shall be governed by the laws of the situs of the real property. If any trust created under this instrument is administered outside California, a court with jurisdiction over the trustee of the trust may order that the law of that state governs the trust, as long as the change of governing law will not adversely affect the interests of the trust beneficiaries.**

8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _**, California, on** _ _[*date*]_ _**.**

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

State of California)
)
County of _ _[*name of county*]_ _)
)
_____)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

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Appendix J

Inter Vivos QDOT Trust

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Description

Transfers at death to a spouse who is not a citizen of the United States generally do not qualify for the normal IRC §2056 estate tax marital deduction unless the spouse is a resident of the United States and becomes a citizen before the estate tax return is filed. IRC §2056(d). However, the rough equivalent of a temporary marital deduction can be obtained by transferring property to a qualified domestic trust ("QDOT") meeting the requirements of IRC §2056A. Under the statutory scheme, distributions of income to the spouse are not subject to tax, but a delayed estate tax is imposed on most distributions of principal other than distributions on account of hardship. IRC §2056A(b)(1)(A). The tax even applies to distributions of principal in 2010, when the estate tax is repealed. IRC §2210(b)(1). The primary function of the QDOT is to provide a device for assuring the government that it will be able to collect this deferred estate tax. In many circumstances the necessity for a QDOT terminates if the surviving spouse later becomes a citizen. If the spouse does not become a citizen, QDOT tax is imposed on the remaining QDOT assets when the spouse dies or when the trust ceases to meet the requirements for a QDOT, whichever occurs first.

If the decedent leaves property to a standard marital deduction trust, the trust can be reformed to satisfy the requirements of IRC §2056A. If, however, property passes outright to the spouse, the temporary marital deduction is available only if the surviving spouse establishes an irrevocable inter vivos trust meeting QDOT requirements. The following form is intended for use by a noncitizen surviving spouse wishing to establish such a trust. The trust must be funded with property included in the decedent's gross estate (or acquired by sale or exchange of such assets). Treas Reg §20.2056A-4(b)(3). Because the QDOT in the following form is a "grantor trust" under IRC §671, no gain or loss will be recognized if the settlor exchanges assets with the trust after the trust is funded. See §2.81A.

The settlor can be the primary trustee of the trust provided the trust instrument appoints a separate United States trustee (a citizen or a domestic corporation) who has the power to withhold the QDOT tax from distributions of principal. IRC §2056A(a)(1)(B). The following form does not make such a division of trustee responsibilities, with the consequence that the trustee must be a United States trustee.

In some cases property cannot be transferred to a trust having a United States trustee. This can occur because the property cannot be transferred (*e.g.,* retirement benefits) or because a foreign jurisdiction does not permit ownership of particular property by a United States trustee or does not recognize trusts. The regulations permit making special arrangements with the IRS in such cases. If the following form is used with pension rights or interests in an IRA, the settlor must execute specified agreements in lieu of transfer documents. See, *e.g.,* Treas Reg §20.2056A-4(c)-(d).

The Mary Doe Irrevocable QDOT Trust

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUST

A. Transfer to Trust

B. Name of Trust

C. Additions to Trust

D. Irrevocability of Trust

ARTICLE TWO: QUALIFIED DOMESTIC TRUST

A. Purpose of Trust

B. Security Requirement

C. United States Trustee

D. Designated Filer

ARTICLE THREE: DISTRIBUTIONS

A. Trustee's Right to Withhold Tax

B. Mandatory Distribution of Income

C. Discretionary Distributions of Principal

D. Settlor's Withdrawal Power

D. Distribution to Settlor on Termination

E. Settlor's Power of Appointment

ARTICLE FOUR: OFFICE OF TRUSTEE

A. Restrictions on Trustee

B. Nomination of Successor Trustees

C. Compensation of Trustee

ARTICLE FOUR: TRUSTEE POWERS

A. Broad Investment Powers

B. Power to Retain Trust Property

C. Power to Hold Unproductive Property

D. Power to Acquire or Dispose of Trust Property

E. Power to Lease Trust Property

F. Power to Manage Securities

G. Power to Register Shares

H. Power to Employ Agents

I. Power to Retain Investment Counsel

J. Power to Borrow

K. Power to Litigate and Compromise Claims

L. Power to Insure

M. Power to Consider Tax Consequences

N. Power to Purchase Bonds at Premium

O. Power to Purchase Bonds at Discount

P. Power to Delay Distributions

ARTICLE FIVE: MISCELLANEOUS

A. Gender and Number

B. Governing Law

The Mary Doe Irrevocable QDOT Trust

8.2-1 Trust agreement

This agreement is made between _ _[*name of settlor*]_ _ (called the "settlor") and _ _[*name of trustee*]_ _, as trustee.

ARTICLE ONE
Creation of Trust

A. *Transfer to Trust*. The settlor hereby transfers and delivers to the trustee, without consideration, _ _[*ten dollars ($10) or more/the property described in Schedule A, attached to this trust*]_ _. All property subject to this trust from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.

8.5-1 Name of trust

B. *Name of Trust*. This trust may be referred to as _ _[*e.g., The Mary Doe Irrevocable Qualified Domestic Trust*]_ _.

10.122-1 Authorization of additions to trust

C. *Additions to Trust*. Other property acceptable to the trustee may be added to this trust by the settlor.

8.7-1 Irrevocability of trust

D. *Irrevocability of Trust*. This trust is irrevocable, and the settlor has no power of amendment.

ARTICLE TWO
Qualified Domestic Trust

2.81B-1 Construction of trust

A. *Purpose of Trust*. This trust is intended to be a qualified domestic trust ("QDOT") satisfying the requirements of Internal Revenue Code §2056A, and applicable Treasury Regulations, including Treasury Regulation §§20.2056A-0 through 20.2056A-13. All provisions of this trust shall be construed in a manner which will result in the trust satisfying those requirements and the trustee shall administer the trust accordingly. The trustee shall have continuing authority to modify this trust to the extent necessary to satisfy those requirements.

Comment: The foregoing language is not required, but is highly recommended.

2.81C-1 Compliance with security requirement

B. *Security Requirement*. This trust must be administered in compliance with Treasury Regulation §20.2056A-2(d)(1)(i)(A), (B), or (C).

Comment: The governing instrument must contain the language of this subparagraph or far more extensive language concerning compliance with requirements for security arrangements. Treas Reg §20.2056A-2(d)(1)(i). Rev Proc 96-54, 1996-2 Cum Bull 386.

2.81D-1 United States trustee

C. *United States Trustee*. In accordance with the requirements of Internal Revenue Code §2056A, this trust shall at all times have at least one trustee who is a citizen of the United States with a tax home (as defined in Internal Revenue Code §911(d)(3)) in the United States or a domestic corporation. The trustee satisfying this requirement is hereafter referred to as "the United States trustee." No distribution (other than a distribution of income) may be made from this trust unless the United States trustee has the right to withhold from such distribution the tax imposed by Internal Revenue Code §2056A.

Comment: The provisions of this subparagraph are required by IRC §2056A(a)(1)(A)-(B) and Treas Reg §20.2056A-2(d)(2).

[*Optional*]

2.81E-1 Designated filer

D. *Designated Filer*. Property of the settlor's predeceased spouse has been transferred to more than one qualified domestic trust for the benefit of the settlor. The Internal Revenue Code §2056A(b)(2)(C) designated filer for all of such trusts is _ _[*e.g., the United States trustee of this trust*]_ _.

Comment: This paragraph is not needed unless there is more than one QDOT. If there are multiple QDOTs, QDOT tax will be imposed at the maximum estate tax rate unless there is a designated filer. IRC §2056A(b)(2)(C). A designated filer is named on the estate tax return and a majority of the trustees can elect a replacement if necessary. Treas Reg §20.2056A-9. Multiple QDOTs with different beneficiaries create difficult coordination problems because the QDOTs which distribute principal first will often be subject to lower estate tax rates than the QDOTs distributing principal later.

ARTICLE THREE
Distributions

2.81F-1 Distribution of income and principal

A. *Trustee's Right to Withhold Tax*. The provisions of this Article Three are subject to the right of the United States trustee to withhold from distribution the tax imposed by Internal Revenue Code §2056A, as set forth in Article Two.

B. *Mandatory Distribution of Income*. During the lifetime of the settlor, the trustee shall pay to or apply for the benefit of the settlor, at quarter-annual or more frequent intervals, all income of the trust and such amounts of principal as may be so paid or applied without making a distribution which will be subject to tax (regardless of whether any tax would be due) under Internal Revenue Code §2056A(b).

C. *Discretionary Distributions of Principal*. If the foregoing amounts are insufficient, the trustee shall pay to or apply for the benefit of the settlor, at quarter-annual or more frequent intervals, such additional sums are the trustee determines are appropriate for the settlor's health, education, maintenance and support. In exercising its discretion, the trustee is not required to take into account other income and resources available for these purposes.

D. *Settlor's Withdrawal Power*. The trustee shall further pay to or apply for the benefit of the settlor such additional sums as the settlor may from time to time request in writing. This power of withdrawal may be exercised on behalf of the settlor by an attorney-in-fact if so authorized in the appointing instrument.

E. *Distribution to Settlor on Termination*. If this trust is terminated during the life of the settlor, the balance of the trust estate shall be distributed to the settlor.

G. *Settlor's Power of Appointment*. On the death of the settlor, the remaining trust estate shall be distributed as the settlor directs in a written instrument delivered to the trustee during the settlor's lifetime. This is a

general power of appointment, which may be exercised in favor of any desired appointee including the settlor's estate. In the event this power of appointment is not effectively exercised with respect to any assets of the trust estate, those assets shall be distributed on the death of the settlor as follows: _ _[*specify*]_ _.

Comment: If the settlor has a revocable trust estate plan, it may be desirable for the QDOT trust to pour over to the revocable trust.

ARTICLE FOUR
Office of Trustee

2.81G-1 Restrictions

A. *Restrictions on Trustee*. The provisions of this Article Four are subject to the restrictions contained in Article Two.

2.81G-2 Designation of successor trustees

B. *Nomination of Successor Trustees*. If at any time a trustee ceases to act as trustee, the settlor may name a new trustee. If the settlor fails to do so, the _ _[*person(s)/institution(s)*]_ _ listed below shall serve as successor trustee(s) in the order named:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

_ _[*If the nominated successor also fails to qualify or ceases to act, _ _[name]_ _ may name a successor trustee.*]_ _

Comment: In the context of a QDOT, it is permissible to give the settlor the power to name successor trustees.

10.51-1 Reasonable compensation (individual trustee)

C. *Compensation of Trustee*. The trustee _ _[*other than a settlor*]_ _ shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

ARTICLE FIVE
Trustee Powers

10.57-1 Introduction to trustee's powers

To carry out the purposes of the trusts created by this instrument, and subject to the limitations provided elsewhere in this instrument, the trustee shall have, without necessity of application to any Court, the following powers in addition to those conferred by California Trust Law.

10.60-1 Broad investment powers under prudent investor rule

A. *Broad Investment Powers*. The trustee may invest in any kind of property (real, personal, or mixed) or any kind of investment (specifically including, but not limited to, corporate obligations of every kind; preferred or common stocks; shares of investment trusts, investment companies, and mutual funds _ _[*including any common trust funds administered by the trustee*]_ _; life insurance policies; notes, real estate, bonds, debentures, mortgages, deeds of trusts, mortgage participations, market funds, and index funds appropriate under the then-prevailing circumstances) or engage in any course of action or investment strategy consistent with the standards of the Uniform Prudent Investor Act (UPIA) (Probate Code §§16002(a), 16003, 16045-16054).

10.63-1 Power to retain property (standard clause)

B. *Power to Retain Trust Property*. The trustee may continue to hold any property _ _[*, including any shares of the trustee's own stock,*]_ _ and to operate at the risk of the trust estate any business that the trustee receives or acquires under the trust as long as the trustee, at the trustee's discretion, considers it advisable to do so.

10.64-1 Power to retain unproductive or underproductive property

C. *Power to Hold Unproductive Property*. The trustee may retain, purchase, or otherwise acquire unproductive or underproductive property.

10.68-1 Power to sell, exchange, manage, encumber, and grant options on property (standard clause)

D. *Power to Acquire or Dispose of Trust Property*. The trustee may acquire or dispose of trust property, at public or private sale, for cash or credit (including deferred payments extending beyond the duration of this trust); exchange trust property; manage, control, divide, develop, improve, exchange, partition, change the character of, repair, alter, or abandon trust property; encumber, mortgage, or pledge trust property for a term within or beyond the term of the trust in connection with the exercise of any power vested in the trustee; and grant options on trust property.

10.70-1 Power to lease, including oil and mineral development (standard clause)

E. *Power to Lease Trust Property*. The trustee may lease trust property for terms within or beyond the term of the trust for any purpose (including exploration for and removal of gas, oil, minerals, and geothermal energy) and enter into community oil leases and pooling and unitization agreements.

10.72-1 Power to manage securities (standard clause)

F. *Power to Manage Securities*. The trustee shall have all the rights, powers, and privileges of an owner of the securities held in the trust, including, but not limited to, the powers to:

(1) Vote, give proxies, and pay assessments;

(2) Participate in voting trusts and pooling agreements and enter into shareholders' agreements, including, but not limited to, buy-sell agreements, close corporation and S corporation shareholders' agreements, and limited liability company member agreements;

(3) Consent to foreclosures, reorganizations, consolidations, mergers, and liquidations;

(4) Deposit securities with and transfer title to any protective or other committee on any terms that the trustee, at the trustee's discretion, considers advisable; and

(5) Exercise or sell stock subscription or conversion rights.

10.73-1 Power to register shares for sale (closely held or controlled public corporation)

G. *Power to Register Shares*. The trustee may register, or qualify for exemption from registration, shares of stock in any corporation with any agency of any government (including, but not limited to, the United States Securities and Exchange Commission); participate in any such registration or exemption from registration; apply for and secure approval of the agency for sale of these shares; sell these shares or participate in the public or private sale of these shares; enter into any agreement for the sale with any broker, investment banker, or underwriter; incur and pay all expenses connected with the registration, qualification, or sale; execute any indemnification agreement or other instrument required to consummate the registration, underwriting, or sale; and take all other actions necessary or appropriate to consummate the registration, qualification, or sale.

Comment: This power should be inserted only when trust corpus includes shares of a closely held business or controlled public corporation and the trustee is likely to sell shares to the public.

10.77-1 Power to employ agents

H. *Power to Employ Agents*. The trustee may employ any custodian, attorney, accountant, corporate fiduciary, or any other agent or agents to assist the trustee in the administration of this trust _ _[*and to rely on the advice given by these agents*]**_ _. The power to employ agents includes the power to delegate management and investment functions according to Probate Code §16052.**

10.78-1 Individual trustee's power to employ investment counsel

I. *Power to Retain Investment Counsel*. The trustee may retain professional investment counsel of the trustee's choice, regarding investments held by these trusts, as long as the selected counsel is currently handling _ _[*specify parameters, e.g., at least five other accounts of similar or greater size*]_ _. If investment counsel is retained, the trustee shall abide by the counsel's decision but shall not be held liable or otherwise surcharged for losses directly attributable to investments made on the investment counsel's advice. While investment counsel is retained by the trustee, the trustee shall not be required to review trust investments subject to the investment counsel's supervision unless the trustee is apprised of facts clearly indicating that counsel is not performing competently. The trustee need not take action on those investments unless the trustee receives written instructions from the investment counsel. If counsel is retained, the trustee's fees for the trustee's ordinary services while counsel is retained shall be _ _[*reduced to a sum equal to _ _[number]_ _ percent of the fee normally charged by the trustee for ordinary services to such property/reasonably reduced*]_ _. The trustee shall have the power exercisable at the trustee's discretion to discharge such counsel and to employ other counsel or to administer the trust without such counsel.

10.80-1 Power to borrow (standard clause)

J. *Power to Borrow*. The trustee may borrow money and encumber trust property by mortgage, deed of trust, pledge, or otherwise, for the debts of the trust or the joint debts of the trust and a co-owner

10.85-1 Power to initiate and defend litigation and power to compromise (standard clause)

K. *Power to Litigate and Compromise Claims*. The trustee may initiate or defend, at the expense of the trust, any litigation that the trustee considers advisable relating to the trust or any property of the trust estate, and compromise, submit to arbitration, abandon, or otherwise adjust any claims or litigation against or in favor of the trust, as long as the trustee determines, at the trustee's discretion, that such action will be beneficial to the trust. The trustee's powers under this clause shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no obligations or duties, however, for any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss connected with these matters.

10.87-1 Power to insure (standard clause)

L. *Power to Insure*. The trustee may carry, at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.

10.96-1 Power to consider tax consequences of distributions

M. *Power to Consider Tax Consequences*. When determining whether to distribute income or corpus authorized by this trust and the person to whom it is made, the trustee may consider the tax consequences to the trust and to the beneficiaries to whom distribution may be made.

19.28-1 Power to purchase bonds at premium

N. *Power to Purchase Bonds at Premium*. The trustee may purchase bonds and pay any premiums connected with the purchase that the trustee at the trustee's discretion considers advisable,

19.29-1 Power to purchase bonds at discount

O. *Power to Purchase Bonds at Discount*. The trustee may purchase bonds at such discount as the trustee at the trustee's discretion considers advisable.

10.109-1 Power to withhold payment if conflicting claims arise

P. *Power to Delay Distributions*. When an event occurs on which the trustee is required to divide or distribute trust property, the trustee may delay the division or distribution of all or part of the property (without later payment of interest) for the period of time necessary to ascertain and provide for the payment of any tax

claim or other liability, contingent or otherwise, against the property. During this period, the trustee may pay the net income of the trust to the beneficiaries entitled to it. Any income not distributed shall, on resolution of any tax claim or other liability, be payable to the person entitled to it immediately after income is received by the trustee. This clause shall not be deemed to postpone or defer the vesting of any interest created under the dispositive clauses of the trust.

ARTICLE SIX
Miscellaneous

10.128-1 Gender and number

A. *Gender and Number*. In all matters of interpretation necessary to give effect to any clause of this trust, the masculine includes the feminine and neuter, the singular includes the plural, and the plural includes the singular.

10.126-1 Specifying law to govern validity, construction, and administration of trust

B. *Governing Law*. The internal laws (and not the law of conflicts) of the State of California _ _[*in force*]_ _ _ _[*on the date of execution of this trust/from time to time*]_ _ shall govern the validity, construction, interpretation, and administration of _ _[*this trust/any trust created under this instrument*]_ _, except that all matters relating to real property shall be governed by the laws of the situs of the real property. If any trust created under this instrument is administered outside California, a court with jurisdiction over the trustee of the trust may order that the law of that state governs the trust, as long as the change of governing law will not adversely affect the interests of the trust beneficiaries.

8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

State of California)
)
County of _ _[*name of county*]_ _ **)**
)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

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Appendix K

Nongrantor Charitable Lead Annuity Trust

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Description

This form establishes a nongrantor charitable lead annuity trust that pays a fixed amount per year to a charity for a selected number of years (the "charitable term"). The trust qualifies for a gift tax deduction, but not an income tax deduction. The trust is suitable for a wealthy donor who has already exhausted available charitable income tax deductions and wishes to make additional charitable gifts. If trust investment results are better than those assumed when the gift to the remaindermen is valued at the inception of the trust under IRC §7520, the additional investment benefits pass to the remaindermen free of gift tax. See chap 18A.

The John and Mary Doe Charitable Lead Annuity Trust

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUST

- **A. Transfer to Trust**
- **B. Name of Trust**
- **C. Irrevocability of Trust**

ARTICLE TWO: PAYMENTS TO CHARITY

- **A. Payment of Guaranteed Annuity**
- **B. Adjustment for Incorrect Valuation**

ARTICLE THREE: PAYMENTS TO OTHER BENEFICIARIES

ARTICLE FOUR; LIMITED POWER TO AMEND

ARTICLE FIVE: OFFICE OF TRUSTEE

- **A. Nomination of Successor Trustees**
- **B. Resignation of Trustee**
- **C. Removal and Appointment of Trustee**
- **D. Waiver of Trustee Bond**
- **E. Compensation of Trustee**
- **F. Nonliability of Successor Trustee**

ARTICLE SIX: TRUSTEE PROHIBITIONS

- **A. Trustee Self-Dealing**

B. No Investment Restriction on Trustee

C. Payment of Estate and Gift Taxes

ARTICLE SEVEN: TRUSTEE POWERS

ARTICLE EIGHT: MISCELLANEOUS

A. Calendar Year

B. Governing Law

ACCEPTANCE BY TRUSTEE

SCHEDULE A

The John and Mary Doe Charitable Lead Annuity Trust

8.2-1 Trust agreement

This agreement is made between _ _[*names of settlors*]_ _ (called the "settlors") and _ _[*name of trustee*]_ _, as trustee.

ARTICLE ONE
Creation of Trust

8.3-1 Declaration of trust

A. *Transfer to Trust*. The settlors hereby transfer and deliver to the trustee, without consideration, the property described in Schedule A attached to this trust. All property subject to this trust from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this agreement. No additional contributions may be made to the trust.

8.5-1 Name of trust

B. *Name of Trust*. This trust may be referred to as _ _[*e.g., The John and Mary Doe*]_ _ Charitable Lead Annuity Trust.

8.7-1 Trust is irrevocable

C. *Irrevocability of Trust*. This trust is irrevocable and may not be altered or amended in any respect except as specifically authorized by this instrument and may not be terminated except through distributions permitted by this instrument.

18.74-1 Additional contributions prohibited

D. *Additional Contributions Prohibited*. No additional contributions shall be made to the trust after the initial contribution.

ARTICLE TWO
Payments to Charity

18A.21-1 Payment of Guaranteed Annuity

A. *Payment of Guaranteed Annuity*. The "charitable beneficiary" of the trust is _ _[*name of charity*]_ _. The "charitable term" of this trust begins immediately and terminates _ _[*number of years of lead term*]_ _ hereafter. The "annual annuity amount" is _ _[*number*]_ _ percent of the fair market value of the trust on _ _[*date*]_ _. On the first December 31 during the charitable term, the trustee shall distribute to the charitable beneficiary the annual annuity amount multiplied by a fraction having a numerator of the number of days of the charitable

term that fall within the current calendar year and a denominator of the number of all days in the current calendar year. On each subsequent December 31 during the charitable term, the trustee shall distribute to the charitable beneficiary the annual annuity amount. On the last day of the charitable term the trustee shall distribute to the charitable beneficiary the annual annuity amount multiplied by a fraction having a numerator of the number of days of the charitable term that fall within the calendar year in which the term expires and a denominator of the number of all days in that calendar year. The trustee shall not make any other distributions until the charitable term has expired and all required distributions to the charitable beneficiary have been made. These distributions shall not be prepaid or commuted.

B. *Adjustment for Incorrect Valuation*. For purposes of the previous paragraph, the initial fair market value of the trust estate is the value as finally determined for federal gift tax purposes. If the initial net fair market value of the trust assets initially determined by the trustee is less than the value finally determined for federal gift tax purposes, the trustee shall pay to the charitable beneficiary an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid plus appropriate interest.

ARTICLE THREE
Payments to Other Beneficiaries

17.46-1 Distributions on termination

On expiration of the charitable term and payment of the payments to be made to the charitable beneficiary as provided above, the balance of the trust estate shall be _ _[*specify desired distribution or provide for retaining trust estate in continued trust with desired distribution provisions*]_ _.

ARTICLE FOUR
Limited Power To Amend

18A.25-1 Savings clause

The settlor(s) _ _[*intends/intend*]_ _ that the interest passing to _ _[*name of charity*]_ _ under this trust shall be a guaranteed annuity that qualifies for tax deductions under Internal Revenue Code §§2055 and 2522. All clauses of this instrument shall be interpreted according to this intention. The trustee shall have the power to amend the terms of this instrument in writing without application to any court to the extent permitted by the Internal Revenue Code and applicable Treasury Regulations to qualify and continue to qualify the trust for those deductions. If at any time a distribution is otherwise to be made to _ _[*name of charity*]_ _ and _ _[*name of charity*]_ _, which is not an organization described in Internal Revenue Code §§2055(a) and 2522(a), the trustee shall make the distribution to one or more organizations selected by the trustee, at the trustee's discretion, which are then so described.

ARTICLE FIVE
Office of Trustee

10.33-1 Designation of successor trustees

A. *Nomination of Successor Trustees*. If at any time the initial trustee fails to qualify or ceases to serve as trustee, the _ _[*person(s)/institution(s)*]_ _ listed below shall serve as successor trustee(s) in the order named:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

If the nominated successor also fails to qualify or ceases to act, _ _[*name*]_ _ shall have the power to name a successor trustee.

10.28-1 Resignation of Trustee

B. *Resignation of Trustee*. Any trustee may resign at any time on sixty (60) days' written notice to the settlor(s). The trustee shall continue to act until a successor trustee accepts the trusteeship.

10.30-1 Trustee removal and replacement by beneficiary or third party

C. *Removal and Appointment of Trustee*. By written instrument delivered to the trustee, _ _[*name of beneficiary or third party*]_ _ may remove any trustee serving under this trust and appoint any _ _[*person/corporation*]_ _ _ _[*except _ _[himself/herself]_ _ _ _[or any settlor or any party related or subordinate to any settlor (within the meaning of Internal Revenue Code §672(c))*]_ _]_ _ as successor trustee or cotrustee, with this designation superseding any appointment made under this trust. This power to name a successor trustee or cotrustee may also be exercised in the event no trustee is acting for any other reason.

10.49-1 Trustee's bond

D. *Waiver of Trustee Bond*. No bond shall be required of any person named in this instrument as trustee or of any person appointed as trustee in the manner specified in this trust for the faithful performance of his or her duties as trustee.

10.51-1 Reasonable compensation (individual trustee)

E. *Compensation of Trustee*. The trustee shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

10.41-1 Successor trustee's nonliability for predecessor's acts

F. *Nonliability of Successor Trustee*. No successor trustee shall be liable for any act, omission, or default of a predecessor trustee. The successor trustee may accept the accounting records of the predecessor trustee showing assets on hand without further investigation and without incurring any liability to any person claiming or having an interest in the trust.

ARTICLE SIX
Trustee Prohibitions

18A.23-1 Private foundation prohibitions

A. *Prohibited Transactions*. During the charitable term the trustee is prohibited from engaging in any act of self-dealing as defined in Internal Revenue Code §4941(d), from retaining any excess business holdings as defined in Internal Revenue Code §4943(c) that would subject the trust to tax under Internal Revenue Code §4943, from making any investments that would subject the trust to tax under Internal Revenue Code §4944, and from making any taxable expenditures as defined in Internal Revenue Code §4945(d). The trustee shall make distributions at such time and in such manner so as not to subject the trust to tax under Internal Revenue Code §4942.

Comment: In the rare case that the present value of the lead interest at the inception of the trust is less than 60 percent of the total assets of the trust on that date, the trust will not be subject to IRC §§4943-4944, in which case the prohibitions concerning those sections may be deleted. IRC §4947(b)(3)(A); Treas Reg §1.170A-6(c)(2)(i)(D).

18.83-1 Investment of trust assets

B. *No Investment Restriction on Trustee*. Nothing in this trust instrument shall be construed to restrict the trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

18.85-1 No taxes payable from trust

C. *Payment of Estate and Gift Taxes*. No gift, legacy, succession, inheritance, estate taxes, or generation-skipping transfer taxes that may be assessed against the property of the trust created by this instrument by reason of a settlor's transfer to the trust or a settlor's death shall be paid out of any property held in this trust. Each settlor agrees on behalf of himself or herself, his or her heirs, legal representatives, successors, and assigns to provide for payments of any such taxes from sources other than property held by this trust and to indemnify and hold harmless the trustee from any and all liability for such taxes. Each settlor agrees that the trustee shall not be liable for any federal or state death taxes or generation-skipping transfer taxes payable. Each settlor imposes an obligation on _ _[*his/her*]_ _ estate to pay all such taxes, and each settlor agrees to

provide for the payment of all such taxes from sources other than the trust estate.

ARTICLE SEVEN
Trustee Powers

10.58-1 Trustee's powers

The trustee is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

(1) Each power enumerated in California Probate Code §§16047, 16052, 16200, and 16220-16249 and any successor statutes as amended from time to time.

(2) The power to make or decline to make any tax election affecting the trust or its beneficiaries.

(3) The power to determine the market value of any investment of any trust for any purpose on the basis of such quotation, evidence, data, or information as the trustee may deem pertinent and reliable and to make any division or distribution pro rata or non-pro rata, in undivided interests or in kind or partly in money and partly in kind on partial or final distribution.

ARTICLE EIGHT
Miscellaneous

18.87-1 Taxable year

A. *Calendar Year*. The taxable year of the trust shall be the calendar year.

18.88-1 Governing law

B. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state*]_ _. The trustee is prohibited, however, from exercising any power or discretion granted under those laws that would be inconsistent with the qualification of the trust under Internal Revenue Code §664 and the corresponding regulations.

8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]_
_ _[*Typed name*]_ _
Settlor

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

State of California)
)
County of _ _[*name of county*]_ _)
)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

ACCEPTANCE BY TRUSTEE

In consideration of the foregoing, the trustee accepts the trust thus committed to it and agrees to act in accordance with the terms stated above.

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

[*Acknowledgment; see §8.12*]

SCHEDULE A

Items:

1.

2.

Accepted by the trustee:

Dated: _ _ _ _ _ _ _ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

Comment: See discussion in the Note in §18.40 regarding the use of dated and signed Schedule A as proof of creation and funding of charitable remainder trust.

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Appendix L

Grantor Retained Annuity Trust

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Description

This form establishes a grantor retained annuity trust that pays a fixed amount per year to the grantor for a selected number of years (the trust term). The trust is suitable for a wealthy donor who has already exhausted the IRC §2505 gift tax applicable exclusion amount and wishes to make additional gifts without payment of gift tax. The trust is designed to have a gift tax value of zero, as permitted by *Audrey J. Walton* (2000) 115 TC 589, acq 2003-44 Int Rev Bull 964. To this end, the trust does not terminate on the death of the grantor, and the annuity amount is paid to the grantor's estate if the grantor dies during the trust term. If trust investment results are better than those assumed when the gift to the remaindermen is valued at the inception of the trust under IRC §7520, the additional investment benefits will pass to the remaindermen free of gift tax. See chap 15.

The John J. Smith Grantor Retained Annuity Trust

TABLE OF CONTENTS

OPENING DECLARATION

ARTICLE ONE: TRUST NAME

ARTICLE TWO: TRUST ESTATE

A. Administration of Trust Estate

B. Additional Contributions Prohibited

ARTICLE THREE: IRREVOCABILITY OF TRUST

ARTICLE FOUR: TERM OF TRUST

ARTICLE FIVE: OPERATION DURING TRUST TERM

A. Payment of Annuity Amount

B. Determination of Annuity Amount

C. Proration of Annuity Amount

D. No Payments to Other Beneficiaries

E. Commutation Prohibited

F. Payment to Settlor or Settlor's Estate

ARTICLE SIX: DISTRIBUTION ON TRUST TERMINATION

ARTICLE SEVEN: OFFICE OF TRUSTEE

A. Nomination of Successor Trustees

B. Compensation of Trustee

ARTICLE EIGHT: TRUSTEE POWERS

ARTICLE NINE: GOVERNING LAW

ARTICLE TEN: STATEMENT OF INTENT

SCHEDULE A

The John J. Smith Grantor Retained Annuity Trust

15.19-1 Declaration of transfer to trustee

I, _ _[*name of settlor*]_ _ (called the "settlor"), hereby transfer and deliver to _ _[*name of trustee*]_ _, as trustee, the property described in Schedule A attached to this instrument.

ARTICLE ONE
Trust Name

15.20-1 Trust name

The trust created by this instrument may be referred to as the _ _[*name(s) of settlor(s), e.g., John J. Smith*]_ _ Grantor Retained Annuity Trust.

ARTICLE TWO
Trust Estate

15.21-1 Trust estate

A. *Administration of Trust Estate*. All property subject to this instrument from time to time, including the property listed in Schedule A, is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.

B. *Additional Contributions Prohibited*. No additions may be made to the trust estate during the trust term.

Comment: A prohibition on additional contributions to the GRAT is required by Treas Reg §25.2702-3(b)(5).

ARTICLE THREE
Irrevocability of Trust

15.22-1 Irrevocability of trust

This trust is irrevocable and may not be altered or amended.

ARTICLE FOUR
Term of Trust

15.23-1 Trust term

This trust is effective immediately and terminates _ _[*number*]_ _ years after the date of this trust. The period before termination is hereafter referred to as the trust term.

ARTICLE FIVE
Operation During Trust Term

15.24-1 Operation during trust term

During the trust term, the trustee shall distribute to the settlor an annuity at the times and in the amounts

set forth in this Article Five. If the settlor is not then living, the trustee shall distribute the required annuity amount to the settlor's estate.

15.25-1 Payment for each year of trust

A. *Payment of Annuity Amount*. The settlor's right to receive the annuity amount shall begin on the date of this document. The trustee may not issue a note, other debt instrument, option, or similar financial arrangement in satisfaction of the annuity amount. The annuity amount shall be payable to the settlor _ _[*annually/semiannually/quarterly/monthly*]_ _ for each taxable year of the trust term. The annuity amount may be paid after the close of the taxable year as long as the payment is made no later than the date by which the trustee is required to file the federal income tax return of the trust for the year (without regard to extensions) or, if no return is required to be filed because the trust is a grantor trust, the date by which the trustee would be required to file a return if one were required.

15.26-1 Annuity amount

B. *Determination of Annuity Amount*. The annuity amount shall equal _ _[*number*]_ _ percent of the initial value of the property contributed to this trust as finally determined for federal tax purposes. If this value is incorrectly determined by the trustee then, within a reasonable time after the value is set for federal tax purposes, the trustee shall pay to the settlor (in the case of undervaluation), or the settlor shall repay to the trustee (in the case of overvaluation), an amount equal to the difference between the amount that the trustee should have paid to the settlor and the amount actually paid to the settlor.

15.27-1 Short taxable year

C. *Proration of Annuity Amount*. If a taxable year of the trust is for a period of less than 12 months, including the taxable year in which the trust terminates, the annuity amount shall be the amount otherwise determined for the year, multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

Comment: This provision is mandatory. Treas Reg §§25.2702-3(b)(3).

15.29-1 Limitation on trust distributions

D. *No Payments to Other Beneficiaries*. The trustee shall make no distribution to any person other than the settlor or the settlor's estate during the trust term, provided, however, that this provision does not limit the trustee's ability to make distributions for trust expenses.

Comment: This provision is mandatory. Treas Reg §25.2702-3(d)(3).

15.30-1 Commutation prohibited

E. *Commutation Prohibited*. Commutation (prepayment) of the interest of the settlor is prohibited.

Comment: This provision is mandatory. Treas Reg §25.2702-3(d)(5).

15.31-1 Distribution on expiration of trust term

F. *Payment to Settlor or Settlor's Estate*. If the settlor survives the expiration of the trust term, the trustee shall pay the settlor all remaining amounts due under the obligation to pay the annuity as set forth herein. If the settlor fails to survive the trust term, the trustee shall pay all remaining amounts due under the obligation to pay the annuity as set forth herein together with the portion of the trust estate includable in the settlor's gross estate to the settlor's estate. Any amounts remaining after such payment shall be distributed in accordance with Article Six.

ARTICLE SIX
Distributions on Trust Termination

15.32-1 Distribution on termination

On expiration of the trust term, this trust shall terminate and be distributed as follows: _ _[*Specify distribution to family members and others.*]**_ _**

ARTICLE SEVEN
Office of Trustee

15.33-1 Trustees

A. *Nomination of Successor Trustees*. If at any time the _ _[*person/institution*]**_ _ named as trustee fails to qualify or ceases to act as trustee, the _ _**[*persons/institutions*]**_ _ listed below shall serve as successor trustees in the order named:**

First: _ _[*Name of successor trustee*]**_ _**

Second: _ _[*Name of second successor trustee*]**_ _**

_ _[*If the nominated successor also fails to qualify or ceases to act, _ _*[*name*]**_ _** *shall have the power to name a successor trustee.*]**_ _**

B. *Compensation of Trustee*. The trustee shall be entitled to reasonable compensation for services rendered to the trust.

ARTICLE EIGHT
Trustee Powers

15.34-1 Trustee powers

To carry out the purposes of the trust created by this instrument and subject to any limitations stated elsewhere in this instrument, the trustee shall have the following powers in addition to those conferred by California Trust Law:

(1) To retain, purchase, or otherwise acquire underproductive property.

(2) To manage, control, grant options on, sell, convey, exchange, partition, divide, improve, and repair trust property.

(3) To lease trust property.

(4) To borrow money and to encumber trust property by mortgage, deed of trust, pledge, or otherwise.

(5) To initiate or defend, at the expense of the trust, any litigation relating to the trust or any property of the trust estate.

(6) To carry insurance of the kinds and in the amounts the trustee considers advisable, at the expense of the trust, to protect the trust estate and the trustee personally against any hazard.

(7) To partition, allot, and distribute the trust estate on final distribution in undivided interests or in kind, or partly in money and partly in kind, at valuations determined by the trustee, and to sell any property the trustee considers necessary for division or distribution. The trustee may, in the trustee's discretion, make a nonprorata division between beneficiaries if the respective assets distributed to the beneficiaries have equivalent or proportionate fair market values. The income tax bases of assets distributed non-pro rata need not be equivalent and may vary to a greater or lesser amount, as determined by the trustee in the trustee's discretion.

ARTICLE NINE
Governing Law

15.35-1 Applicable law

The laws of the State of California shall govern the validity, construction, interpretation, and administration

of this trust.

ARTICLE TEN
Statement of Intent

15.36-1 Statement of intent

It is the settlor's intent that this trust shall provide the settlor with a qualified annuity interest under Treasury Regulation §25.2702-3(b) and (d). All provisions of this instrument shall be interpreted according to this intention. Unless prohibited by the Code, Treasury Regulations, or any revenue rulings, revenue procedures, notices, or other administrative pronouncements by the Internal Revenue Service, the trustee shall have the power, without application to any court, to amend the provisions of this document to comply with any additional requirements for qualification as a Grantor Retained Annuity Trust under Internal Revenue Code §2702.

Executed at _ _[*city*]_ _ , California, on _ _[*date*]_ _.

__[*Signature of trustee*]__
_ _[*Typed name*]_ _
Trustee

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

[*Acknowledgment; see §8.12*]

SCHEDULE A

15.37-1 Description of transferred property

Property Transferred and Delivered to the Trustee

_ _[*Describe property*]_ _

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Appendix M

Third Party Special Needs Trust

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Description

This form establishes a third party special needs trust for a disabled beneficiary to be funded by, *e.g.*, grandparents. The trust is designed to avoid the loss of eligibility for public benefits such as Supplemental Security Income (SSI) and Medi-Cal. The trust terminates if it results in the loss of eligibility for public benefits. See chap 13.

The John Doe Special Needs Trust

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUST

- **A. Trust Agreement**
- **B. Irrevocability of Trust**
- **C. Purpose of Trust**

ARTICLE TWO: DISTRIBUTIONS

- **A. Distribution for Special Needs**
- **B. Trustee's Absolute Discretion**
- **C. Trust Advisory Committee**

ARTICLE THREE: TERMINATION

- **A. Termination on Death of Beneficiary**
- **B. Backstop Termination Clause**
- **C. Payment of Expenses**

ARTICLE FOUR: OFFICE OF TRUSTEE

- **A. Nomination of Successor Trustees**
- **B. Waiver of Trustee Bond**
- **C. Compensation of Trustee**
- **D. Nonliability of Successor Trustee**

ARTICLE FIVE: TRUSTEE POWERS

ARTICLE SIX: MISCELLANEOUS

- **A. Trustee to Consider Public Benefits**

B. Trust Estate to Supplement Public Benefits

C. Governing Law

SCHEDULE A

The John Doe Special Needs Trust

ARTICLE ONE
Creation of Trust

A. *Trust Agreement*. This trust, dated _ _[*date*]_ _, is made between _ _[*names of settlors*]_ _, as settlors, and _ _[*names of trustees*]_ _, as trustees. By execution of this agreement, the settlors transfer to the trustees the property described in Schedule A, and the trustees accept the property as the initial trust estate. The trustees and successor trustees shall hold and dispose of the trust estate for the sole benefit of _ _[*name of beneficiary*]_ _, as beneficiary, on the terms of trust set forth in this agreement. The singular term "trustee" shall include the plural term "trustees" unless the context indicates otherwise.

B. *Irrevocability of Trust*. This trust is irrevocable and unamendable; provided, however, that in the event that any provision of this trust fails to meet the financial eligibility requirements of any program of means-tested public benefits for which the beneficiary is or may be eligible, the then-acting trustee or trustees may, in his, her, or their discretion, amend the trust to ensure eligibility for such benefits. Any such amendment shall be in a writing dated and signed by the trustee or trustees and duly acknowledged. In no event shall said trustee have any power or authority under this Article that shall constitute a general power of appointment under Internal Revenue Code §2041 and applicable regulations. In addition, nothing herein shall be construed as depriving any person of the right to seek modification or reformation of this trust under California Probate Code §§15400-15414, or other California Probate Code sections then in effect that govern such trusts. In no event shall the beneficiary have any right or power to alter, amend, revoke, or terminate the Trust, or any of the terms of the Trust instrument, in whole or in part. Furthermore, the beneficiary shall have no right, power, or legal authority to direct the use of the trust corpus for the beneficiary's own support and maintenance.

C. *Purpose of Trust*. The beneficiary of this trust suffers from a disability that substantially impairs _ _[*his/her*]_ _ ability to provide for _ _[*his/her*]_ _ own care and custody and constitutes a substantial handicap. The purpose of this trust is to supplement, not supplant, the public benefits that would be available to the beneficiary if the trust did not exist. _ _[*Currently, the beneficiary has/During the term of the trust, the beneficiary will have*]_ _ basic living needs such as special programs and equipment that public benefits may not provide. It is vitally important that the beneficiary receive these services to maintain a level of human dignity and humane care. If this trust were to be invaded by creditors, subjected to any liens or encumbrances, or cause public benefits to be terminated, the trust corpus would likely be depleted before the beneficiary's death—especially because the cost of care for disabled persons (not including any emergency needs) is high. In this event, there would be no coverage for emergencies or supplementation of basic needs.

The following trust provisions should be interpreted in light of these concerns and this stated intent. The trustee shall hold, administer, and distribute all property allocated to the trust for the benefit of the beneficiary during the beneficiary's lifetime, unless this trust is terminated earlier.

ARTICLE TWO
Distributions

A. *Distribution for Special Needs*. The trustee may pay to or apply for the benefit of the beneficiary as much of the trust net income and principal as the trustee, in the trustee's discretion, considers necessary or advisable from time to time to meet the beneficiary's special needs. Any income not distributed shall be accumulated and added to principal. As used in this instrument, "special needs" are the requisites for maintaining the beneficiary's good health, safety, and welfare when, in the trustee's discretion, such requisites are not being provided by any public agency, office, or department of any city, county, or state government; the federal government; or any private agency. "Special needs" may include, but are not limited to, the following: _ _[*e.g., dental care; recreation and entertainment; special equipment; and programs of training, education, and treatment supplemental to those that the beneficiary is entitled to receive under a government assistance program*]_ _.

B. *Trustee's Absolute Discretion*. Although a primary intent of this trust is to preserve the beneficiary's eligibility for public benefits, the overriding goal of the trust is to ensure that the beneficiary's standard of living will be comfortable and enjoyable. Consequently, the availability of public benefits to pay for a specific need shall not deprive the trustee of the authority, in the trustee's sole and absolute discretion, to make distributions of trust assets for the specific need, even if the distributions cause the reduction of public benefits.

C. *Trust Advisory Committee*. The Trust Advisory Committee (TAC) is responsible to advise the trustee as to distributions that would be in the best interests of the beneficiary. The TAC serves in an advisory capacity only and its role is to make recommendations to the trustee. The trustee has sole and absolute discretion with regard to trust distributions.

The TAC members, named below, were chosen because of their knowledge and experience in assisting persons with disabilities and/or their personal interest in the beneficiary. The TAC shall consist of a minimum of three and a maximum of five members. The initial members of the TAC are:

1. _ _[*name*]_ _, _ _[*address*]_ _, _ _[*relationship*]_ _

2. _ _[*name*]_ _, _ _[*address*]_ _, _ _[*relationship*]_ _

3. _ _[*name*]_ _, _ _[*address*]_ _, _ _[*relationship*]_ _

The trustee shall consider the TAC's advice concerning distributions. If it is impossible or impractical for the trustee to obtain the TAC's advice before a distribution, the trustee may make a distribution without such advice.

No trustee or TAC member shall be personally liable to any beneficiary for the trustee's or TAC member's acts or failure to act, except for willful misconduct, gross negligence, or reckless indifference to the interests of any beneficiary.

If a TAC member is unwilling or unable, for any reason, to serve or to continue to serve as a TAC member, the remaining TAC members shall appoint a successor member so that there will be at least three members serving at all times.

Each TAC member shall be entitled to reasonable compensation for services rendered in this capacity as determined in the trustee's discretion.

ARTICLE THREE
Termination

A. *Termination of Trust*. On the beneficiary's death, the undistributed balance of the trust estate shall be distributed to _ _[*e.g., the settlors' then-living issue, by right of representation*]_ _**.**

B. *Backstop Termination Clause*. Despite any contrary provision in this trust, if the existence of this trust renders the beneficiary ineligible for Supplemental Security Income, Medi-Cal, or any other federal, state, or local program of public benefits, the trustee may, but need not, terminate this trust in whole or in part.

After paying the expenses of trust administration and termination, the trustee shall distribute the portion terminated to the persons and in the relative shares set forth in paragraph _ _[*number*]_ _ **as if the beneficiary were deceased.**

It is the intent of this trust that if it terminates during the beneficiary's lifetime, the distributee shall conserve, manage, and distribute the proceeds of the former trust estate for the benefit of the former beneficiary to ensure that _ _[*he/she*]_ _ **has sufficient funds for** _ _[*his/her*]_ _ **basic living needs when public benefits are unavailable or insufficient. This request is precatory, not mandatory.**

In determining whether the existence of the trust may render the beneficiary ineligible for SSI, Medi-Cal, or any other program of public benefits, the trustee is granted full and complete discretion to initiate either administrative or judicial proceedings, or both, for the purpose of determining eligibility. All costs relating to

such proceedings (including reasonable attorney fees) shall be a proper charge to the trust estate.

C. *Payment of Expenses*. On the death of the beneficiary or other termination of this trust, the trustee may, in the trustee's discretion, pay any death taxes attributable to any part of the trust estate or otherwise, last-illness and funeral expenses, and expenses related to administration or distribution of the trust estate if, in the trustee's opinion, other satisfactory provisions have not been made for the payment of these expenses. The trustee shall make no payments for expenses incurred for the beneficiary's health, support, and maintenance if any city, county, state, federal or other government agency was obligated to pay for those expenses while the beneficiary was alive.

ARTICLE FOUR
Office of Trustee

A. *Nomination of Successor Trustees*. If at any time the initial trustee fails to qualify or ceases to serve as trustee, the _ _[*person(s)/institution(s)*]_ _ listed below shall serve as successor trustee(s) in the order named:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

If the nominated successors also fail to qualify or cease to serve, _ _[*name*]_ _ shall have the power to name a successor trustee.

B. *Waiver of Trustee Bond*. No bond shall be required of any person named in this instrument as trustee or of any person appointed as trustee in the manner specified in this trust for the faithful performance of his or her duties as trustee.

C. *Compensation of Trustee*. The trustee shall be entitled to reasonable compensation based on the trustee's fee schedule as it exists from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

D. *Nonliability of Successor Trustee*. No successor trustee shall be liable for any act, omission, or default of a predecessor trustee. The successor trustee may accept the accounting records of the predecessor trustee showing assets on hand without further investigation and without incurring any liability to any person claiming or having an interest in the trust.

ARTICLE FIVE
Trustee Powers

The trustee of each trust established under this instrument is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

(1) Each power enumerated in California Probate Code §§16047, 16052, 16200, 16220-16249, and any successor statutes as amended from time to time.

(2) The power to invest and reinvest in any kind of property or type of investment.

(3) The power to operate any business at the risk of the trust estate.

(4) The power to retain, purchase, or otherwise acquire unproductive property.

(5) The power to divide any trust created under this instrument into two or more trusts and to administer any addition to a trust as a separate trust.

(6) The power to exercise all rights, powers, and privileges of an owner of securities, insurance, or any other property owned by the trust.

(7) The power to lend money to persons not currently entitled to distributions from the trust as long as the loan is adequately secured and bears a reasonable rate of interest.

(8) The power to loan or advance the trustee's own funds to the trust for any trust purpose, with interest at current rates; to receive security for such loans; to purchase assets of the trust at their fair market value as determined by an independent appraisal of those assets; and to sell property to the trust at a price not in excess of its fair market value as determined by an independent appraisal.

(9) The power to make or decline to make any tax election affecting the trust or its beneficiaries.

(10) The power to borrow money and to encumber trust property.

(11) The power to partition, allot, and distribute trust assets on any prorata or nonprorata division or distribution of any trust, in undivided interests or in kind or partly in money and partly in kind. For such purposes, assets shall be valued as of the date they are distributed or otherwise allocated.

ARTICLE SIX
Miscellaneous

A. *Trustee to Consider Public Benefits*. The trustee is not responsible for seeking support and maintenance for the beneficiary from available public resources. In making distributions for the beneficiary's special needs as defined in paragraph _ _[*number*]_ _, the trustee shall, however, consider the applicable resource and income limitations of the public benefit programs for which the beneficiary is eligible, including SSI, Social Security Disability Insurance, Medicare, Medi-Cal, In-Home Supportive Services, Temporary Assistance for Needy Families (TANF), known in California as California Work Opportunities and Responsibility to Kids (CalWORKs), the appropriate Regional Center established under the Lanterman Developmental Disabilities Services Act, the State Department of Mental Health, county mental health services, and any other appropriate federal, state, or local agency serving disabled individuals. All references in this instrument to "Medi-Cal" shall include any other state's equivalent Medicaid program.

B. *Trust Estate to Supplement Public Benefits*. It is the intent of this trust that the trust estate shall be used to supplement public benefits, not supplant them. For purposes of determining the beneficiary's eligibility for SSI, Medi-Cal, TANF, regional center assistance, and residential and program services from the State Department of Developmental Services and any other program of public benefits, no part of the undistributed income or principal of the trust estate shall be considered an available resource to the beneficiary. However, the availability of public benefits to pay for a specific need shall not deprive the trustee of the authority to make a distribution that causes a reduction of public benefits.

C. *Governing Law*. The internal laws (and not the law of conflicts) of the State of California shall govern the validity, construction, interpretation, and administration of this trust.

Executed at _ _[*city*]_ _**, California, on** _ _[*date*]_ _**.**

__[*Signature*]__
_ _[*Typed name of settlor*]_ _
Settlor

_ _[*Typed name of trustee*]_ _
Trustee

State of California)
)
County of _ _[*name of county*]_ _)
)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

SCHEDULE A

Property Transferred and Delivered to the Trustee

_ _[*Describe property*]_ _

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Appendix N

Generation-Skipping Dynasty Trust

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Description

The following form is appropriate for a grantor trust that will be made exempt from the generation-skipping transfer (GST) tax as a result of allocation of the settlor's GST exemption. The trust is designed to be used in connection with the sale of interests in a family investment company by the settlor in exchange for a promissory note with a face value equal (or nearly equal) to the gift tax value of the interests, so that there is little or no taxable gift on the sale. There is no gain or loss on the sale because the trust is disregarded for income tax purposes. For a detailed discussion and related forms, see chap 13A.

CAVEAT: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book.

The John Doe and Mary Doe 2009 Dynasty Trust

TABLE OF CONTENTS

ARTICLE ONE: ESTABLISHMENT OF TRUST AND NAMING OF TRUSTEES

ARTICLE TWO: IRREVOCABILITY AND UNAMENDABILITY OF TRUST

ARTICLE THREE: DECLARATIONS REGARDING BENEFICIARIES

ARTICLE FOUR: DISPOSITION OF TRUST ESTATE

4.1. During Settlor's Lifetime

4.2. Following Settlor's Death

4.3. Separate Trusts for Issue

(a) During Descendant's Lifetime

(b) After Descendant's Death

4.4. Ultimate Disposition if No Issue

4.5. Overriding Provisions

(a) Restrictions on Settlor's Power as Trustee

(b) Beneficiary Self-Dealing

(c) Insurance on Life of Trustee-Beneficiary

(d) Division of Trust into Exempt and Nonexempt Generation-Skipping Subtrusts

(e) Combination of Substantially Identical Trusts Under This Instrument

(f) Addition of Trust to Substantially Identical Trust Under Another Instrument

(g) Equitable Adjustments

(h) S Corporation Stock and Electing Small Business Trust

(i) Anti-Retaliation Provision

(j) Trustee's Authority to Retain Shares of _ _[*Name of Company*]**_ _**

(k) Grantor Trust Provisions

(1) Settlor's Power to Reacquire Principal of the Trust and Substitute Other Property of Equivalent Value

(2) Special Trustee's Power to Add Charitable Beneficiaries

ARTICLE FIVE: GENERAL TRUST PROVISIONS

5.1. Mandatory and Discretionary Distributions of Income and Principal

5.2. Discretionary Payments to More Than One Beneficiary

5.3. Use of Trust Property by Beneficiaries

5.4. Purchase of Property from and Loans to Beneficiaries

5.5. Spendthrift Provision

5.6. Perpetuities Savings Provision

5.7. Multiple Trusts—No Physical Division Required

5.8. Additions to Trust

ARTICLE SIX: TRUSTEE'S ADMINISTRATIVE POWERS

6.1. Trustee Self-Dealing

6.2. Retention, Disposition, or Liquidation of Interest in Closely Held Entity; Power to Guarantee Loans to the Entity

6.3. Closely Held Entity Regarded as Separate from Trust

6.4. Management of Closely Held Entity

6.5. Specific Authority Regarding Certain Transactions

6.6. Beneficiary with Power of Revocation or Withdrawal

ARTICLE SEVEN: PROVISIONS RELATING TO TRUSTEE

7.1. Resignation, Declination, and Removal of Trustee and Appointment of Successor Trustee

7.2. Disclaimed and Precluded Trustee Powers; Special Trustee

7.3. Actions by Multiple Trustees

7.4. Trustee's Duty to Report Information and Account to Beneficiaries

7.5. Limits on Liability of Trustee

7.6. Indemnification of Trustee for Environmental Problems

7.7. Bonding of Individual Trustee; Custody of Assets

ARTICLE EIGHT: DEFINITIONS AND MISCELLANEOUS PROVISIONS

8.1. Definition of Beneficiary and Primary Beneficiary

8.2. Definition of Education

8.3. Definition of General Welfare

8.4. Definition of GST-Tax Inclusion Ratio

8.5. Definition of Health

8.6. Determination of Heirs

8.7. Definition of Incompetent

8.8. Definition of Issue

8.9. Definition of Net Fair Market Value

8.10. Definition of Qualified Relatives and Qualified Charities

8.11. Definition of Support and Maintenance

8.12. Distributions to or for the Benefit of Individual Beneficiary

8.13. Governing Law

8.14. Ninety-Day Survival Requirement

8.15. Powers to Withdraw Principal; $5000 or 5 Percent Annual Power of Withdrawal

8.16. Representation of Incompetent Beneficiary

8.17. Testamentary Powers of Appointment

ACCEPTANCE BY TRUSTEE

SCHEDULE A

The John Doe and Mary Doe 2009 Dynasty Trust

ARTICLE ONE
Establishment of Trust and Naming of Trustees

I, _ _[*name of settlor*]_ _, a resident of _ _[*name of county*]_ _ County, California (sometimes referred to as the "Settlor"), hereby transfer and deliver to _ _[*the Settlor/_ _[name of trustee*]_ _]_ _, as trustee, the property described in the attached Schedule A. If _ _[*the Settlor/_ _[name of trustee*]_ _]_ _ fail(s) to qualify or cease(s) to act as the trustee of any trust established under this instrument, I hereby name _ _[*name of spouse*]_ _ as the trustee if _ _[*he/she*]_ _ is then living _ _[*and was married to me at that time*]_ _; and if _ _[*name of spouse*]_ _ fails to qualify or ceases to act as the trustee of any trust established hereunder, I hereby name _ _[*name of successor trustee*]_ _ as the trustee. I reserve the right, by an instrument in writing, to appoint a trustee or cotrustee, remove any trustee or cotrustee (without cause), appoint one or more alternative successor trustees

or cotrustees, remove a successor trustee or cotrustee (without cause) and appoint a new successor trustee or cotrustee, and alter the order in which two or more successor trustees or cotrustees shall serve as the trustee or cotrustee _ _[*; and following my death or Incompetency (as defined in Section 8.6, below)* _ _[*name of spouse*]_ _ *shall have the same right if* _ _[*he/she*]_ _ *is then living and married to me or was married to me at the time of my death or Incompetency*]_ _**.**

Notwithstanding the foregoing, after attaining age 35, each Primary Beneficiary of a separate trust established under Section 4.3, below, shall have the right to act as the sole trustee of that trust, by delivering an instrument in writing exercising this right to the existing trustee and copies of such instrument to the other Beneficiaries of the trust; and if he or she later ceases to act as the trustee, the persons named or appointed as provided above or appointed pursuant to Section 7.1, below, shall act as successor trustees in the order named; provided, however, that this right to act as the sole trustee may not be exercised if the Trustee determines that the Primary Beneficiary is substantially unable to manage his or her financial resources or resist fraud or undue influence.

This trust may be referred to as the "_ _[*Name of Settlor*]_ _ **2009 Dynasty Trust." The term "Trustee" refers to any person or persons acting as trustee. All property subject to this trust (the "Trust Estate") shall be administered as provided below. The capitalized terms used in this instrument shall have the meanings specified in Article Eight, below, or as defined elsewhere herein.**

ARTICLE TWO
Irrevocability and Unamendability of Trust

Except as specifically provided in this instrument, this trust is irrevocable and unamendable.

ARTICLE THREE
Declarations Regarding Beneficiaries

This trust is for the benefit of My Issue. I have _ _[*number*]_ _ **children now living, whose names and birthdates are as follows:** _ _[*insert names and birthdates*]_ _

All references to "My Child" and "My Children" are to them and the term "My Issue" refers to My Children and their Issue.

ARTICLE FOUR
Disposition of Trust Estate

The Trustee shall administer the Trust Estate as follows:

4.1. ***During Settlor's Lifetime*****. During my lifetime the Trustee shall pay to My Issue as much of the net income and principal of the trust (or two separate trusts designated as the "Exempt Trust" and the "Nonexempt Trust," established pursuant to Section 4.5(d), below) as (a) is necessary for their proper Health, Education, Support, and Maintenance and (b) the Trustee in its discretion deems appropriate for their General Welfare, subject to Subsections (a) and (b) of Section 4.5, below. The Primary Beneficiaries of the trust(s) are My Children.**

4.2. ***Following Settlor's Death*****. Following my death the trust(s) shall be distributed to those of My Issue who survive me, per stirpes (by right of representation), subject to Section 4.3, below** _ _[*; provided, however, that if* _ _[*name of spouse*]_ _ *survives me*_ _[*and was married to me at the time of my death*]_ _**,** *the trust(s) shall continue for* _ _[*his/her*]_ _ *lifetime in the same manner as provided during my lifetime in Section 4.1, above, and following* _ _[*his/her*]_ _ *death the trust(s) shall be distributed to those of My Issue who survive* _ _[*him/her*]_ _*, per stirpes (by right of representation), subject to Section 4.3, below*]_ _**.**

4.3. ***Separate Trusts for Issue*****. Any share of the Trust Estate otherwise required to be distributed to one of My Issue (hereinafter referred to as "My Descendant"), other than by the exercise of a power of withdrawal or appointment, shall instead be retained and administered by the Trustee in a separate trust as provided below bearing My Descendant's name (or two separate trusts designated as My Descendant's "Exempt Trust" and My Descendant's "Nonexempt Trust," established as a result of Section 4.5(d), below):**

(a) ***During My Descendant's Lifetime*****. During My Descendant's lifetime the Trustee shall pay to My Descendant and his or her Issue as much of the net income and principal of the trust(s) as (1) is necessary for**

their proper Health, Education, Support, and Maintenance, and (2) the Trustee in its discretion deems appropriate for their General Welfare, subject to Section 4.5(b), below. After attaining age 25, My Descendant shall have a $5000 or 5 Percent Annual Power of Withdrawal with respect to the trust(s); provided, however, that this power of withdrawal may not be exercised if the Trustee determines that My Descendant is substantially unable to manage his or her financial resources or resist fraud or undue influence. Notwithstanding the foregoing, as long as either trust holds an interest in (A) a parcel of real property situated in California that has an assessed value less than its full cash value or fair market value as determined for property tax purposes as of the time of acquisition, (B) a tangible article of a personal nature, or (C) a personal residence, the Trustee shall pay to My Descendant the entire net income with respect to that interest and as much of the principal with respect to it as (1) is necessary for his or her proper health, education, support, and maintenance and (2) the Trustee in its discretion deems appropriate for My Descendant's general welfare, subject to Section 4.5(b); and that interest shall be excluded in determining, but may be utilized in satisfying, the amount subject to My Descendant's $5000 or 5 Percent Annual Power of Withdrawal percent annual power of withdrawal with respect to the trust _ _[*; provided, however, that if My Descendant is a child of one of My Children who is deceased but my said grandchild's other parent is living and is treated as a child of mine for purposes of Article XIIIA, §2(h)(2)(A), of the California Constitution, and if an interest in property described in clause (A) of this sentence, above, would otherwise benefit from the grandparent-grandchild exclusion from a "change in ownership" for California property tax purposes, the Trustee shall instead pay to such other parent during his or her lifetime (but not after the death of My Descendant) the entire net income with respect to that interest and as much of the principal with respect to it as the Trustee in its discretion deems appropriate for any purpose***]_ _**. The Primary Beneficiary of the trust(s) is My Descendant.**

(b) *Following My Descendant's Death*. Following My Descendant's death, the trust(s) shall be distributed to those of his or her Heirs who are My Issue, per stirpes (by right of representation), subject to this Section 4.3 and Section 4.5(e), below; provided, however, that My Descendant shall have (1) a General Testamentary Power of Appointment over that portion of the trust(s) that otherwise would be subject to the federal estate or generation-skipping transfer tax at that time as a result of his or her death, and (2) a Special Testamentary Power of Appointment over the balance of the trust(s), exercisable in favor of his or her Qualified Relatives and Qualified Charities.

4.4. *Ultimate Disposition if No Issue*. If, at any time before full distribution of the Trust Estate, I have died or attained age _ _[*e.g., 60*]_ _, I have no living Issue, and no other disposition of the Trust Estate or any portion thereof is directed by this instrument, the Trust Estate or such portion shall be distributed to me if I am then living, or if I am not, to _ _[*name of spouse*]_ _ if _ _[*he/she*]_ _ is then living and was married to me at the time of my death, or if _ _[*he/she*]_ _ is or was not, in equal shares to those of _ _[*name of spouse's*]_ _ and my nieces and nephews who are then living (and to the living Issue of our deceased nieces and nephews, per stirpes (by right of representation), subject to Section 4.3, above, as though our nieces and nephews were My Children, or if none of our nieces and nephews and none of their Issue is then living, to _ _[*name(s) of charity(ies)*]_ _.

4.5. *Overriding Provisions*. Anything in this instrument to the contrary notwithstanding, the following provisions shall apply to each trust:

(a) *Restrictions on Settlor's* _ _[*and* _ _[*Name of Spouse's*]_ _]_ _ *Powers, and on Powers of a Related or Subordinate Party Appointed by* _ _[*Me/Either of Us*]_ _*, as Trustee*. While I am or _ _[*name of spouse*]_ _ is living, neither I, _ _[*name of spouse*]_ _, nor any successor trustee appointed by _ _[*me/either of us*]_ _ pursuant to the last sentence of the first paragraph of Article 1, above, who is a "related or subordinate party" to _ _[*me/either of us*]_ _ as defined in Internal Revenue Code §672(c) shall have the power as trustee to (1) vote (directly or indirectly) any shares of stock of a Controlled Corporation (as defined in Internal Revenue Code §2036(b)) owned by the trust, (2) exercise any "Incident of Ownership" (within the meaning of Internal Revenue Code §2042) with respect to any insurance policy on my life _ _[*or the life of* _ _[*name of spouse*]_ _]_ _ held in the trust, (3) sell (directly or indirectly) any shares of stock or life insurance policy referred to in clauses (1) or (2) of this Subsection (a), above, to me _ _[*or* _ _[*name of spouse*]_ _]_ _, (4) make discretionary payments of income or principal to any Beneficiary for his or her General Welfare or to any Qualified Charity, or (5) do anything else that would cause any portion of the Trust Estate to be included in my gross estate _ _[*or the gross estate of* _ _[*name of spouse*]_ _]_ _ for federal estate tax purposes, and those powers may be exercised only by a trustee other than me _ _[*or* _ _[*name of spouse*]_ _]_ _, as provided in the second sentence of Section 7.2, below.

(b) *Trustee-Beneficiary Self-Dealing*. A power to make discretionary payments of income or principal to a

particular Beneficiary for his or her General Welfare or otherwise, to enter into a transaction with a particular Beneficiary for less than an adequate and full consideration in money or money's worth, to disclaim property in favor of a particular Beneficiary or other person, or to do anything else, directly or indirectly, that would cause any portion of the trust to be included in the Trustee's gross estate for federal estate tax purposes, may be exercised only by a trustee other than that Beneficiary or other person (or a "related or subordinate party" within the meaning of Internal Revenue Code §672(c), appointed by him or her pursuant to Section 7.1, below), as provided in the second sentence of Section 7.2, below.

(c) *Insurance on Life of Trustee-Beneficiary*. A Beneficiary who is acting as a trustee shall not have the power to exercise any "Incident of Ownership" (within the meaning of Internal Revenue Code §2042) with respect to any insurance policy on the life of such Beneficiary held in the trust, if it would cause the proceeds of such policy to be included in his or her gross estate for federal tax purposes and such proceeds otherwise would not be so included. Any such Incident of Ownership may be exercised only by a trustee other than that Beneficiary, as provided in the second sentence of Section 7.2, below.

(d) *Division of Trust into Exempt and Nonexempt Generation-Skipping Subtrusts*. If the trust's GST Tax Inclusion Ratio otherwise would be greater than zero and less than one, the Trustee shall establish another trust as follows so that the GST Tax Inclusion Ratio for the original trust is zero (in which case it will be wholly exempt from the federal generation-skipping transfer tax) and for the other trust is one (in which case it will be wholly subject to such tax): The Trustee shall distribute to the other, nonexempt trust the amount necessary to reduce the Net Fair Market Value of the original, exempt trust to an amount such that its GST Tax Inclusion Ratio is zero. The amount distributable to the non-exempt trust may be satisfied in cash or in kind, or partly in each; and assets distributed in kind shall be deemed to satisfy this amount on the basis of their values at the date or dates of distribution. If the Net Fair Market Value of the exempt trust is incorrectly determined, then within a reasonable period after the value is finally determined for Federal estate or gift tax purposes, the Trustee shall distribute from the exempt trust to the nonexempt trust (in the case of an undervaluation) or shall return from the non-exempt trust to the exempt trust (in the case of an overvaluation) an amount equal to the difference between the amount properly distributable to the non-exempt trust and the amount actually distributed to that trust. Both of these trusts shall be administered as otherwise provided in this instrument, except that any distribution that would constitute a "Generation-skipping Transfer" (as defined in Internal Revenue Code §2611) shall be made from the exempt trust to the extent possible, and all other distributions generally should be made from the non-exempt trust.

(e) *Combination of Substantially Identical Trusts Under this Instrument*. All property that otherwise would be administered in two or more trusts established under this instrument that have substantially identical terms and GST Tax Inclusion Ratios shall be combined and administered as a single trust.

(f) *Addition of Trust to Substantially Identical Trust Under Another Instrument*. Any trust being administered under this instrument that is substantially identical to, and has the same GST Tax Inclusion ratio as, a trust established by me _ _[*or* _ _[*name of spouse*]_ _]_ _ under another instrument may in the Trustee's discretion be added to that trust and administered according to its terms.

(g) *Equitable Adjustments*. Subject to subsections (a) and (b) of this Section 4.5, above, the Trustee shall make additional payments to Beneficiaries, or make adjustments in the rights of any Beneficiary or between the income and principal accounts, to compensate for the consequences of any tax decision or election, investment or other administrative decision, or other circumstance that has had the effect, directly or indirectly, of unfairly preferring one Beneficiary or group of Beneficiaries over others, as determined by the Trustee in its discretion.

(h) *S Corporation Stock and Electing Small Business Trust*. If the trust owns stock of an S corporation and would otherwise be an Electing Small Business Trust, the Trustee shall exercise all powers only in a manner consistent with, and shall amend the trust if necessary to conform to the requirements of, Subchapter S of Chapter 1 of Subtitle A (Sections 1361-1379) of the Internal Revenue Code.

(i) *Anti-Retaliation Provision*. A Beneficiary who is acting as a trustee of the trust and who either (1) is removed as trustee for fraud, willful misconduct, or gross negligence in the performance of his or her duties as trustee, or (2) resigns as trustee under threat of being so removed and is later found by the court to have performed his or her duties in such a manner, shall not be entitled to exercise a Special Testamentary Power of Appointment over the trust except as authorized by the court.

(j) *Trustee's Authority to Retain Shares of* _ _[*name of company*]_ _. The Trustee is authorized to retain the shares of _ _[*name of company*]_ _ or any successor thereto or affiliate thereof, and acquire additional shares thereof, for as long as the Trustee in its discretion deems appropriate, without regard to its general duty of diversification; and I desire, but do not direct, that it do so.

(k) *Grantor Trust Provisions*.

(1) *Settlor's Power to Reacquire Principal of the Trust and Substitute Other Property of Equivalent Value*. During my lifetime I shall have the power as Settlor (in a nonfiduciary capacity, without the approval or consent of the Trustee or any other person acting in a fiduciary capacity, and without regard to the effect it may have on any Beneficiary of the trust) to reacquire all or any portion of the principal of the trust (other than shares of stock of a Controlled Corporation (as defined in Internal Revenue Code §2036(b)) or insurance policies on my life or the life of _ _[*name of spouse*]_ _ by substituting other property having an equivalent fair market value; provided, however, that the federal income tax basis of such other property must be no less than the federal income tax basis of such principal. I shall assist and cooperate with the Trustee to determine the value of the property to be acquired and substituted by me prior to effecting any such substitution. Any such reacquisition of principal and substitution of other property shall be binding on the Trustee and all Beneficiaries of the trust, and neither the Trustee nor any Beneficiary shall have any recourse against me for any such action. If I become Incompetent, this power may be exercised by the person acting as my attorney-in-fact under a durable general power of attorney for financial management, or if there is none, by the conservator of my estate.

(2) *Special Trustee's Power to Add Charitable Beneficiaries*. During my lifetime the first successor to the trustee who has the power to make discretionary payments of income or principal to any Beneficiary for his or her General Welfare under Section 4.1, above, which successor is not related or subordinate to me or any of My Issue (within the meaning of Internal Revenue Code §672(c)), shall have the power from time to time to add one or more Qualified Charities to the class of Beneficiaries designated to receive the income or principal of the trust, or to delete any such Qualified Charity from such class, by an instrument in writing delivered to the Trustee specifying such Qualified Charities, and such successor shall act as a special trustee with respect to such power. The Trustee (who must be someone other than such special trustee) shall pay to such Qualified Charities as much of the net income and principal of the trust as the Trustee in its discretion deems appropriate, and the standards and purposes applicable to payments to individual Beneficiaries shall not apply. The special trustee shall irrevocably release and relinquish this power at any time if he, she, or it deems it appropriate to do so, and any such release and relinquishment of this power shall be binding on that special trustee and on all successor special trustees specified or appointed pursuant to the terms of this trust instrument. Following my death this power shall lapse, and any such Qualified Charities shall no longer be Beneficiaries of the trust.

ARTICLE FIVE
General Trust Provisions

Except as otherwise specifically provided, the following general provisions shall apply to every trust established under this instrument:

5.1. *Mandatory and Discretionary Payments of Income and Principal*. Mandatory payments of income shall be made quarter-annually, unless otherwise requested by the Beneficiary, but no less often than annually. In determining whether payments are necessary for an individual Beneficiary's proper Health, Education, Support, and Maintenance, or whether discretionary payments for an individual Beneficiary's General Welfare or otherwise are appropriate, the Trustee shall take into consideration any other income or resources of the Beneficiary (including his or her ability to be gainfully employed), known to the Trustee and reasonably available for these purposes (as well as the size of the trust and the current circumstances and probable future needs of all the Beneficiaries). However, the Beneficiary need not exhaust his or her other income or resources in order to be entitled to such payments. In making payments to a minor individual Beneficiary, the Trustee shall construe its authority liberally to permit payments reasonably necessary to ease the financial burden on the guardian of the person of the minor, or other suitable individual with whom the minor resides, and on such individual's family, resulting from the minor's presence in his or her household; provided, however, that these payments may only be made by a trustee other than such guardian or other individual, as provided in the second sentence of Section 7.2, below. Discretionary payments of income or principal for an individual Beneficiary's General Welfare or otherwise, as well as payments for his or her proper Health, Education, Support, and Maintenance, may be made to or for the benefit of the Beneficiary, and on such terms and conditions as the Trustee may specify, either outright or to the Trustee or any other qualified person, in trust

(including the establishment of higher education savings entities under §§529 and 530 of the Internal Revenue Code) and may include the creation of powers of appointment. Any net income not distributed (or required to be distributed) shall be added to principal.

5.2. *Discretionary Payments to More than One Beneficiary*. If discretionary payments may be made to more than one Beneficiary, the Trustee may pay more to or for the benefit of some Beneficiaries than others and make payments to or for the benefit of one or more Beneficiaries to the exclusion of others if the Trustee deems this necessary or appropriate. Any such payments shall be charged against the trust as a whole rather than against the ultimate distributive share of a Beneficiary to whom or for whose benefit the payment is made. Discretionary payments to an individual's Issue may be made to Issue of any degree, including those whose ancestor or ancestors are still living.

5.3. *Use of Trust Property by Beneficiaries*. A Beneficiary who is entitled to the net income of all or a portion of the trust property shall be entitled to use or occupy any such real or tangible personal property rent-free, but subject to payment of property taxes, insurance premiums, expenses for maintenance and ordinary repairs, reasonable amounts for depreciation or amortization, and similar items generally allocated to trust income. The Trustee is authorized to permit any other Beneficiary having a present interest in the trust to use or occupy any trust property on such terms and conditions as the Trustee deems proper, whether rent-free, in consideration of payment of property taxes, insurance premiums, expenses for maintenance and ordinary repairs, reasonable amounts for depreciation or amortization, and similar items generally allocated to trust income, or otherwise.

5.4. *Purchase of Property from and Loans to Beneficiaries*. The Trustee is authorized (a) to purchase property belonging to a Beneficiary of the trust, and (b) to make loans (or guarantee, or encumber or hypothecate trust property for, loans made) to a Beneficiary of the trust, on such terms and conditions as the Trustee deems proper.

5.5. *Spendthrift Provision*. No interest in the income or principal shall be anticipated, assigned, or encumbered, or subject to any creditor's claim or to legal process, prior to its actual receipt by the Beneficiary; provided, however, that any individual Beneficiary may assign all or part of his or her interest in the trust to any one or more of his or her Qualified Relatives and Qualified Charities, or to a trust that is primarily for the benefit of the Beneficiary and/or such persons.

5.6. *Perpetuities Savings Provision*. Unless sooner terminated in accordance with other provisions of this instrument, the trust shall terminate 21 years after the death of the last survivor of those of My Qualified Relatives and all other Beneficiaries who are living at the time the trust becomes irrevocable, but only if California has not repealed its rule against perpetuities (presently in Probate Code §§21200-21231). All principal and undistributed income shall be distributed to the then income Beneficiaries of the trust in the proportions in which they are, at the time of termination, unconditionally entitled to receive the income; provided, however, that if the rights to income are not then fixed by the terms of the trust, distribution under this section shall be made to those of My Issue, per stirpes (by right of representation), or if there is none, in equal shares to those Beneficiaries who are then entitled or authorized in the Trustee's discretion to receive income payments.

5.7. *Multiple Trusts-No Physical Division Required*. There need be no physical segregation or division of the various trusts except as segregation or division may be required by the termination of any of the trusts, but the Trustee shall keep separate accounts for the different undivided interests.

5.8. *Additions to Trust*. Property may be added to the trust by any person by designating it as the beneficiary of a life insurance policy or Employee Benefit Plan, by exercising a power of appointment in favor of the trust, or in any other manner; but any such property not acceptable to the Trustee may be disclaimed.

ARTICLE SIX
Trustee's Administrative Powers

Except as otherwise specifically provided, the Trustee shall have the following powers with respect to every trust established under this instrument, in addition to the powers specified in California Probate Code §§16200-16249. All powers shall be exercised with due regard to the Trustee's fiduciary obligations, and the Trustee shall be mindful of the fact that it is subject to the standard of care prescribed by §16040, and the other duties specified in California Probate Code §§16000-16105:

6.1. *Trustee Self-Dealing*. The Trustee shall have the power to lend or advance its own funds to the trust for

any purpose, with interest not in excess of current rates, to receive no more than adequate security for such loans in the form of a mortgage, pledge, deed of trust, or other encumbrance of any assets of the trust, to purchase trust property for no less than its fair market value as determined by an independent appraisal, and to sell property to the trust at a price not in excess of its fair market value as determined by an independent appraisal.

6.2. *Retention, Disposition, or Liquidation of Interest in a Closely Held Entity; Power to Guarantee Loans to the Entity*. The Trustee is authorized to continue to hold and operate, to sell, or to liquidate, at the risk of the Trust Estate, any interest in a closely held entity (*i.e.*, a proprietorship, partnership, limited liability company or partnership ("LLC" or "LLP"), or corporation) that the Trustee receives or acquires under the trust, as the Trustee deems advisable. This authorization to sell shall include sales to the partnership, LLC, LLP, or corporation itself and to another partner, member, or shareholder, regardless of whether such partner, member, or shareholder also is the Trustee. The Trustee also is authorized to guarantee any loans, at the risk of the Trust Estate, made to any such closely held entity, as the Trustee deems advisable.

6.3. *Closely Held Entity Regarded as Separate from Trust*. The Trustee shall incur no liability for misconduct, mismanagement, or negligence on the part of any employee, partner, member, officer, or director of a closely held entity in which the trust has an interest, who is not an officer or employee of the Trustee. In the absence of any notice to the contrary, the Trustee may accept as correct financial or other statements rendered by an accountant for any such entity. Any such entity shall be regarded as an entity separate from the trust, and no accounting as to its or operations shall be required to be made by the Trustee.

6.4. *Management of Closely Held Entity*. The Trustee is encouraged, but not required, to vote any shares of a closely held entity to elect as directors, managers, and officers of the entity those persons actively participating in its management at the time of the addition of the shares to the trust. The management of the entity and the conduct of its operations may be delegated to such persons as the board of directors or managers of the entity shall direct.

6.5. *Specific Authority Regarding Certain Transactions*. The Trustee shall have the power to buy commodities, to trade securities on margin, to sell securities short, to borrow securities, to cause credit to be extended through securities' accounts and to secure the performance of obligations in securities' accounts with assets in such accounts, and to trade in options (including the purchase and sale of puts and calls and the writing of index participation contracts and covered and uncovered option contracts).

6.6. *Beneficiary with Power of Revocation or Withdrawal*. If any Beneficiary has a currently exercisable power of revocation or withdrawal over any portion of the trust and is acting as the sole trustee of the trust, he or she shall have the power to deal with the property subject to such power in the same manner as if the property were owned by him or her outright, free of trust. If any Beneficiary has such a power but is not acting as the sole trustee, the Trustee shall follow all directions of that Beneficiary with respect to the property subject to such power; and the Trustee shall not be liable to that Beneficiary or to any other person for any loss resulting from following such directions.

ARTICLE SEVEN
Provisions Relating to the Trustee

Except as otherwise specifically provided, the following provisions shall apply to every trust established under this instrument:

7.1. *Resignation, Declination, and Removal of Trustee and Appointment of Successor Trustee*. A person may resign or decline to serve as trustee of the trust by delivering an instrument in writing to the cotrustee, if any, to each Beneficiary of the trust, and to the successor trustee, if any, named or appointed as provided in this instrument. An individual trustee shall be deemed to have resigned or declined to serve if he or she dies or becomes Incompetent. A majority of the individual trustees, or if there is no individual trustee, a majority of the Beneficiaries of the trust (which majority must include all of the Primary Beneficiaries of the trust), may, by an instrument in writing, appoint a corporate trustee or cotrustee or remove a corporate trustee or cotrustee, without cause, and appoint a substitute corporate trustee or cotrustee. All of the Primary Beneficiaries of the trust who have attained age 35 acting together, or if there is no Primary Beneficiary then a majority of the Beneficiaries of the trust who have attained that age, may, by an instrument in writing, appoint a trustee or cotrustee, remove any trustee or cotrustee, without cause, appoint one or more alternative successor trustees or cotrustees, remove a successor trustee or cotrustee, without cause, and appoint a new successor trustee or

cotrustee, and alter the order in which two or more successor trustees or cotrustees shall serve as the trustee or cotrustee. Notwithstanding the preceding two sentences, if the event causing the trust to terminate has occurred or the trust is fully withdrawable by the Beneficiaries, a majority in interest of the Beneficiaries acting together may, by an instrument in writing, appoint any trustee or cotrustee or remove any trustee or cotrustee, without cause, and, if necessary or desirable, appoint a substitute trustee or cotrustee. Any corporate trustee or cotrustee appointed pursuant to one of the preceding three sentences must be authorized to engage in a trust business in one or more states of the United States, unless otherwise authorized by all of the Beneficiaries of the trust or by the court. Any such resignation or removal shall be effective upon acceptance in writing by the person then entitled to act as the Trustee or as otherwise ordered by the court. References in this section to a trustee or cotrustee include a successor trustee or cotrustee, who shall be authorized to act as a special trustee as provided in the second sentence of Section 7.2, below.

7.2. *Disclaimed and Precluded Trustee Powers; Special Trustee*. The Trustee may disclaim, release, or restrict any of its powers by delivering a written instrument to the cotrustee, if any, to the first person specified as the successor trustee in Article 1, above, if any, and to each Beneficiary, specifying the powers disclaimed, released, or restricted and the nature of any such restriction. Any such disclaimed, released, or restricted power, as well as any other power that the Trustee is precluded from exercising, shall be exercised only by the cotrustee, or if there is none, by the person specified as the successor trustee in Article 1 or appointed pursuant to Section 7.1, above, who shall act as special trustee with respect to such powers. The Trustee shall provide sufficient liquidity in the trust or otherwise act in a manner that will enable the special trustee to carry out its duties.

7.3. *Actions by Multiple Trustees*. If two or more persons are acting as cotrustees, all must unite in any act to bind the trust property, unless otherwise agreed by all of them in writing.

7.4. *Trustee's Duty to Report Information and Account to Beneficiaries*. The Trustee shall report information and account to the Beneficiaries as provided in California Probate Code §§16060-16064. Notwithstanding the foregoing, if (a) the Trustee delivers to a Beneficiary an account or report and a notice in the form provided in California Probate Code §16461(c)(3) with respect to said account or report, which notice advises the Beneficiary that he or she has a specified period of time, which period shall not be less than 180 days from the Beneficiary's receipt of the account or report, to deliver to the Trustee the Beneficiary's written objection (if any) to the account or report, and (b) the Beneficiary does not deliver to the Trustee, within the period specified in the notice, the Beneficiary's written objection to the account or report, then the Trustee shall not be liable to the Beneficiary for any claim against the Trustee (excluding any claim for fraud, willful misconduct, or gross negligence in the Trustee's performance of his, her, or its duties) with respect to any item that is adequately disclosed (as provided in California Probate Code §16460(a)(1)) in the account or report.

7.5. *Limits on Liability of Trustee*. An individual named or appointed as a trustee in or according to this instrument who is serving without compensation (other than reimbursement for his or her reasonable expenses) shall not be liable to any Beneficiary for the individual trustee's act or failure to act, except for fraud, willful misconduct, or gross negligence in the performance of his or her duties as trustee. In addition, (a) a majority of the Beneficiaries of the trust (which majority must include all of the Primary Beneficiaries of the trust), or (b) a majority in interest of the Beneficiaries if the event causing the trust to terminate has occurred or the trust is fully withdrawable by the Beneficiaries, may, by an instrument in writing, amend the trust to provide that any other Trustee shall not be liable to any Beneficiary for the Trustee's act or failure to act, except for fraud, willful misconduct, or gross negligence in the performance of its duties as trustee; and a majority (or majority in interest) of the Beneficiaries may later terminate this limitation of the Trustee's liability by an instrument in writing delivered to the Trustee and all of the other Beneficiaries of the trust. Any such termination shall be effective with respect to all acts or failures to act occurring more than 30 days after delivery of such instrument to the Trustee.

7.6. *Indemnification of Trustee for Environmental Problems*. The Trustee shall be reimbursed and indemnified from the trust for any and all liabilities, penalties, claims, and expenses of any kind or nature (including, without limitation, reasonable fees and disbursements of counsel or consultants) in any manner arising out of or related to any environmental problem, whether currently existing or subsequently arising (including but not limited to, any release or threatened release of any contaminant into the indoor or outdoor environment), on, at, under, or in connection with any property held in the trust, including, but not limited to, real property owned or operated directly by the trust and real property owned or operated by a closely held corporation or by a general or limited partnership or limited liability company in which the trust has an ownership or management interest (collectively, "Liabilities and Costs"), even if the Liabilities and Costs equal

the entire value of the trust; provided, however, that the Trustee shall have no right to indemnification or reimbursement hereunder for any Liabilities and Costs attributable to the Trustee's gross negligence, willful misconduct, or fraud.

7.7. *Bonding of Individual Trustee; Custody of Assets*. No bond shall be required of any individual named or appointed as a trustee in or according to this instrument, whether acting jointly or severally in the administration of the Trust Estate, unless requested in writing by any of the Primary Beneficiaries or by a majority of the other Beneficiaries of the trust. Substantially all intangible personal property of the trust shall be held in the custody of the corporate trustee, or if there is no corporate trustee, in the custody of a corporation authorized to engage in a trust business in one or more states of the United States if requested in writing by any of the Primary Beneficiaries or by a majority of the other Beneficiaries of the trust.

ARTICLE EIGHT
Definitions and Miscellaneous Provisions

Except as otherwise specifically provided, the following provisions apply to this instrument:

8.1. *Definition of Beneficiary and Primary Beneficiary*. The terms "Beneficiary" and "Beneficiaries" refer only to those beneficiaries generally entitled to notice of hearing on a petition described in Section 17200 of the California Probate Code. The terms "Primary Beneficiary" and "Primary Beneficiaries" refer to the beneficiary or beneficiaries, if any, who are specified as such in this instrument; and if no one is so specified, the trust shall be treated as having no Primary Beneficiary. The interests in the trust of other beneficiaries (as defined in Section 24 of the California Probate Code) are subordinate to the interests of the Primary Beneficiary or Beneficiaries.

8.2. *Definition of Education*. The term "Education" shall be construed to include (but is not limited to) undergraduate, graduate, and non-degree programs of study, at an accredited institution of the individual's choice, as long as such studies are pursued to his or her advantage. In making payments for education, the Trustee shall take into consideration the individual's related living and traveling expenses to the extent that they are reasonable.

8.3. *Definition of General Welfare*. The term "General Welfare" shall be construed as broadly or as narrowly as the Trustee deems appropriate. It may, for example, include (a) payments for the individual's entertainment, travel, vacations, and promising business opportunities, (b) payments to or for the benefit of the individual that would likely result in a significant reduction in taxes otherwise payable with respect to trust income and/or principal, and (c) distributions resulting in the termination of the trust in favor of the individual if he or she is of sufficient age, maturity, and competence to manage the assets properly and there is no compelling tax or other advantage to continuing the trust.

8.4. *Definition of GST-Tax Inclusion Ratio*. The term "GST Tax Inclusion Ratio" refers to the federal generation-skipping transfer tax inclusion ratio described in Internal Revenue Code §2642.

8.5. *Definition of Health*. The term "Health" includes both mental and physical well-being, and includes payments for psychiatric and psychological counseling and fitness programs designed to maintain and improve the individual's condition as well as to treat an illness, injury, or disorder. I desire, but do not direct, that no payments be made for the prolongation of the individual's life or the provision or continuance of life-sustaining treatment if the burdens of the treatment outweigh the expected benefits, and that the Trustee consider the relief of suffering and the quality as well as the extent of the possible extension of the individual's life in deciding whether to make payments for life-sustaining treatment.

8.6. *Determination of Heirs*. An individual's Heirs shall be determined as provided under California law relating to the succession of separate property not acquired from a predeceased spouse.

8.7. *Definition of Incompetent*. An individual shall be deemed to be "Incompetent" if (a) he or she is an unemancipated minor, (b) a conservator of the person or estate is acting on behalf of the individual, (c) the court has determined that the individual is incompetent or lacks capacity, or (d) the agent designated in the individual's power of attorney for health care (including the person appointed by the individual as his or her health care agent in an advance health care directive), or one licensed physician who is the individual's attending physician or primary care physician, has declared in writing under penalty of perjury that in his or her opinion the individual is substantially unable to manage his or her financial resources or resist fraud or

undue influence.

8.8. *Definition of Issue*. The term "Issue" refers to lineal descendants of all generations.

8.9. *Definition of Net Fair Market Value of a Trust*. In determining the "Net Fair Market Value" of a trust as of a particular time, the Trustee shall take into account accrued tax (and other) liabilities but shall disregard potential future tax liabilities with respect to unrealized gains or losses.

8.10. *Definition of Qualified Relatives and Qualified Charities*. The term "Qualified Relatives" refers to an individual's grandparents, their Issue, the Spouses of their Issue, and the Issue of such Spouses. The terms "Spouse" and "Spouses" include widows and widowers, regardless of whether they have remarried. The term "Qualified Charities" refers to those organizations that are described in Internal Revenue Code §§170(c), 2055(a), and 2522(a).

8.11. *Definition of Support and Maintenance*. The terms "Support" and "Maintenance" shall be construed liberally to include payments that are necessary to maintain the individual in his or her accustomed manner of living.

8.12. *Distributions to or for Benefit of Individual Beneficiary*. Any income or principal required or authorized to be distributed to an individual Beneficiary may be either applied for the Beneficiary's benefit or distributed (a) directly to the Beneficiary if he or she is of sufficient age, maturity, and competence to manage it properly, (b) to the legal guardian or conservator of the Beneficiary's estate, or (c) to the Trustee or any other qualified person as custodian for the Beneficiary, up to the maximum age permitted, under the Uniform Transfers/Gifts to Minors Act of any state selected by the Trustee. Distributions for the benefit of an individual Beneficiary include distributions for the Support or Maintenance of an individual whom the Beneficiary is legally obligated to support or maintain.

8.13. *Governing Law*. This instrument shall be construed and administered in accordance with the laws of the State of California and the United States of America; and unless otherwise indicated, all words and phrases used herein shall have the same meanings as they have in the California Probate, Family, and Civil Codes and the Internal Revenue Code. Reference to, or incorporation by reference of, any law shall mean such law as amended from time to time.

8.14. *Ninety-Day Survival Requirement*. An individual shall not be deemed to have survived another (or an event resulting from the death of another) unless the former survives the latter for 90 days.

8.15. *Powers to Withdraw Principal; $5000 or 5 Percent Annual Power of Withdrawal*. A present power to withdraw all or a portion of the trust may be exercised in whole or in part at any time during the powerholder's lifetime and lapses on his or her death. If a Beneficiary has a "$5,000 or 5 Percent Annual Power of Withdrawal" with respect to the trust, the Trustee shall pay to the Beneficiary such sums as the Beneficiary may request in writing, not exceeding with respect to any calendar year the greater of the following amounts: five thousand dollars ($5,000) or five percent (5%) of the Net Fair Market Value of the trust determined as of the end of the calendar year (or such greater amount as may be specified in Sections 2041(b)(2) and 2514(e) of the Internal Revenue Code). A $5000 or 5 Percent Annual Withdrawal Power (a) may be exercised by a written instrument delivered to the trustee at any time during the calendar year, but will be effective only if the Beneficiary is living at the end of the calendar year, (b) is noncumulative, and (c) lapses at the end of the calendar year to the extent not exercised. To the extent practicable, such sums requested pursuant to the exercise of a $5,000 or 5 Percent Annual Power of Withdrawal shall be paid to the Beneficiary within the first 65 days of the following calendar year (or within such other time period as may be specified in Section 663(b) of the Internal Revenue Code).

8.16. *Representation of Incompetent Beneficiary*. Unless otherwise ordered by the court, an individual Beneficiary who is Incompetent may be represented by the legal guardian or conservator of the estate of the Beneficiary, or if there is none, by the legal guardian or conservator of the person of the Beneficiary, or if there still is none, by (a) the person legally entitled to custody of the Beneficiary (if the Beneficiary is an unemancipated minor), or (b) the person acting as attorney-in-fact for the Beneficiary under a durable general power of attorney for property matters (if the Beneficiary is an emancipated minor or an adult).

8.17. *Testamentary Powers of Appointment*. If an individual has a "General Testamentary Power of Appointment" over the trust, the power holder has the power to direct the Trustee to distribute the trust

property to such one or more persons, including the power holder's own estate, as the power holder may appoint. If an individual has a "Special Testamentary Power of Appointment" over the trust, the power holder has the power to direct the Trustee to distribute the trust property to such one or more specified persons as the power holder may appoint, other than the power holder's creditors, his or her estate, or creditors of his or her estate. Any testamentary power of appointment may be exercised by a will or notarized instrument (including a revocable trust) whether executed before or after the power becomes exercisable, but only if the document specifically refers to and exercises such power. An appointment may be either outright or in trust (including the creation of further powers of appointment) and on such terms and conditions as the power holder may specify; provided, however, that the exercise of a Special Testamentary Power of Appointment may not create another power of appointment that can be validly exercised so as to postpone the vesting of any estate or interest in the trust property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

IN WITNESS WHEREOF, I have executed this trust instrument at _ _[*name of city*]_ _ **, California, on** _ _[*date*]_ _**.**

__[*Signature*]__
_ _[*Typed name*]_ _
Settlor _ _[*and Trustee*]_ _

State of California)
)
County of _ _[*name of county*]_ _)
)
_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

[*Add if settlor is not sole trustee*]

ACCEPTANCE BY TRUSTEE

I certify that I have read the foregoing trust instrument, and I accept the Trust Estate upon the terms and conditions under which it is to be administered by the Trustee.

[*Add one of the following alternatives*]

[*Alternative: Individual trustee*]

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _**, Trustee**

[*Alternative: Corporate trustee*]

Date: _ _ _ _ _ _ _ _[*NAME OF TRUST COMPANY*]_ _**, Trustee**

By: __[*Signature*]__
Name: _ _[*Typed name of officer*]_ _
Its: _ _[*Title of officer*]_ _

[*Acknowledgment; §8.12*]

[*Continue*]

SCHEDULE A

TO THE _ _[*NAME OF TRUST*]_ _ 2009 DYNASTY TRUST

_ _[*Number*]_ _ shares (the "Shares") of _ _[*Name of company*]_ _, LLC (the "Company"), which is the Settlor's separate property. The Shares are being transferred by the Settlor to _ _[*himself/_ _[name of trustee*]_ _]_ _, as Trustee of the _ _[*Name of Settlor*]_ _ 2009 Dynasty Trust (also, "this Trust"), in exchange for this Trust's promissory note, payable to the Settlor (or _ _[*his/her*]_ _ designee), having a principal amount equal to eighty percent (80%) of the fair market value of the Shares, bearing interest at the mid-term applicable federal rate as of the date hereof, compounded annually, payable on each anniversary date of this Trust instrument, and payable in full on the ninth anniversary date of this Trust instrument, in the form attached to this Schedule A as Exhibit 1 (the "Note").

It is estimated that the fair market value of the Shares on the date hereof is $_ _[*amount*]_ _ and that the principal amount of the Note is $_ _[*80 percent of preceding amount*]_ _ ($_ _[*amount*]_ _ × 0.80). If a qualified independent appraiser determines that for gift tax purposes the fair market value of the Shares is more or less than $_ _[*amount*]_ _, the principal amount of the Note shall be increased or reduced to an amount that equals eighty percent (80%) of the fair market value of the Shares as determined by said appraiser (also, the "appraiser adjusted fair market value"). If the fair market value of the Shares is finally determined for federal gift tax purposes to be more or less than $_ _[*amount*]_ _ or the appraiser adjusted fair market value (also, the "final adjusted fair market value"), the principal amount of the Note shall be further increased or reduced to an amount that equals eighty percent (80%) of the final adjusted fair market value of the Shares. Both of these adjustments shall be retroactive to the date of this instrument.

EXHIBIT 1

[*Attach installment promissory note; see §§13A.15-13A.17*]

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Appendix O

Charitable Remainder Annuity Trust

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Description

This is a joint and survivor charitable remainder annuity trust funded with community property for the benefit of the settlors during their joint lifetimes and for the survivor during his or her lifetime. The settlors will receive an annuity amount equal to 5 percent of the initial fair market value of the trust assets during their joint lifetimes, and the survivor will continue to receive the amount during his or her lifetime. On the death of the survivor, the remaining property in the trust will be transferred to a public charity. An institution will serve as the trustee. For a form of charitable remainder unitrust, see Appendix F.

WARNING: On the effect of estate tax repeal and IRC §2511(c) on charitable remainder trusts, see §18.11A.

NOTE: If a private foundation is or may be the remainder beneficiary at the time when any principal or income of the trust is to be distributed to it, omit the reference to IRC §170(b)(1)(A) in Article 3(A) and Article 6(D).

CAVEAT: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix.

The John and Mary Doe Charitable Remainder Annuity Trust

TABLE OF CONTENTS

ARTICLE ONE: CREATION OF TRUST

- **A. Transfer to Trust**
- **B. Purpose of Trust**
- **C. Name of Trust**
- **D. Irrevocability of Trust**
- **E. Additional Contributions Prohibited**

ARTICLE TWO: ANNUITY PAYMENTS

- **A. Payment of Annuity Amount**
- **B. Time of Payment**
- **C. Proration of Annuity Amount**
- **D. Adjustment for Incorrect Valuation**

ARTICLE THREE: DISTRIBUTION TO CHARITY

- **A. Disposition of Remainder**

B. Termination of Annuity Payments

C. Partial Distributions in Kind

ARTICLE FOUR: LIMITED POWER TO AMEND

ARTICLE FIVE: OFFICE OF TRUSTEE

A. Nomination of Successor Trustees

B. Resignation of Trustee

C. Removal of Trustee

D. Appointment of Successor Trustee

E. Waiver of Trustee Bond

F. Compensation of Trustee

G. Corporate Trustee

H. Nonliability of Trustee

ARTICLE SIX: TRUSTEE PROHIBITIONS

A. Trustee Self-Dealing

B. No Investment Restriction on Trustee

C. Payment of Estate and Gift Taxes

D. No Other Noncharitable Payments

ARTICLE SEVEN: TRUSTEE POWERS

ARTICLE EIGHT: MISCELLANEOUS

A. Calendar Year

B. Governing Law

ACCEPTANCE BY TRUSTEE

SCHEDULE A

The John and Mary Doe Charitable Remainder Annuity Trust

8.2-1 Trust agreement

This agreement is made between _ _[*names of settlors*]_ _ (called the "settlors") and _ _[*name of trustee*]_ _, as trustee.

ARTICLE ONE
Creation of Trust

A. *Transfer to Trust*. The settlors hereby transfer and deliver to the trustee, without consideration, the property described in Schedule A attached to this trust. All property subject to this trust from time to time is

referred to as the trust estate and shall be held, administered, and distributed according to this agreement.

B. *Purpose of Trust*. The settlors desire to establish a charitable remainder annuity trust within the meaning of Section 664(d)(1) of the Internal Revenue Code of 1986 (hereinafter referred to as the "Code").

8.5-1 Name of trust

C. *Name of Trust*. This trust may be referred to as _ _[*e.g., The John and Mary Doe*]_ _ Charitable Remainder Annuity Trust.

8.7-1 Trust is irrevocable

D. *Irrevocability of Trust*. This trust is irrevocable and may not be altered or amended in any respect except as specifically authorized by this instrument and may not be terminated except through distributions permitted by this instrument.

18.74-1 Additional contributions prohibited

E. *Additional Contributions Prohibited*. No additional contributions shall be made to the trust after the initial contribution.

ARTICLE TWO
Payments

18.49-1 Joint and survivor recipients

18.50-1 Payment during joint lifetimes

A. *Payment of Annuity Amount*. The trustee shall pay the following annuity amount in each taxable year of the trust, in _ _[*an annual/equal* _ _[*semiannual/quarterly/monthly*]_ _]_ _ payment(s), to the following persons:

(1) During the joint lifetimes of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _, to _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ in equal shares an annuity amount equal to 5 percent of the initial net fair market value of the trust assets.

(2) After the death of the first to die of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _, to the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ an annuity amount equal to 5 percent of the initial net fair market value of the trust assets.

18.52-1 Payment from income, then principal

B. *Time of Payment*. The annuity amount shall be paid at the _ _[*beginning/end*]_ _ of each payment period from income and, to the extent that income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal.

18.63-1 Proration of annuity amount

C. *Proration of Annuity Amount*. In determining the annuity amount, the trustee shall prorate the same on a daily basis for a short taxable year of the trust and for the taxable year of the trust in which the interest of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ terminates.

18.71-1 Adjustment for incorrect valuation in annuity trust

D. *Adjustment for Incorrect Valuation*. If the initial net fair market value of the trust assets is incorrectly determined, then, within a reasonable period after the value is finally determined for federal tax purposes, the trustee shall pay to _ _[*name(s) of recipient(s)*]_ _ (in the case of an undervaluation) or receive from _ _[*name(s) of recipient(s)*]_ _ (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

ARTICLE THREE
Distribution to Charity

18.67-1 Charitable remainder beneficiaries and alternative remainder beneficiaries

A. *Disposition of Remainder*. (1) On the death of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _, the entire remaining principal and accumulated income of the trust estate, other than any payment due to that survivor, shall be distributed as provided in paragraph (2).

(2) Any portion of the trust estate directed to be disposed of under this paragraph shall be distributed to _ _[*name of charity*]_ _. If _ _[*name of charity*]_ _ is not an organization described in Internal Revenue Code §§170(b)(1)(A), 170(c), 2055(a), and 2522(a) when any income or principal of the trust estate is to be distributed to it, the trustee shall distribute the income or principal to one or more organizations selected by the trustee, at the trustee's discretion, which are then so described.

B. *Termination of Annuity Payment*. In the year in which the death of the survivor of _ _[*name of recipient*]_ _ and _ _[*name of recipient*]_ _ occurs, the trustee's obligation to pay the annuity amount shall terminate with the regular payment immediately preceding _ _[*his/her*]_ _ death.

Comment: If a private foundation is or may be the remainder beneficiary at the time when any principal or income of the trust is to be distributed to it, omit the reference to IRC §170(b)(1)(A).

18.99-1 Partial distributions to charitable organizations

C. *Partial Distributions in Kind*. The adjusted basis for federal income tax purposes of any trust assets distributed in kind shall be fairly representative of the adjusted basis of all trust assets available for distribution on the date of distribution.

ARTICLE FOUR
Limited Power To Amend

18.43-1 Savings provision

The settlors intend that this trust shall qualify as a charitable remainder annuity trust under Internal Revenue Code §664, and all clauses of this instrument shall be interpreted according to this intention. The trustee shall have the power to amend the terms of this instrument in writing without application to any court to the extent permitted by the Internal Revenue Code and applicable Treasury Regulations to qualify and continue to qualify the trust as a charitable remainder annuity trust under Internal Revenue Code §664.

ARTICLE FIVE
Office of Trustee

10.33-1 Designation of successor trustees

A. *Nomination of Successor Trustees*. If at any time the institution named as trustee fails to qualify or ceases to serve as trustee, the _ _[*person(s)/institution(s)*]_ _ listed below shall serve as successor trustee(s) in the order named:

_ _[*First: Name of successor trustee*]_ _

_ _[*Second: Name of second successor trustee*]_ _

If the nominated successor also fails to qualify or ceases to act, _ _[*name*]_ _ shall have the power to name a successor trustee.

10.28-1 Resignation of Trustee

B. *Resignation of Trustee*. Any trustee may resign at any time on sixty (60) days written notice to the settlor(s). The trustee shall continue to act until a successor trustee accepts the trusteeship.

10.30-1 Trustee removal

C. *Removal of Trustee.* The settlors or the survivor of them may remove any trustee at any time on thirty (30) days written notice. On such removal, a successor trustee shall be appointed under the provisions in paragraphs A and D of this article.

Successor trustee if no trustee is acting

D. *Appointment of Successor Trustee*. If no trustee is acting, _ _[*e.g., the charitable remainder beneficiary* (*if more than one, specify which*)]**_ _ shall appoint a successor trustee. If at any time no trustee is acting, and the charitable remainder beneficiary has failed to select a trustee, a successor trustee shall be appointed by a court of competent jurisdiction.**

10.49-1 Trustee's bond

E. *Waiver of Trustee Bond*. No bond shall be required of any person named in this instrument as trustee, or of any person appointed as trustee in the manner specified in this trust, for the faithful performance of his or her duties as trustee.

10.51-1 Reasonable compensation (individual trustee)

F. *Compensation of Trustee*. The trustee shall be entitled to reasonable compensation from time to time for services rendered to the trust and to reimbursement for expenses of the trust that the trustee has paid, both without prior court order.

Trustee includes corporation or association or successor corporation

G. *Corporate Trustee*. Reference in this instrument to the trustee shall include any corporation or association that may become a successor trustee or any successor corporation that may succeed to a corporate trustee's business.

Comment: When an institutional trustee is being used, this provision should be included.

10.41-1 Successor trustee's nonliability for predecessor's acts

H. *Nonliability of Successor Trustee*. All rights, powers, authority, immunity and discretion herein granted or conferred on the original trustee shall survive to and may be exercised or applied in the same manner and to the same extent by or for any successor or substitute that may at any time be acting hereunder. No successor trustee shall be liable for any act, omission, or default of a predecessor trustee. The successor trustee may accept the accounting records of the predecessor trustee showing assets on hand without further investigation and without incurring any liability to any person claiming or having an interest in the trust.

ARTICLE SIX
Trustee Prohibitions

18.81-1 Private foundation prohibitions

A. *Prohibited Transactions*. Except for the payment of the annuity amount to _ _[*name(s) of recipient(s)*]**_ _, the trustee is prohibited from engaging in any act of self-dealing as defined in Internal Revenue Code §4941(d), from retaining any excess business holdings as defined in Internal Revenue Code section 4943(c) that would subject the trust to tax under Internal Revenue Code §4943, from making any investments that would be subject to tax under Internal Revenue Code §4944 of the Code, and from making any taxable expenditures as defined in Internal Revenue Code §4945(d). The trustee shall make distributions at such time and in such manner so as not to subject the trust to tax under Internal Revenue Code §4942.**

Comment: See discussion in §18.80 about leaving out references to IRC §§4943(c) and 4944.

18.83-1 Investment of trust assets

B. *No Investment Restriction on Trustee*. Nothing in this trust instrument shall be construed to restrict the

trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

18.85-1 No taxes payable from trust

C. *Payment of Estate and Gift Taxes*. No gift, legacy, succession, inheritance, estate taxes, or generation-skipping transfer taxes that may be assessed against the property of the trust created by this instrument by reason of a settlor's transfer to the trust or a settlor's death shall be paid out of any property held in this trust. Each settlor agrees on behalf of himself or herself, his or her heirs, legal representatives, successors and assigns, to provide for payments of any such taxes from sources other than property held by this trust and to indemnify and hold harmless the trustee from any and all liability for such taxes. Each settlor agrees that the trustee shall not be liable for any federal or state death taxes or generation-skipping transfer taxes payable. Each settlor imposes an obligation on _ _[*his/her*]_ _ estate to pay all such taxes, and each settlor agrees to provide for the payment of all such taxes from sources other than the trust estate.

Each settlor has provided for the payment of any death taxes and generation-skipping transfer taxes resulting from his or her death from sources other than this trust. Nevertheless, if for any reason, the charitable remainder annuity trust becomes liable for such taxes on the death of the first settlor to die, the interest of _ _[*name of secondary recipient*]_ _ shall not take effect unless _ _[*name of secondary recipient*]_ _ agrees to pay and pays federal or state death and generation-skipping transfer taxes for which the trustee may be liable on the death of the first the settlor to die. If _ _[*name of secondary recipient*]_ _ fails to agree to pay and to pay all such taxes, _ _[*name of secondary recipient*]_ _ shall be considered to have predeceased the first settlor to die for all purposes of the part of this trust attributable to the deceased settlor's death.

18.86-1 No other noncharitable payments

D. *No Other Noncharitable Payments*. No amount other than the annuity amount described in Article Two of this instrument or an amount transferred for full and adequate consideration may be paid to or for the use of any person other than an organization described in Internal Revenue Code §§170(b)(1)(A), 170(c), 2055(a), and 2522(a).

Comment: If a private foundation is or may be the remainder beneficiary at the time when any principal or income of the trust is to be distributed to it, omit the reference to IRC §170(b)(1)(A).

ARTICLE SEVEN
Trustee Powers

10.58-1 Trustee's powers

The trustee is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

(1) Each power enumerated in California Probate Code §§16047, 16052, 16200, 16220-16249, and any successor statutes as amended from time to time.

(2) The power to make or decline to make any tax election affecting the trust or its beneficiaries.

(3) The power to determine the market value of any investment of any trust for any purpose on the basis of such quotation, evidence, data, or information, as the trustee may deem pertinent and reliable; to make any division or distribution prorata or nonprorata, in undivided interests or in kind or partly in money and partly in kind on partial or final distribution.

(4) Notwithstanding any other provision of this instrument, the trustee's powers and discretions shall not include any power or discretion that is in conflict with Internal Revenue Code §664 and the regulations thereunder or any specific provision of this instrument.

ARTICLE EIGHT
Miscellaneous

18.87-1 Taxable year

A. *Calendar Year*. The taxable year of the trust shall be the calendar year.

18.88-1 Governing law

B. *Governing Law*. The operation of the trust shall be governed by the laws of the State of _ _[*name of state*]_ _. The trustee is prohibited, however, from exercising any power or discretion granted under those laws that would be inconsistent with the qualification of the trust under Internal Revenue Code §664 and the corresponding regulations.

8.8-1 Signature when agreement of trust is used

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]_
_ _[*Typed name*]_ _
Settlor

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor

State of California)
)
County of _ _[*name of county*]_ _)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY of the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

ACCEPTANCE BY TRUSTEE

In consideration of the foregoing, the trustee accepts the trust thus committed to it and agrees to act in accordance with the terms stated above.

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

[*Acknowledgment; see §8.12*]

SCHEDULE A

Items:

1.

2.

Accepted by the trustee:

Dated: _ _ _ _ _ _

_ _[*Typed corporate name*]_ _
Trustee
By __[*Signature of corporate trustee*]__
_ _[*Typed name and capacity, e.g., President*]_ _

Comment: See discussion in the Note in §18.40 regarding the use of dated and signed Schedule A as proof of creation and funding of charitable remainder trust.

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Appendix P

Qualified Personal Residence Trust (QPRT)

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Description

The following form is appropriate for a qualified personal residence trust (QPRT) for a single settlor that will be exempt from the special valuation rules under IRC §2702(a)(3) and Treas Reg §25.2702-5(c). Married settlors would typically use two trusts, each one containing a one-half interest in the residence. The settlor must have an exclusive right to possession and use of the residence during the trust term, and the trust must prohibit the transfer of the residence to the settlor during or after the trust term. See chap 17.

CAVEAT: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text.

The John J. Smith Qualified Personal Residence Trust

TABLE OF CONTENTS

OPENING DECLARATION

ARTICLE ONE: TRUST NAME

ARTICLE TWO: TRUST ESTATE

A. Administration of Trust Estate

B. Additions to Trust

ARTICLE THREE: IRREVOCABILITY OF TRUST

ARTICLE FOUR: TRUST TERM

ARTICLE FIVE: OPERATION DURING TRUST TERM

A. Limitations on Trust Property

B. Separate Account for Cash Additions

C. Exclusive Use of Residence

D. Distribution of Income

E. Distribution of Excess Cash

F. No Distributions to Other Beneficiaries

G. Payment of Trust Expenses

H. Sale of Residence

I. Destruction of Personal Residence

J. Cessation of Use as Personal Residence

K. Cessation of QPRT Status

L. Transfer of Residence to Settlor Prohibited

ARTICLE SIX: DISTRIBUTIONS ON TRUST TERMINATION

A. Trust Operations Account

B. Accrued Income

C. Distribution of Remainder

ARTICLE SEVEN: CONVERSION TO ANNUITY TRUST

A. Payment of Annuity

B. Deferral of Payment

C. Time of Payment

D. Annuity Amount

E. Proration of Annuity Amount

F. Determination of Annuity Amount

G. Additional Contributions Prohibited

H. No Payments to Other Beneficiaries

I. Commutation Prohibited

J. Distribution on Termination

ARTICLE EIGHT: OFFICE OF TRUSTEE

A. Nomination of Successor Trustees

B. Compensation of Trustee

ARTICLE NINE: TRUSTEE POWERS

ARTICLE TEN: GOVERNING LAW

ARTICLE ELEVEN: STATEMENT OF INTENT

Schedule A: Property Transferred and Delivered to Trustee

Schedule B: Distribution on Termination if Settlor Survives

The John J. Smith Qualified Personal Residence Trust

I, _ _[*name of settlor*]_ _ (called the "settlor"), hereby transfer and deliver to _ _[*name of trustee*]_ _, as trustee, the property described in Schedule A, attached to this instrument.

ARTICLE ONE
Trust Name

The trust created by this instrument may be referred to as the _ _[*name of settlor, e.g., JOHN J. SMITH*]_ _ Qualified Personal Residence Trust.

ARTICLE TWO
Trust Estate

A. *Administration of Trust Estate*. All property subject to this instrument from time to time is referred to as the trust estate and shall be held, administered, and distributed according to this instrument.

B. *Additions to Trust*. No additions may be made to the trust estate except as expressly authorized in this trust.

ARTICLE THREE
Irrevocability of Trust

This trust is irrevocable and may not be altered or amended. Notwithstanding the preceding sentence, the trustee shall have the power, acting alone, to amend the trust to the extent provided in Treasury Regulation §25.2702-5(a)(2) (or any subsequent regulation or statute) in any manner required for the sole purpose of ensuring that the trust qualifies as a qualified personal residence trust for purposes of Internal Revenue Code §2702(a)(3)(A) and Treasury Regulation §25.2702-5(c) (including, with respect to the grantor retained annuity trust (GRAT) administered under Article Seven, the qualification of the annuity interest under Internal Revenue Code §2702(b)(1) and Treasury Regulation §25.2702-3).

ARTICLE FOUR
Trust Term

This trust is effective immediately and terminates on the death of the settlor or expiration of a period of _ _[*number*]_ _ years from the date of this trust, whichever occurs first. The period before termination is referred to as the "trust term."

ARTICLE FIVE
Operation During Trust Term

During the trust term, all assets of the trust shall be administered as follows in accordance with this Article Five, except that assets of the separate account described in Article Seven shall be administered in accordance with Article Seven.

A. *Limitations on Trust Property*. This trust is not permitted to hold any assets other than the following:

(1) One residence, or a portion thereof, used or held for use as a personal residence of the settlor. For purposes of this subparagraph, a personal residence is a single property that is a principal residence within the meaning of Internal Revenue Code §1034, one other residence within the meaning of Internal Revenue Code §280A(d)(1) but without regard to Internal Revenue Code §280A(d)(2), or an undivided interest in either.

(2) Cash in an amount not to exceed the amount required for payment of trust expenses incurred or reasonably expected to be paid by this trust during the 6-month period following the addition of the cash to the trust:

(a) For improvements to be paid within 6 months from the date on which the addition of cash is made to the trust;

(b) For purchase by the trust of an original residence within 3 months after the date of execution of this trust but only if the trustee has previously entered into a contract to purchase that residence; and

(c) For purchase by the trust of a residence to replace another residence within 3 months after the addition of the cash to the trust but only if the trustee has previously entered into a contract to purchase that residence.

(3) Improvements to the residence if the residence, as improved, meets the requirements of a personal residence of the settlor.

(4) Proceeds from the sale of the residence.

(5) Insurance policies on the residence and the proceeds of those policies. For purposes of this Article Five, amounts received as the result of any involuntary conversion of the residence (within the meaning of Internal Revenue Code §1033) shall be treated as insurance proceeds.

B. *Separate Account for Cash Additions*. Any cash initially transferred to the trust estate and any additions of cash to the trust shall be held and administered as a separate account known as the "trust operations account." The trustee may accept any additional contribution of cash and subsequent additions of cash, but no such contribution or addition may be accepted that causes the balance of the account to exceed the limitations set forth in Article Five, subparagraph A(2).

C. *Exclusive Use of Residence*. During the term of this trust, the settlor shall be entitled to exclusive use and possession of the residence (including any replacement residence). This right is subject to the right of the trustee to sell the residence and subject to the provisions in this trust for creation of an annuity interest under Article Seven in the event that the trust ceases to be a qualified personal residence trust (QPRT). If the settlor does not use the residence as a residence at any time, the trustee may hold the residence for use as a personal residence of the settlor, prohibiting occupancy by any other person other than the spouse or a dependent of the settlor, as long as this action will continue to qualify the trust as a QPRT.

D. *Distribution of Income*. All income of the trust shall be distributed to the settlor no less frequently than annually.

E. *Distribution of Excess Cash*. No less frequently than quarterly, the trustee shall determine whether the balance of the trust operations account exceeds the amount permitted by Article Five, subparagraph A(2). If the limit is exceeded, the excess amount shall be immediately distributed to the settlor. On expiration of the trust term, any amounts held in the trust operations account that are not used to pay trust expenses due and payable on the date of termination (including expenses directly related to termination) shall be distributed outright to the settlor within 30 days. If the settlor is deceased, distribution shall be made to the settlor's _ _[*estate/revocable trust*]_ _.

F. *No Distributions to Other Beneficiaries*. No portion of the trust estate may be distributed to any person other than the settlor before expiration of the trust term.

G. *Payment of Trust Expenses*. Subject to the limitations of Article Five, subparagraph A(2), the settlor agrees to make any additions to the trust operations account that may be necessary from time to time to fund the expenses of the trust.

H. *Sale of Residence*. The trustee may sell the residence at any time and may acquire a replacement residence. In exercising its discretion, the trustee shall consider the mandatory obligations of the trustee under this instrument, the needs of the settlor, and the purposes of a QPRT. In the event of sale, the trustee shall hold the proceeds in a separate account under Treasury Regulation §25.2702-5(c)(5)(ii)(C). The trust shall cease to be a QPRT with respect to the proceeds of sale no later than the earlier of:

(1) The date that is 2 years after the date of sale;

(2) Termination of the term holder's interest in the trust; or

(3) The date on which a new residence is acquired by the trust.

I. *Destruction of Personal Residence*. If damage or destruction renders the residence unusable as a residence, the trust ceases to be a QPRT on the date that is 2 years after the date of damage or destruction (or the date of termination of the term holder's interest in the trust, if earlier) unless, before that date, replacement or repairs to the residence are completed or a new residence is acquired by the trust. If the trustee receives proceeds of insurance as a result of damage to or destruction of the residence, the trustee shall hold the proceeds in a separate account under Treasury Regulation §25.2702-5(c)(5)(ii)(D). The trust ceases to be a

QPRT with respect to the insurance proceeds no later than the earlier of:

(1) The date that is 2 years after the date of the destruction or damage;

(2) Termination of the term holder's interest in the trust; or

(3) The date on which the proceeds are expended for the purpose of repairing or replacing the residence.

J. *Cessation of Use as Personal Residence*. Subject to the rules in Article Five, paragraph I that apply when a cessation of use of a residence by the settlor is caused by sale or destruction of the residence, the trust ceases to be a QPRT if the residence ceases to be used or held for use as a personal residence. A residence is held for use by the settlor as long as the residence is not occupied by any other person (other than the spouse or a dependent of the settlor) and is available at all times for use by the settlor as a personal residence.

K. *Cessation of QPRT Status*. Within 30 days after the date on which the trust ceases to be a QPRT with respect to any assets of the trust, those trust assets shall be converted to and held for the balance of the trust term in a separate share of the trust under Article Seven.

L. *Transfer of Residence to Settlor Prohibited*. Except as expressly permitted by Treasury Regulation §25.2702-5(b)(1), (c)(9), the trustee may not sell or transfer the residence, directly or indirectly, to the settlor, the settlor's spouse, or an entity controlled by the settlor or the settlor's spouse during the term of this trust or at any time after the term as long as this trust remains a grantor trust with respect to the settlor within the meaning of Internal Revenue Code §§671-677. The purpose of the previous sentence is to satisfy the requirements of the referenced regulation, and the sentence shall be construed accordingly.

ARTICLE SIX
Distributions on Trust Termination

On expiration of the trust term, this trust shall terminate and be distributed as follows:

A. *Trust Operations Account*. The trust operations account shall be distributed as provided in Article Five, paragraph E.

B. *Accrued Income*. Trust income accrued during the trust term shall be distributed to the settlor, if living, and otherwise to the settlor's _ _[*estate/revocable trust*]_ _.

C. *Distribution of Remainder*. If the trust terminates as a result of the settlor's death, the remaining trust estate shall be distributed outright or in further trust to persons and entities, including the estate and/or creditors of the settlor, that the settlor appoints by an instrument filed with the trustee. If the settlor fails to exercise this power of appointment, distribution shall be made to the settlor's _ _[*estate/revocable trust*]_ _. If the trust terminates as a result of expiration of the time interval stated in Article Four with the settlor surviving that time interval, the remaining trust estate shall be distributed as set forth in Schedule B to this trust.

ARTICLE SEVEN
Conversion to Annuity Trust

If trust assets are to be held and administered as a separate share because the trust has ceased to be a QPRT with respect to those assets, the assets of the separate share shall be administered and distributed in accordance with this Article Seven. This article shall be construed according to the purpose of these provisions, which is to accomplish a conversion to a qualified annuity interest under Treasury Regulation §25.2702-5(c)(8).

A. *Payment of Annuity*. The trustee shall distribute to the settlor from the separate account an annuity at the times and in the amounts set forth in this Article Seven.

B. *Deferral of Payment*. The settlor's right to receive the annuity amount shall begin on the date of the sale of the residence, the date of damage to or destruction of the residence, or the date on which the residence ceases to be used or held as a personal residence (cessation date). The trustee may, however, defer payment of any annuity amount otherwise payable after the cessation date until the date that is 30 days after the assets

are converted to a qualified annuity interest (conversion date). Any deferred payment must bear interest from the cessation date at a rate no less than the Internal Revenue Code §7520 rate in effect on the cessation date. At the trustee's sole discretion, the trustee may reduce the aggregate deferred annuity payments by the amount of income actually distributed from the trust to the settlor during the deferral period.

C. *Time of Payment*. The annuity amount shall be payable to the settlor annually for each taxable year of the trust term. The trustee may not issue a note, other debt instrument, option, or similar financial arrangement in satisfaction of the annuity amount. The annuity amount may be paid after the close of the taxable year as long as the payment is made no later than the date by which the trustee is required to file the federal income tax return of the trust for the year (without regard to extensions).

D. *Annuity Amount*. The annuity amount shall not be less than an amount determined as follows:

(1) If, on the conversion date, the trust estate does not include a residence used or held for use as a personal residence of the settlor, the annuity amount shall be the amount determined by dividing the lesser of (a) the value of all interests retained by the settlor as of the date(s) of the original transfer(s) of the residence to the trust or (b) the value of all the trust assets as of the conversion date by an annuity factor determined for the original trust term using the interest rate used in valuing the settlor's interest in the trust at the time of the original transfer.

(2) If, on the conversion date, the trust estate includes a residence used or held for use as a personal residence of the settlor, the annuity amount shall be the amount determined under subparagraph D(1), multiplied by a fraction, the numerator of which is the excess of the fair market value of the trust assets on the conversion date over the amount (including acquisition costs) reinvested in the new residence or expended for repairs of the existing residence, and the denominator of which is the fair market value of the trust estate on the conversion date.

(3) The annuity amount shall be the minimum annuity amount so determined unless the trustee determines that the use of this annuity amount will result in an additional gift by the grantor to the trust as a result of the conversion, in which case the minimum annuity amount shall be increased to the minimum amount that results in there not being such a gift.

E. *Proration of Annuity Amount*. If a taxable year of the trust is for a period of less than 12 months, including the taxable year in which the trust terminates, the annuity amount shall be the amount otherwise determined for the year, multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

F. *Determination of Annuity Amount*. The value of the trust estate for purposes of determining the annuity amount shall be the fair market value of the assets as determined for federal tax purposes. If this value is incorrectly determined by the trustee, within a reasonable time after the value is set for federal tax purposes the trustee shall pay to the settlor (for undervaluation) or the settlor shall repay to the trustee (for overvaluation), an amount equal to the difference between the amount that the trustee should have paid to the settlor and the amount actually paid to the settlor.

G. *Additional Contributions Prohibited*. Additional contributions to a separate account administered under this Article Seven shall be prohibited. If additional assets become subject to administration under this article after other assets are already being administered under it, the additional assets shall be administered separately.

H. *No Payments to Other Beneficiaries*. The trustee shall make no distribution to any person other than the settlor during the trust term as long as this clause shall not limit the trustee's ability to make distributions for trust expenses.

I. *Commutation Prohibited*. Commutation (prepayment) of the interest of the settlor is prohibited.

J. *Distribution on Termination*. On expiration of the trust term, the trustee shall pay the settlor, if living, and otherwise _ _[*the estate of the settlor/the trustee of that revocable trust known as* _ _[*specify name of trust*]_ _]_ _ all remaining amounts due under the obligation to pay the annuity as set forth in this trust. Any amounts remaining after this payment shall be distributed in accordance with Article Six.

ARTICLE EIGHT
Office of Trustee

A. *Nomination of Successor Trustees*. If at any time the _ _[*person/institution*]_ _ named as trustee fails to qualify or ceases to act as trustee, the _ _[*persons/institutions*]_ _ listed below shall serve as successor trustees in the order named:

First: _ _[*Name of successor trustee*]_ _

Second: _ _[*Name of second successor trustee*]_ _

If the nominated successor also fails to qualify or ceases to act, _ _[*name*]_ _ shall have the power to name a successor trustee.

B. *Compensation of Trustees*. The trustee shall be entitled to reasonable compensation from time to time for services rendered to the trust.

ARTICLE NINE
Trustee Powers

To carry out the purposes of the trust created by this instrument and subject to any limitations stated elsewhere in this instrument, the trustee shall have the following powers in addition to those conferred by California Trust Law:

A. To retain, purchase, or otherwise acquire unproductive property.

B. To manage, control, grant options on, sell, convey, exchange, partition, divide, improve, and repair trust property.

C. To lease trust property.

D. To borrow money and to encumber trust property by mortgage, deed of trust, pledge, or otherwise.

E. To initiate or defend, at the expense of the trust, any litigation relating to the trust or any property of the trust estate.

F. To carry, at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.

G. To partition, allot, and distribute the trust estate on final distribution of the trust estate, in undivided interests or in kind or partly in money and partly in kind, at reasonable values determined by the trustee, and to sell any property the trustee considers necessary for division or distribution. The trustee may, in the trustee's discretion, make a nonprorata division between beneficiaries if the respective assets distributed to the beneficiaries have equivalent or proportionate fair market values. The income tax bases of assets distributed nonprorata need not be equivalent and may vary to a greater or lesser amount, as determined by the trustee in the trustee's discretion. The provisions of this paragraph G apply only on distribution of the remainder of the trust under Article Six, paragraph C.

ARTICLE TEN
Governing Law

The laws of the State of California shall govern the validity, construction, interpretation, and administration of this trust.

ARTICLE ELEVEN
Statement of Intent

It is the settlor's intent that this trust shall qualify as a qualified personal residence trust under Treasury

Regulation §25.2702-5(c) and that the provisions of Article Seven shall satisfy the requirements for conversion of the retained interest into a qualified annuity interest. All provisions of this instrument shall be interpreted according to this intention.

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _

[*Acknowledgment; see §8.12*]

SCHEDULE A
Property Transferred and Delivered to Trustee

1. That certain real property, which is a residence of the settlor and commonly known as _ _[*street address*]_ _, which is situated in the City of _ _[*city*]_ _, County of _ _[*county*]_ _, State of California, and more particularly described as follows: _ _[*Insert legal description*]_ _.

2. That certain policy of insurance on the residence described as follows: _ _[*Describe policy*]_ _.

3. Cash in the amount of _ _[*dollar amount*]_ _.

SCHEDULE B
Distribution on Termination if Settlor Survives

If the settlor survives the period of years stated in Article Four, the remaining trust estate shall be distributed _ _[*e.g., in equal shares to the settlor's children, _ _[names]_ _. If any child is not then living, that child's share shall be distributed to any person(s) that the child appoints by a provision in the child's last will or codicil. If this power is not exercised, however, that child's share shall be distributed to its estate*]_ _.

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Table of Statutes, Regulations, and Rules

CALIFORNIA

Constitution

Art II, §10(c): §20.80

Art XIII, §3(k): §17.47

Art XIIIA: §17.47

Art XIIIA, §2(h)(2)(A): §13A.15, App N

Statutes

CIVIL CODE

196: §5.21

196 (former): §5.21

683(a): §12.17

755: §§10.125, 20.10

946: §§10.125, 20.12, 20.17, 20.21

1189(a): §8.11

1190: §8.11

2924.6: §19.50

2928: §19.53

3439.01: §17.111

3439.04: §§17.13, 17.111

3439.04(a): §1.8

3439.04(b): §17.14

3439.04(b)(2): §1.8

3439.04(b)(5): §1.8

3439.09: §17.13

CODE OF CIVIL PROCEDURE

580b: §19.54

709.010: §13.25

CORPORATIONS CODE

704: §10.13

5140(k): §18.18

FAMILY CODE

65: §20.59

125: §20.59

150: §5.21

297: §10.135A

297.5: §§8.10, 10.135A, 14.2

297.5(d): §10.133B

308.5: §10.135A

760: §20.59

761: §§15.12, 16.9, 20.54

761(a): §14.9

770: §20.59

770(a)(3): §20.55

850: §13A.9

852: §20.51

3900: §§5.20-5.21

3900-3902: §5.21

3900-4203: §5.20

3901: §§5.20-5.21

3901(a): §§5.20-5.21

3910: §§5.20, 5.22

3910(a): §5.20

3930: §5.20

4001: §5.20

4050-4076: §5.20

4055: §5.20

4300: §5.20

4400: §5.22

6500: §§5.20, 12.38

6501: §9.27

6701: §12.13

6710: §12.13

7000-7110: §12.13

7002: §12.13

7050(e): §12.13

7122: §12.13

7540: §§10.133B, 14.2

7540-7541: §10.133B

7540-7547: §10.133A

7600-7730: §§10.133A-10.133B, 14.2

7611: §10.133B

7611(d): §10.133A

7611(f): §10.133A

7650(a): §10.133A

FINANCIAL CODE

786: §10.44

1503: §20.42

1563: §10.74

1564: §§10.44-10.45

1750-1751: §20.42

GOVERNMENT CODE

12580-12599.5: §20.70

HEALTH AND SAFETY CODE

25300-25395.15: §19.20

25548.3: §19.20

INSURANCE CODE

280: §11.9A

10110: §11.9A

10110.1(a): §11.9A

10110.1(d): §11.9A

10110.1(e): §11.9A

PROBATE CODE

24: §13A.15, App N

26: §10.133

28: §20.59

50: §10.133

66: §§20.55-20.56, 20.59

80: §12.15

100-101: §20.59

101: §§20.55-20.56

102: §§18.6B, 20.56

120: §20.50

240: §10.130

245-247: §9.5

246: §10.130

246(a): §§9.9, 9.17, 9.21-9.21A, 9.28, 9.32, 9.42-9.43, 9.49, 9.65

247: §§9.9, 10.130

249.5-249.8: §10.133A

260-295: §§9.68, 10.91

264: §10.91

267(a): §10.91

267(b)(14): §10.91

275: §10.91

276-277: §10.91

279(c): §9.68

279(c)(1): §9.68

295: §9.68

600-695: §20.61

611: §9.59, Apps A-E, I

625(b): §10.139

652: §20.63

682: §4.39

850-859: §10.84

850(a)(3): §10.140

859: §10.84

1215: §13.34

1500: §12.19

2108: §12.19

2400-2595: §12.19

2401.3: §12.110

2420(a)-(b): §12.19

2450-2467: §12.19

2450(a): §12.19

2580-2586: §1.4

2610: §12.19

2620(a): §12.19

2623(a)(1): §12.19

2623(a)(2): §12.19

3600: §13.35

3600-3612: §13.35

3600-3613: §§13.28, 13.36

3602(d): §§13.28, 13.32

3602(f): §13.32

3603: §13.35

3604: §13.34

Comment: §13.33

3604(b): §13.33

3604(b)(1): §13.29

3604(b)(2): §13.30

3604(b)(3): §13.31

3604(c): §13.33

3604(d): §13.34

3605(b): §13.34

3605(c): §13.34

3605(e): §13.34

3605(f): §13.34

3610-3611: §13.32

3611(c): §§13.28, 13.32

3613: §13.35

3900-3925: §§3.20, 3.59, 9.4, 9.49A, 12.23, 12.28-12.29, 12.31, 12.36, 12.56, 12.71

3901(f): §12.23

3902-3904: §12.23

3903(a): §12.26

3905(c): §12.26

3906: §§12.45, 12.71, 12.96

3906(a): §12.23

3906(c)(1)-(2): §12.23

3906(c)(2): §12.71

3906(c)(3): §§12.23, 12.71

3907(a): §12.26

3907(c): §12.26

3909: §12.23

3909(a): §12.23

3909(a)(7): §12.23

3910: §12.37

3912(b): §12.25

3912(b)(1): §12.25

3912(b)(2): §12.25

3913: §12.24

3914(a): §12.24

3914(c): §§12.24, 12.35

3914(d): §§12.32, 12.37

3918(b): §12.27

3918(c): §12.27

3918(d): §12.27

3918(f): §12.27

3918(g): §12.27

3919: §12.36

3920: §12.30

3920.5(a): §12.30

3920.5(c): §12.30

3920.5(d): §12.30

3920.5(e): §§12.30, 12.36-12.37

3920.5(f): §12.30

3920.5(g): §12.30

4264: §2.34

5130: §12.17

5140: §12.15

5140(b): §12.15

5142: §12.15

5301(a): §12.17

5302-5303: §12.17

5302(c): §12.15

5600: §§12.15, 12.17

6100: §§12.13, 12.22, 12.45

6205: §10.133

6300-6303: §§20.45-20.46

6402(b): §12.22

6408 (former): §10.133

6450: §20.37

6450-6455: §10.133

6451: §10.133

6453: §§10.133-10.133B

6453(c): §10.133A

6454: §10.133

10582: §10.109A

10585-10587: §10.109A

15000-19403: §7.7

15200: §7.3

15206: §§7.3, 19.2

15209: §13.20

15300-15301: §10.123

15303: §1.8

15304: §§1.8, 2.15, 9.64

15304(a): §2.51

15306(a): §§13.25, 13.38

15306(b): §§13.25, 13.38

15307: §10.123

15400: §§7.3, 8.6, 13.19, 20.8, 20.36

15400-15414: §13.40, App M

15403: §18.36A

15408: §9.6

15408(a): §9.6

15408(b): §9.6

15410(c): §9.6

15410(d): §9.6

15411: §10.101

15412: §10.101

15602: §10.48

15603: §10.27

15620: §10.13

15622: §10.13

15640: §§9.15, 10.27

15641: §10.27

15642: §10.29

15642(a): §10.29

15642(b): §10.29

15642(b)(6): §§10.9, 10.31A

15642(b)(6)(A): §10.9

15642(b)(6)(B): §10.9

15680: §19.87

15680(b): §10.50

15681: §§10.50, 19.87

15683: §10.50

15684: §§10.50, 19.90

15687: §19.87

16000: §§10.13, 20.4

16000-16105: §§19.24, 13A.15, App N

16002: §§10.82, 12.110

16002(a): §§10.59-10.60, 10.76, Apps B, I-J

16002(b): §10.44

16003: §§2.80, 10.59-10.60, 10.76, 10.110, Apps B, I-J

16004: §§10.44, 10.82

16004(c): §10.44

16004.5(a): §10.38

16004.5(b)(2): §10.38

16004.5(b)(5): §10.38

16006: §§10.84, 19.50

16007: §§10.62, 19.34

16009: §§10.42, 10.101

16010: §10.84

16011: §10.84

16012: §10.13

16012(a): §10.76

16012(c): §§10.59, 10.76

16013: §10.8

16015: §10.44

16040: §13A.15, App N

16040-16041: §10.38

16040(b): §20.4

16040(c): §10.62

16045-16054: §§2.59, 10.59-10.60, 10.76, 11.41, 18A.5, Apps B, I-J

16046(b): §§10.59, 19.6

16047: §§10.58, 19.34, Apps A, C-F, K, M, O

16047(a)-(b): §10.59

16047(c)(8): §10.62

16047(e): §§10.59, 10.67, 19.23-19.24, 19.27, 19.30, 19.67

16048: §§10.62, 10.65

16049: §10.62

16052: §§10.58, 10.76-10.77, 19.6, Apps A-F, I-K, M, O

16052(a): §§10.59, 19.6

16060-16064: §13A.15, App N

16062(a): §10.117

16062(e): §10.117

16064(a): §10.117

16064(c): §10.117

16080: §9.20

16080-16082: §10.10

16081: §5.23

16081(b): §§9.50, 10.6

16081(c): §§9.50, 10.6, 10.38

16082: §5.23

16102: §18.80

16102-16103: §18.80

16103: §§18.15, 18.80

16105: §§18.42, 18.104

16200: §§10.58, 10.67, Apps A, C-F, K, M, O

16200-16249: §§10.109A, 13A.15, App N

16200(a): §10.91

16202: §§10.64, 10.66

16220: §§10.62, 10.108

16220-16249: §10.58, Apps A, C-F, K, M, O

16222: §§10.62, 19.79

16222(a): §19.80

16222(b): §19.80

16222(c): §19.80

16224: §19.27

16225: §10.59

16225(b): §10.44

16226: §10.67

16227: §19.32

16228: §§10.79, 19.4, 19.30

16230: §19.4

16231: §§10.69, 19.58

16232: §19.112

16233: §19.4

16234-16237: §10.71

16234(a): §19.24

16234(b): §19.24

16234(c): §19.24

16235: §19.24

16236: §19.24

16237: §§19.24, 19.79

16238: §§10.74, 19.24

16239: §19.24

16240: §10.86

16241: §§10.79, 19.30

16242: §10.84

16244: §§10.81, 19.67

16246: §10.106

16247: §§10.44, 10.76, 19.6

16249: §10.84

16320-16375: §§2.59, 3.12, 3.59, 10.109A, 10.110, 10.112-10.112C, 18.58, 19.26, 19.37-19.37A, 19.52

16328: §§2.39A, 2.39C, 2.80, 3.10, 3.12, 9.41, 10.110, 10.116A, 19.11

16335: §3.12

16335(a)(1): §§10.110, 10.113, 10.115, 20.4

16335(a)(2): §§10.110, 10.115

16335(a)(3): §§10.110, 10.115

16335(a)(4): §10.115

16335(b): §§10.93, 10.116A

16336: §§2.80, 3.10, 3.12, 3.18A, 10.109A, 10.110-10.111, 10.116A, 19.11, 19.37-19.37A, 19.38

Comment: §19.34

16336(a): §2.39A

16336(b)(1): §§2.39A, 2.79

16336(b)(7): §§2.39A, 10.110

16336.4: §§2.39A, 3.12, 10.109A, 10.111, 10.116A, 19.11

16336.4-16336.6: §10.109C

16336.4-16336.7: §§2.80, 3.10, 3.18A, 9.41, 10.110, 10.116A, 19.11, 19.37

16336.4(b)(3): §10.116A

16336.4(e): §10.116A

16336.4(e)(4): §§2.39A, 2.39C

16336.4(e)(4)(A): §§2.80, 10.116A

16336.4(h)(1): §§2.39A, 10.116A

16336.5: §§2.39A, 10.116A

16336.5(a): §10.116A

16336.5(b): §10.116A

16336.6: §§2.39A, 10.116A

16336.7: §10.116A

16336.7(a): §10.116A

16338: §10.116A

16345(a): §10.113

16345(d): §10.113

16350: §19.25

16350(b): §19.25

16350(c)(1)-(3): §19.25

16350(c)(4): §19.25

16350(d)(1): §19.25

16352: §§19.93-19.94

16352(a): §19.92

16352(b): §19.92

16355: §§19.37, 19.92

16355(b): §19.11

16356: §19.11

16357: §10.112

16357(b): §19.27

16362: §19.110

16363: §§19.19, 19.110

16363(a)(1): §19.110

16363(a)(2): §19.110

16363(a)(3): §19.110

16364: §§19.19, 19.110

16365(b): §19.72

16370(c): §§19.6, 19.15, 19.17, 19.40, 19.51

16371(a): §19.51

16372: §§19.19, 19.110

16372(b): §§19.15, 19.17, 19.19, 19.40, 19.51

16373(b): §§19.6, 19.17

16373(b)(2): §19.15

16374(b): §19.15

16375(a)(1): §10.93

16375(a)(2): §3.59

16401(b): §10.59

16402: §10.38

16403: §10.38

16420(a)(5): §10.29

16460(a)(1): §13A.15, App N

16461: §10.38

16461-16462: §10.8

16461(c)(3): §13A.15, App N

16463(c): §10.44

16464(b): §10.44

16465(b): §10.44

16500: §§10.109A, 10.109C

16500-16504: §§10.109A, 10.109C, 10.110, 10.116A

16501(a): §10.109B

16501(b)-(c): §10.109B

16501(d): §§10.109A, 10.109C

16502: §§10.109B-10.109C

16503(b): §10.109B

16503(c): §10.109B

16503(c)-(d): §10.109B

16503(d): §10.109B

16504: §10.109A

17200: §§10.27, 10.118, 13.34, 18.42, 18.104, 13A.15, App N

17200(b)(10): §10.29

17200(b)(15): §§18.42, 18.104

17400-17457: §20.61

18000-18005: §10.38

18003(a)-(b): §10.13

18003(c): §10.8

18100-18100.5: §7.7

18100.5: §10.27

18103-18104: §19.2

19000-19403: §9.64

20100-20125: §18.84

20100-20225: §20.84

20110: §18.84

20110(b)(1): §11.7

20113: §20.84

21102(a): §20.4

21103: §§20.4, 20.12

21108: §13.20

21115: §10.133

21200-21225: §20.63

21200-21231: §§1.8, 9.58, 13A.5, 13A.15, App N

21205: §§13A.5, 20.63

21205(b): §18A.20

21220: §9.59

21225(e): §20.68

21300-21322: §10.136

21310-21315: §10.136

21350: §10.9

21350(a): §10.29

21525(a): §2.77

21541: §18A.24

REVENUE AND TAXATION CODE

61(c): §14.11

62(d): §§14.11, 15.14, 16.11, 17.47

62(p): §§14.11, 15.14, 16.11

63.1: §§13A.3, 17.47

63.1(a)(1)-(2): §§14.11, 15.14, 16.11

63.1(a)(3): §§14.11, 15.14, 16.11

63.1(c)(3): §14.11

63.1(e)(1)(B): §§14.11, 15.14, 16.11, 17.47

63.1(e)(1)(C): §§14.11, 15.14, 16.11, 17.47

69.5: §17.47

218: §17.47

11911: §17.48

13302: §§2.6, 2.84, 20.80

13302-13304: §20.80

13304: §§20.82-20.83

16710: §4.3

17016: §20.82

17024.5: §5.2

17024.5(a)(1): §3.2

17024.5(b)(6): §3.2

17041(e): §3.7

17201: §§18.20, 19.60

17276(c): §3.21

17731: §§3.2, 10.5, 10.11, 10.21, 10.71, 10.82, 10.99, 18.31, 18.33, 20.92

17734: §20.94

17742-17744: §20.94

17742-17745: §5.2

17742(a): §20.92

17743: §20.92

17744: §20.92

17953: §§20.92, 20.94

18001: §20.94

18001-18005: §20.93

18002: §20.93

18004: §20.93

18036-18039: §12.51

19516: §20.95

23732-23735: §18.34

WELFARE AND INSTITUTIONS CODE

14009.5(b): §13.34

ACTS BY POPULAR NAME

California Uniform Transfers to Minors Act (CUTMA): §§3.20, 3.59, 9.4, 9.47, 9.49A, 10.105, 12.23, 12.28-12.29, 12.31, 12.36, 12.45, 12.56, 12.71

Carpenter-Presley-Tanner Hazardous Substances Account Act: §19.20

Independent Administration of Estates Act: §10.109A

Lanterman Developmental Disabilities Services Act: §13.45, App M

Proposition 6, §5: §20.80

Trust Law: §§7.7, 10.57, 14.27, 15.34, 16.32, 17.105, Apps B, I-J, L, P

Uniform Fraudulent Transfer Act: §1.8

Uniform Parentage Act (UPA): §§10.133A-10.133B, 14.2

Uniform Principal and Income Act (UPAIA): §§2.59, 3.12, 3.59, 10.109A, 10.110-10.112C, 10.113, 10.115, 18.58, 19.26, 19.37-19.37A, 19.52

Uniform Prudent Investor Act (UPIA): §§2.59, 10.59-10.60, 10.76, 11.41, 18A.5, Apps B, I-J

Uniform Statutory Rule Against Perpetuities (USRAP): §9.58

Uniform Testamentary Additions to Trusts Act: §20.45

Regulations

CALIFORNIA CODE OF REGULATIONS

Title 18

462.160(b)(1)(A), Examples 2-3: §13A.3

13303.3: §20.77

Title 22

50489.9: §§13.22, 13.27

50489.9(a)(1): §13.23

50489.9(a)(3): §13.24

50489.9(a)(3)(A): §13.24

50489.9(b)(2): §§13.23-13.24

Rules

CALIFORNIA RULES OF COURT

7.903: §13.36

7.903(b): §13.32

7.903(c): §§13.32, 13.36

7.903(c)(5)-(8): §13.32

7.903(d): §13.32

Rulings

STATE BOARD OF EQUALIZATION LETTERS TO ASSESSORS

2006/010, Q&A B2: §17.47

UNITED STATES

Constitution

Art VII, §5: §20.72

Amend XIV: §20.73

Statutes

UNITED STATES CODE

Title 1

7: §14.2

Title 11

Ch 7: §17.14

Ch 13: §17.14

541(a)(5)(A): §10.123

541(c)(2): §1.8

548(e): §1.8

548(e)(1)(A): §17.14

Title 15

77a-77aa: §§18.17, 19.105

77e: §19.108

77e(1): §19.108

77m: §19.108

78j(b): §19.105

78l: §19.107

78m(d): §19.107

78p: §§19.105, 19.107

78p(a): §19.107

80a-3(c)(10): §18.119

Title 17

201: §19.115

203: §19.115

203(a): §19.116

204-205: §19.115

302: §19.116

304(a): §19.116

304(b): §19.116

304(c): §19.116

304(d): §19.116

Title 29

1001-1461: §19.117

Title 42

402(d)(1)(B): §13.16

423(d): §13.16

1382(a)(1)(B): §13.9

1382(a)(2)(B): §13.9

1382(a)(3)(A): §13.9

1382(a)(3)(B): §13.9

1382b(a)(2)(A): §13.9

1382b(c): §§13.12, 13.18

1382b(e)(2): §13.18

1382b(e)(3)(A): §13.18

1382b(e)(3)(B): §13.18

1396a(a)(10): §13.13

1396p(d): §13.5

1396p(d)(3)(A): §13.21

1396p(d)(3)(B): §13.21

1396p(d)(4): §13.18

1396p(d)(4)(A): §§13.4, 13.21, 13.27

1396p(d)(4)(B): §13.21

1396p(d)(4)(C): §§13.21, 13.27

6901-6992k: §19.20

6907(n)(1): §19.20

6991b(h)(9): §19.20

9601-9675: §19.20

BANKRUPTCY CODE

See Title 11 United States Code

INTERNAL REVENUE CODE

Chapter 1, subchapter S: §§19.96, 19.100

Chapter 11: §11.16

Chapter 13: §17.3

Chapter 14: §§2.25, 19.74-19.75, 19.80

1(e): §§1.7, 3.7, 3.67, 9.36, 12.5, 12.70

1(g): §§1.7, 3.19, 9.8, 12.5, 12.12, 12.37B, 12.39, 12.56

1(g)(2): §12.5

1(g)(4): §12.5

1(g)(4)(C): §§3.19, 12.5

1(h): §§1.7, 3.7, 3.67

55: §3.9

55(b)(1)(A): §3.69

63(c)(5)(A): §3.19

67: §3.21

67(e): §§3.5, 3.9

72: §§2.55, 18.119

101(a): §2.81H

101(a)(2): §§11.9A, 11.12

101(a)(2)(A): §11.12

101(a)(2)(B): §§11.4, 11.12

121: §§17.10, 17.16, 17.41-17.42, 17.110-17.112

152(c): §§3.19, 12.5, 12.56

162: §19.60

163(h)(3): §17.41

163(k): §2.89

164(a)(1): §17.41

167(d): §§3.5, 19.19

170: §§2.41, 6.5, 18.3, 18.23, 18.45, 18A.1, 18A.24, 18A.28

170(a): §§18.9B, 18.25

170(a)(3): §18.14

170(b): §§2.40, 18.64, 18A.1, 18A.5

170(b)(1)(A): §§18.20, 18.65-18.67, 18.86, 18.107, Apps F-H, O

170(b)(1)(B): §3.50

170(b)(1)(D): §18A.1

170(b)(1)(E): §2.72

170(c): §§13A.15, 18.6B, 18.11A, 18.19-18.20, 18.23, 18.45, 18.64-18.67, 18.86, 18.96, 18A.24, Apps F-H, N, O

170(c)(2): §3.65

170(c)(3): §3.65

170(c)(4): §3.65

170(c)(5): §§3.65, 18.66

170(d): §18.20

170(e): §§18.9B, 18.20

170(e)(1)(B)(ii): §18.66

170(e)(5)(B): §18.66

170(f)(2)(A): §18.20

170(f)(2)(B): §§3.49, 18A.1, 18A.5

170(f)(2)(C): §3.50

170(f)(3)(B): §18.79

170(f)(3)(B)(i): §§18.2, 18.123

170(f)(4): §18.123

170(f)(7): §18.101

170(f)(8): §§2.72, 18.20

170(f)(10): §18.20

170(f)(12): §18.20

170(f)(13): §2.72

170(h): §2.72

170(h)(4)(A): §2.72

170(h)(4)(B): §2.72

172(b): §3.21

212: §19.60

213(c): §3.5

267: §19.65

267(a)(1): §3.8

267(b)(4)-(8): §3.8

267(b)(13): §3.8

280A(d): §17.26

280A(d)(1): §17.77, App P

280A(d)(2): §17.77, App P

301: §§2.91, 3.69F

302: §3.69F

303: §§2.39A, 2.45-2.46, 2.89, 2.91

303(a): §2.91

303(b)(2): §2.91

303(b)(3): §2.91

305: §3.69F

318: §§2.56, 19.103

351: §3.63

355: §3.69F

356: §3.69F

401(a)(13): §19.117

453: §19.63

454: §19.27

501(a): §9.43

501(c)(3): §3.69E

508(e): §§18.79-18.80, 18A.22

511-514: §18.34

512(a)(1): §18.34

512(b)(1)-(3): §18.34

512(b)(4)-(5): §18.34

512(b)(5): §18.34

512(b)(12): §18.34

512(b)(13): §18.34

514(b): §18.34

529: §§3.20, 12.37A, 13A.15

530: §§3.20, 12.37B, 13A.15

584: §§3.39, 10.44

611(b): §19.19

641: §1.7

641-692: §§3.2-3.3, 3.56

641(b): §3.5

641(c)(1)(A): §3.67

641(c)(2)(A): §3.67

641(c)(2)(B): §3.67

641(c)(2)(C): §3.67

641(c)(2)(C)(i): §3.67

641(c)(2)(C)(ii): §3.67

641(c)(2)(C)(iii): §3.67

641(c)(2)(D): §3.67

641(c)(3): §3.67

641(c)(4): §3.67

642: §6.5

642(b): §3.5

642(b)(2)(C)(ii): §3.19

642(c): §§2.72, 3.5, 3.18, 3.18B, 3.51, 18.105, 18.107, 18A.6, 19.19

642(c)(1): §§3.5, 18A.5

642(c)(5): §§18.2, 18.106

642(c)(5)(A): §18.107

642(c)(5)(C): §18.107

642(e): §19.19

642(g): §§2.73, 3.5

642(h): §3.21

643: §1.7

643(a): §3.10

643(a)(1)-(2): §3.10

643(a)(3): §3.10

643(a)(4): §3.10

643(a)(5): §3.10

643(a)(6): §3.73

643(b): §§2.80, 3.12, 3.59, 15.11, 16.8, 18.58-18.59, 18.107, 19.99-19.100, App G

643(f): §§3.3, 9.30, 10.95

643(h): §3.73

643(i): §§3.70, 3.73

644: §§3.6, 9.43, 18.87

645: §§3.1, 3.44A, 4.2

651: §§3.5, 3.11-3.12, 18.107, 20.92

651-663: §18.107

651-664: §1.7

651-668: §16.8

651(a)(1): §3.12

652: §§3.12, 10.6

652(a): §18.107

652(b): §3.10

661: §§3.5, 3.14, 13.26

661-662: §3.18E

661(a): §§3.15, 3.18B

661(a)(2): §3.37

662: §§3.18, 3.37, 5.21, 10.6

662(a): §3.18B

662(a)(1): §§3.18-3.18A, 3.18C

662(a)(2): §§3.18, 3.18B

662(b): §18A.6

663(a): §§3.18B, 3.74

663(a)(2): §3.18A

663(b): §§3.15, 3.18, App N

663(c): §3.18E

664: §§2.14, 2.28, 3.45, 6.5, 7.4, 18.3, 18.14-18.15, 18.21, 18.37-18.39, 18.42-18.43, 18.54, 18.78, 18.88, 18.92, 18.102, 18.107, 18.122, Apps F-G, K, O

664(b): §§3.47, 18.31-18.32

664(b)(1): §18.45

664(b)(2): §18.45

664(b)(3): §18.45

664(c): §§18.14, 18.33-18.34

664(c)(1): §18.35

664(c)(2): §18.35

664(d): §18.9B

664(d)(1): §§18.2, 18.7, Apps H, O

664(d)(1)-(3): §18.16

664(d)(1)(A): §§18.6A, 18.45-18.46

664(d)(1)(B): §18.6B

664(d)(1)(C): §§18.6B, 18.19, 18.64

664(d)(1)(D): §§18.6A, 18.7, 18.16, 18.45-18.46, 18.101

664(d)(2): §§18.8-18.9, Apps F-G

664(d)(2)-(3): §18.2

664(d)(2)(A): §§18.6A, 18.45, 18.53, 18.55

664(d)(2)(B): §18.6B

664(d)(2)(C): §§18.6B, 18.19, 18.64

664(d)(2)(D): §§18.6A, 18.8, 18.16, 18.45-18.46, 18.55, 18.101

664(d)(3): §18.9, App G

664(d)(4): §18.43, App F

664(f): §§18.12, 18.100-18.101

665-668: §§3.74, 10.95

665(b): §3.74

665(c): §10.95

666(a): §3.74

668(a): §3.74

668(c): §3.74

671: §§2.39A, 2.81-2.81A, 3.57, 11.12, 14.8, 15.11, 17.41, 17.44, 18A.1-18A.2, 18A.5, 18A.27, 19.92, 19.97-19.98, App J

671-677: §§1.7, 3.22, 3.38, 3.43-3.44, 10.5, 10.121, 12.99-12.100, 12.113, 17.88-17.89, 19.55, 19.77, App P

671-678: §§18.94-18.95, 20.23

671-679: §§2.8, 3.23, 7.6, 12.56, 13.26, 13A.6, 18.6, 18.11A, 19.54, 19.61, 19.64, 19.66, 19.96

672: §§5.8-5.9

672(a): §§3.26, 10.7, 12.113

672(b): §3.26

672(c): §§2.62, 3.26, 3.36, 3.44, 9.12, 9.14-9.15, 9.52, 10.6, 10.29-10.30, 11.6, 11.20, 13A.15, Apps A-E, I, K, N

672(c)(2): §5.28

672(e): §§3.26, 3.36, 3.40, 5.10-5.12, 5.15, 10.5, 10.81, 10.99-10.100, 11.12

672(f): §3.72

673: §§3.25, 3.38, 3.50, 5.17, 9.38B

673-677: §3.53

673(a): §§3.50, 9.46, 14.8, 15.11, 17.43, 18A.3

674: §§5.9, 5.17, 5.28, 9.14, 9.30, 9.38, 10.3, 10.11, 12.113, 19.12, App A

674-675: §10.3

674(a): §§3.26, 3.30, 3.38, 5.17, 9.39, 9.57, 10.5, 10.10, 12.56, 12.113, 19.14, 19.16, 19.18

674(b): §§3.30, 9.38F, 9.39, 10.5, 12.113

674(b)-(d): §12.56

674(b)(1): §§3.31, 9.38A

674(b)(2): §9.38B

674(b)(3): §§3.40, 9.38C, 14.8, 15.11

674(b)(4): §§9.38D, 18A.27

674(b)(5): §§9.20, 9.24, 9.38D, 9.39, 9.45, 12.113, 17.43

674(b)(5)-(6): §§9.39-9.40

674(b)(5)-(8): §12.113

674(b)(5)(A): §§3.32, 9.19-9.20, 10.10

674(b)(5)(B): §§3.32, 9.20

674(b)(6): §§3.33, 9.20, 9.31, 9.35, 9.39, 9.45, 12.47, 12.113

674(b)(6)(A): §3.33

674(b)(6)(B): §§3.33, 9.39

674(b)(7): §§3.34, 9.20, 9.27, 9.30, 9.38E, 9.39, 12.113, App C

674(b)(8): §§9.38F, 10.111, 12.113

674(c): §§3.30, 3.36, 3.40, 3.44, 5.10, 9.14, 10.5, 10.7, 12.53, 12.110, 18.94

674(c)-(d): §5.17

674(c)(1): §12.113

674(d): §§3.30, 3.35, 9.16, 9.19, 9.35, 9.39, 12.113

675: §§3.41A, 9.22, 9.29, 10.21, 10.52, 10.82, 10.99, 12.56

675-677: §5.17

675(1): §§3.27, 10.82, 10.99

675(1)-(3): §10.99

675(2): §§3.27, 5.10, 10.99

675(3): §§3.27, 3.41A, 10.81, 10.99

675(4): §§3.27, 3.53, 10.52, 10.71, 19.47, 19.97

675(4)(A): §18.14

675(4)(C): §§3.41-3.41A, 3.44, 14.8, 15.11

676: §§3.28, 3.44A, 5.17

677: §§2.31, 2.53, 2.55, 2.81A, 5.17, 5.21

677(a): §§2.39A, 9.67, 10.6, 14.8, 15.11, 16.8

677(a)(1): §§3.29, 3.37, 18.14

677(a)(2): §§3.29, 15.11

677(a)(3): §§3.29, 3.42, 11.6, 11.12-11.13, 17.43

677(b): §§3.31, 3.37, 5.26, 12.35, 12.74

678: §§1.7, 2.72, 3.22, 3.38-3.39, 3.43-3.44, 3.54, 3.59, 3.61-3.62, 3.70, 10.25, 10.34, 10.91, 12.104, 19.47, 19.92, 19.98

678(a): §§3.53, 3.58, 3.62, 9.53

678(a)(1): §§3.38, 9.53, 12.100

678(a)(2): §§3.38, 12.57, 12.100, 13A.3

678(b): §§3.38, 3.44, 3.53, 12.99-12.100

678(c): §§5.26, 9.53

679: §§3.2, 3.27, 3.69F, 3.70, 3.74-3.75

679(a)(1): §3.70

679(a)(2)(A): §3.70

679(a)(2)(B): §3.70

679(a)(3)(A): §3.70

679(a)(3)(B): §3.70

679(a)(4)(A): §3.70

679(a)(4)(C): §3.70

679(a)(5): §3.69G

679(b): §3.70

679(c)(1): §3.70

679(c)(3): §3.70

679(c)(4): §3.70

679(c)(5): §3.70

679(c)(6): §3.70

679(d): §3.70

681(a): §18A.6

684: §§3.74-3.75

691(b): §2.73

704: §19.74

704(e): §§19.74, 19.77

731: §3.69F

752: §6.16

871(a): §3.69

871(d): §3.69

897: §3.69

901(b)(5): §3.73

911(d)(3): §2.81D, App J

1000: §17.112

1001: §18.36A

1001(e): §18.36A

1001(e)(1): §18.36A

1001(e)(3): §18.36A

1011(b): §19.55

1012: §3.65

1014: §§2.39A, 2.91, 3.44C, 4.36, 9.46, 9.54, 12.44, 12.50, 12.89, 14.8, 14.10, 15.11, 15.13, 16.8, 16.10, 17.16, 17.29, 17.42, 17.66, App I

1014(a): §2.46

1014(b)(6): §§2.46, 14.9, 15.12, 16.9, 20.51

1014(b)(9): §12.17

1014(e): §2.45

1015(a): §§14.8, 15.11, 16.8, 17.111

1015(b): §19.55

1015(d): §§2.46, 14.8, 15.11, 16.8

1015(d)(2): §19.55

1022: §§2.39A, 2.46, 2.91, 3.44C, 12.44, 12.50, 12.89, 17.16, 17.29, App I

1022(d)(1)(C): §2.45

1031: §§17.42, 19.64, 20.83

1033: §17.77, App P

1034: §17.77, App P

1034 (former): §§17.26, 17.42, 17.77

1035: §3.20

1041: §§5.12, 11.4

1221: §§18.36A, 19.64

1231: §19.64

1245: §19.64

1250: §19.64

1271-1275: §19.27

1274(d): §§2.22, 3.44B, 13A.8-13A.9, 13A.18, 14.13, 15.16, 16.13, 17.54

1274(d)(1): §§6.9, 14.1, 15.1, 16.1, 17.7

1361-1379: §§3.52, 13A.15, App N

1361(b): §§14.8, 15.11

1361(b)(1)(A): §3.66

1361(b)(2)(A)(v): §19.102A

1361(c)(2): §1.3

1361(c)(2)(A)(i): §§3.53, 3.57, 19.97

1361(c)(2)(A)(ii): §3.55

1361(c)(2)(A)(v): §§3.64, 14.8, 15.11

1361(c)(2)(B)(ii): §3.55

1361(c)(2)(B)(v): §3.66

1361(d): §§1.3, 19.96

1361(d)(1)-(2): §19.99

1361(d)(1)(B): §§3.58, 3.61, 19.101

1361(d)(2): §§3.58, 3.61

1361(d)(2)(C): §3.61

1361(d)(3): §§14.8, 15.11, 19.99

1361(d)(3)(A)(i): §§3.58, 3.60

1361(d)(3)(A)(ii): §3.58

1361(d)(3)(A)(iii): §3.58

1361(d)(3)(A)(iv): §3.58

1361(d)(3)(B): §§3.58-3.60, 19.99

1361(e): §§1.3, 3.54, 3.64, 14.8, 15.11, 19.96, 19.99, 19.102A

1361(e)(1)(A)(ii): §3.65

1361(e)(1)(B)(ii)-(iii): §3.65

1361(e)(1)(C): §3.65

1361(e)(2): §3.66

1361(e)(3): §3.65

1362: §§14.8, 15.11, 16.8

1362(a)(2): §§3.61, 3.65

1362(d)(3): §3.63

1362(f)(1)(A): §§3.61, 3.65

1363(a): §3.63

1366: §3.67

1366(d): §19.97

1411: §3.7

2001: §§4.1, 4.18, 18A.9

2001(b): §§2.2, 2.6, 17.38

2001(c): §§2.5, 4.6, 13A.4

2001(c)(1): §2.6

2001(c)(2: §2.7

2001(e): §17.38

2001(f): §2.46A

2001(f)(2): §17.62

2007-127: §3.26

2010: §§2.6, 4.1, 12.66, 13A.2, 13A.9, 17.66, App I

2010(c): §§2.5, 2.39A, 2.72, 4.17, 4.39, 5.5, 9.60, 12.3, 12.89, 12.114, 20.80

2011: §§2.6, 2.84, 4.3, 20.80

2011 (former): §§20.79-20.80, 20.82-20.83

2011(b): §2.84

2011(c)(1)-(3): §2.84

2011(f): §2.84

2012: §§2.6, 2.85, 5.4, 5.16, 9.66

2013: §§2.6, 2.82, 2.86, 4.39, 9.46

2013(b): §2.86

2013(c): §2.86

2031: §6.5

2031(a): §2.69

2031(c): §2.72

2032: §2.72

2032(c): §2.72

2032(d): §2.72

2032A: §§2.39A, 2.45, 2.72

2032A(a)(2)-(3): §2.72

2032A(b)(1): §2.72

2032A(c): §2.72

2032A(c)(7): §2.72

2032A(c)(8): §2.72

2033: §§2.47-2.48, 2.57, 6.3, 9.46, 12.48

2035: §§2.39A, 2.56, 2.64-2.65, 4.29, 5.4, 11.9-11.9B, 11.12, 11.16, 11.19, 17.38

2035-2038: §§2.6, 2.68, 2.85, 10.121

2035-2042: §2.47

2035(a): §§2.16, 2.64, 10.4, 11.3, 11.7

2035(b): §§2.4, 2.64, 12.4, 17.38

2035(c): §§2.45-2.46

2035(c)(1): §2.72

2035(c)(1)(A): §2.46

2035(d): §2.68

2036: §§1.8, 2.19, 2.23A, 2.23D, 2.39A, 2.48, 2.64, 2.71, 3.26, 3.41, 5.15, 5.18, 5.24, 5.27, 6.3, 9.66, 10.1, 10.3-10.4, 10.8, 10.21, 10.29, 10.71, 10.99, 11.4, 12.12, 12.32-12.33, 12.52, 12.115, 13A.14, 14.4, 14.15, 15.4, 15.6B, 15.18, 16.3, 16.15, 17.16, 17.58, 17.61, 17.63, 17.69, 17.109, 18.19, 18A.7, 19.47, 19.60-19.61, 19.100, 19.103, 20.49

2036-2038: §§2.16, 2.43, 2.48, 2.64, 10.4

2036(a): §§2.48, 2.68, 9.52, 17.35-17.36, 18.22, 19.14, 19.16, 19.18

2036(a)(1): §§2.16, 2.48-2.51, 2.53-2.54, 3.24, 5.15, 11.5, 14.6

2036(a)(2): §§2.23D, 2.48, 2.52, 2.58, 2.60, 5.15, 9.12, 9.22, 9.34, 9.44, 10.4, 10.52, 11.5, 12.110, 18.22

2036(b): §§2.48, 2.56, 2.61, 13A.15, 18.22, 19.103-19.104, Apps C, N

2036(b)(1): §10.52

2036(b)(2): §§10.54, 10.100, 19.103, Apps B, I

2036(b)(3): §2.56

2036(c): §4.23

2037: §§2.57, 12.47, 12.51, App B

2037-2038: §2.48

2037(a): §2.68

2038: §§1.8, 2.34, 2.39A, 2.48, 2.52, 2.59-2.60, 5.15, 6.3, 9.6, 9.12, 9.22, 9.34, 9.40, 10.3-10.4, 10.8, 10.21, 10.29, 10.52, 12.12, 12.32-12.33, 12.115, 13.3, 18A.7, 19.47, 19.100

2038-2042: §10.1

2038(a): §2.68

2038(a)(1): §§5.15, 13.37, 19.14, 19.16, 19.18

2039: §15.4

2039(a): §2.66

2039(b): §2.66

2040: §§2.6, 2.67

2040(a): §§2.67, 12.17

2040(b)(1): §2.67

2041: §§2.23B, 2.39A, 2.65, 4.10, 4.39, 5.24, 7.6, 9.6, 9.52, 9.60, 10.6, 10.32, 10.38, 10.91, 10.93, 10.99, 11.6, 11.16, 12.32, 12.48, 12.54, 12.98, 12.105, 12.115, 13.40, 13A.2, 15.6B, 19.11, 19.100, 20.23, App M

2041(a)(2): §§2.11, 2.65, 12.89

2041(a)(3): §4.39

2041(a)(3)(B): §12.88

2041(b): §10.6

2041(b)(1): §§9.56, 10.25

2041(b)(1)(A): §§9.10, 9.52, 9.56, 10.25

2041(b)(1)(C)(i): §9.52

2041(b)(1)(C)(ii): §9.52

2041(b)(1)(C)(iii): §9.52

2041(b)(2): §§12.105, 13A.3, 13A.15, App N

2042: §§2.6, 2.47, 2.64, 10.4, 10.88, 11.3, 11.6, 11.12, 13A.15, Apps C, N

2042(1): §§2.63, 11.3

2042(2): §§2.63, 11.3

2043: §2.68

2043(b): §2.68

2043(b)(2): §2.68

2044: §§2.23B, 2.36A, 2.39D, 2.79, 10.6, 18.122, 18A.7

2044(b)(1)(B): §18.21

2046: §20.60

2053: §§2.68, 2.73, 2.91, 13.37

2053-2054: §2.89

2053(a)(4): §2.72

2054: §2.73

2055: §§2.41, 2.71, 2.74, 6.5, 18.3, 18.11A, 18.23, 18.25, 18.45, 18.66, 18.122, 18A.1, 18A.7, 18A.24-18A.25, App K

2055(a): §§13A.15, 18.65-18.67, 18.86, 18A.25, Apps F-H, K, N, O

2055(e): §§6.3, 18.22

2055(e)(2): §§2.74, 18.123

2055(e)(3): §18.101

2055(e)(3)(B)(i): §18.105

2055(e)(3)(B)(ii): §18.105

2055(e)(3)(C): §18.105

2055(e)(3)(C)(ii): §18.103

2055(e)(3)(C)(iii)(I): §18.104

2055(e)(3)(C)(iii)(II): §18.104

2055(e)(3)(C)(iv): §18.104

2055(e)(3)(D): §18.105

2055(e)(3)(E): §18.105

2055(e)(3)(F): §18.102

2055(e)(3)(J): §18.101

2055(e)(4): §19.114

2056: §§2.71, 2.75, 10.110, 11.8, 15.6, 20.80, App J

2056-2056A: §20.23

2056(b)(1)(A)-(B): §2.75

2056(b)(1)(C): §2.75

2056(b)(3): §2.77

2056(b)(5): §§2.78, 10.6, 19.98

2056(b)(7): §§1.2, 2.79, 10.6, 18.121-18.122

2056(b)(7)(B): §§2.39A, 18.107, 18.122

2056(b)(8): §§18.23, 18.96

2056(b)(8)(B): §18.21

2056(b)(10): §2.78

2056(d): §§1.2, 2.75, 7.4, 18.23, 18.122, App J

2056(d)(1): §2.80

2056(d)(1)(B): §2.67

2056(d)(2): §2.80

2056(d)(2)(B): §2.80

2056(d)(3): §2.82

2056(d)(5): §2.81

2056A: §§2.75, 2.80-2.81B, 2.81D, 2.81F, 7.4, 11.2, 18.23, 18.122, App J

2056A(a): §2.81

2056A(a)(1): §2.81

2056A(a)(1)(A)-(B): §2.81D, App J

2056A(a)(1)(B): App J

2056A(a)(3): §2.80

2056A(b): §2.81F, App J

2056A(b)(1)(A): §2.81F, App J

2056A(b)(1)(B): §§2.81A, 2.81F

2056A(b)(2)(C): §2.81E, App J

2056A(b)(12): §2.83

2056A(d): §2.80

2057: §2.72

2057(b)(1): §2.72

2057(b)(1)(D): §2.72

2057(e)(1): §2.72

2057(e)(2)(B): §2.72

2057(f): §2.72

2058: §§2.84, 20.79

2102: §2.1

2106: §§18.3, 18.45

2106(a)(3): §2.1

2205-2207B: §20.84

2206: §11.7

2207A: §§2.79, 10.6

2207A(a)(2): §2.79

2207A(b): §2.39D

2210: §12.3

2210(b)(1): §2.81F, App J

2210(b)(2): §§2.81A, 2.81F

2501: §§1.3, 2.8

2501-2502: §13A.4

2502: §2.5

2502(b): §2.2

2502(c): §§2.5, 2.31

2503: §§9.13, 12.111, 12.113-12.115, 18A.17

2503(b): §§1.6, 2.7, 2.34, 2.36A, 2.39, 2.43, 4.1, 4.4, 4.15, 4.21-4.22, 4.34, 4.42, 11.2, 11.11, 11.13-11.14, 11.17, 12.3, 12.6, 12.12, 12.19, 12.31, 12.34, 12.37A, 12.38, 12.49, 12.54, 12.64, 12.66-12.68, 12.70-12.75, 12.80, 12.87, 12.96-12.98, 12.101, 12.111, 17.32, 17.34, 18.21, 18A.8, 18A.28, Apps A, C-E

2503(c): §§2.1, 2.37, 3.44, 11.11, 12.1, 12.6, 12.38-12.40, 12.42-12.43, 12.46, 12.49-12.51, 12.54-12.57, 12.63-12.64, 12.66, 12.68-12.71, 12.73, 12.80, 12.100, 12.111, 13A.11, 17.18, App B

2503(c)(1): §12.39

2503(c)(2)(A): §12.43

2503(c)(2)(B): §§12.44, 12.46, 12.48

2503(e): §§2.38, 4.14, 12.14, 12.37A

2504(c): §2.46A

2505: §§2.1, 2.4-2.5, 4.1, 4.21, 12.66, 13A.4, 13A.9, 17.66, App L

2505(a): §§2.46, 12.3, 12.114

2511: §§2.8, 2.39D, 9.56

2511(c): §§2.8, 3.46, 18.2, 18.7, 18.11-18.11A, 18.12-18.13, 18.15-18.16, 18.25-18.26, 18.38, 18.40, 18.53, 18.60, 18.62, 18.66, 18.70, 18.72, 18.123, Apps F, O

2512: §§2.23B, 6.5

2512(b): §§2.8, 2.33

2513: §§2.43, 4.4, 4.42, 12.51, 12.87, 12.96, 15.12, 16.9, 17.29, 17.38

2513(a)(1): §17.38

2513(a)(2): §17.38

2514: §§2.39A, 4.10, 9.56, 10.6, 10.38, 10.91, 11.6, 12.89, App E

2514(b): §2.11

2514(c): §§9.56, 12.101

2514(c)(1): §§2.12, 9.56

2514(c)(3)(A): §2.13

2514(c)(3)(B): §2.13

2514(e): §§2.11, 4.1, 4.10, 12.57, 12.86-12.89, 12.91, 12.96-12.98, 12.101-12.104, 12.109-12.110, 13A.15, Apps A, E, N

2515: §4.31

2516: §2.33

2516(1): §2.68

2518: §§9.68, 10.91, 20.60

2518(b)(2): §9.68

2518(c): §9.68

2518(c)(2): §10.91

2519: §2.39D

2522: §§2.40-2.41, 6.3, 6.5, 18.3, 18.11A, 18.25, 18.45, 18.66, 18A.1, 18A.8, 18A.24-18A.25, 18A.28, App K

2522(a): §§13A.15, 18.65-18.67, 18.86, 18A.25, Apps F-H, K, N-O

2522(c): §§2.42, 6.3, 18.21, 18.101

2522(c)(2): §§18.123, 19.49

2522(c)(2)(A): §2.41

2522(c)(3): §19.114

2522(c)(4): §§18.37, 18.103-18.105

2523: §§2.36A, 2.39, 10.110, 19.11

2523(c): §9.62

2523(e): §2.39

2523(f): §§2.39-2.39C, 2.41, 18.21, 18.121, App I

2523(f)(2): §§14.9, 15.12, 16.9, 18.107

2523(f)(2)-(3): §2.39A

2523(f)(2)(B): §§14.9, 15.12, 16.9

2523(f)(5): §2.39A

2523(g): §§2.41, 18.21, 18.107

2523(i): §§2.36A, 2.39, 18.21

2523(i)(2): §18.21

2601: §§1.3, 12.116

2603(a)(1): §§4.9, 4.11, 4.32, 10.98

2603(a)(2): §§4.12, 4.31-4.32, 10.98

2603(a)(3): §4.31

2604: §4.3

2611: §13A.15, App N

2611(a): §4.6

2611(a)(3): §12.34

2611(b)(1): §§4.14, 4.38, 12.14

2611(b)(2): §9.30A

2612: §18A.9

2612-2613: §§12.34, 12.116

2612(a): §§5.6, 9.14A

2612(a)(1): §4.12

2612(a)(1)(A): §9.14A

2612(b): §§4.9, 5.6, 9.8, 9.14A

2612(c): §5.6

2612(c)(1): §4.8

2613(a): §§4.8, 5.6

2613(a)(1): §4.5

2613(b): §§5.6, 18A.9

2621-2622: §4.6

2621(a): §4.9

2621(b): §§4.11, 10.98

2623: §§4.6, 4.8

2624: §6.5

2631: §§2.39A, 5.5, 9.14A, 9.24A, 9.30A, 9.60, 11.17, 12.34, 12.108, 12.111, 13A.9, 18A.9, App I

2631-2632: §5.6

2631(a): §4.17

2631(c): §§4.37, 13A.2

2632: §§4.1, 4.3, 11.17, 13A.2

2632(a): §4.21

2632(b): §4.21

2632(b)(3): §4.22

2632(c): §§4.17, 4.21, 4.26A, 4.42

2632(d): §§4.17, 4.21, 4.26B

2632(e): §4.27

2641: §§4.6, 4.18, 18A.9

2641(b): §9.30A

2642: §§13A.15, 18A.9, App N

2642(a): §§4.18, 13A.2

2642(a)(2)(B)(ii)(II): §18A.10

2642(a)(3): §4.20

2642(c): §§4.15, 4.34, 11.17, 12.12, 12.19, 12.34, 12.75, 13A.11, App B

2642(c)(1): §12.14

2642(c)(2): §§12.55, 12.89, 12.108, 12.116

2642(e): §§4.28, 18A.2-18A.3, 18A.10

2642(e)(1)(A): §18A.10

2642(e)(1)(B): §18A.10

2642(e)(2): §18A.10

2642(f): §§4.29, 11.16, 12.96, 12.98, 13A.2, 15.6B, 17.45

2642(f)(3): §17.57

2642(g): §§4.17, 4.21, 4.26A-4.26B

2651(b): §4.5

2651(b)(2): §5.6

2651(d): §4.5

2651(d)(1): §4.5

2651(d)(2): §4.5

2651(d)(3): §4.5

2651(e): §4.16

2651(f)(3): §§9.46, 18.84

2652(a): §§4.4, 12.108, 15.6B

2652(a)(3): §§4.4, 10.6

2652(b)(1): §4.2

2652(b)(3): §4.2

2652(c)(1): §4.8

2652(c)(2): §4.8

2653: §§4.13, 4.37

2653(a): §9.14A

2654(b): §5.29

2654(b)(2): §§4.1, 4.20, 17.45

2664: §§4.3, 11.17

2701: §§2.14, 2.26, 19.75

2701-2704: §§2.25, 17.3, 19.74, 19.80

2701(a)(1): §19.75

2701(a)(2): §19.75

2701(a)(2)(A): §19.75

2701(a)(3)(A): §19.75

2701(a)(3)(B): §19.75

2701(a)(4): §3.44C

2701(b)(1): §19.75

2701(b)(2): §2.26

2701(e)(1): §2.26

2701(e)(2): §§2.26, 6.25

2702: §§1.2, 1.6, 2.14, 2.27-2.28, 3.44B, 6.25-6.26, 7.4, 14.1-14.3, 14.5, 14.9-14.10, 15.1-15.2, 15.5-15.6, 15.6C, 15.11, 15.13, 15.28, 15.36, 16.1-16.2, 16.8, 16.10, 16.26, 16.34, 17.1-17.2, 17.7-17.8, 17.18, 17.35, 18A.28, 19.75, Apps I, L

2702(a)(1): §14.2

2702(a)(2): §§6.25, 16.1

2702(a)(2)(A): §§6.3, 6.25, 14.2

2702(a)(2)(A)-(B): §2.27

2702(a)(2)(B): §§3.44B, 6.3, 6.25

2702(a)(3): §6.25, App P

2702(a)(3)(A): §17.74, App P

2702(a)(3)(A)(ii): §§2.28, 6.3, 14.10, 17.2

2702(a)(3)(A)(iii): §§2.28, 17.2

2702(b): §§2.27, 6.25, 14.2

2702(b)(1): §17.74, App P

2702(b)(1)-(2): §6.3

2702(c)(1): §2.27

2702(c)(2): §2.27

2702(c)(3): §2.27

2702(e): §§2.27, 14.2, 15.1, 16.1

2703: §§2.29-2.30, 2.72, 19.76

2703-2704: §2.23B

2703(a): §§2.23D, 19.76

2703(b): §19.76

2703(b)(3): §19.76

2704: §§2.30, 2.72

2704(a): §2.30

2704(a)(2): §2.30

2704(b): §2.30

2704(c)(2): §§2.27-2.28, 6.25, 14.2, 15.1, 16.1

2801: §2.1

3406: §3.39C

4940-4945: §18.64

4940-4948: §§18.11, 18.36

4940(a): §18A.22

4940(c): §18A.22

4941: §§3.46, 18.36-18.36A, 18.40, 18.70, 18.79-18.80, 18.122-18.123

4941-4945: §18A.22

4941(d): §§18.79, 18.81, 18A.23, Apps F-H, K, O

4942: §§18.36, 18.79, 18.81, 18A.22-18A.23, Apps F, K, O

4943: §§3.46, 18.15, 18.79-18.81, 18A.23, Apps F, K, O

4943-4944: §§18.79, 18A.23, App K

4943(c): §§18.79, 18.81, 18A.23, Apps F, K, O

4944: §§18.79-18.81, 18A.23, Apps F, K, O

4945: §§3.46, 18.36, 18.40, 18.70, 18.79-18.80

4945(d): §§18.81, 18A.23, Apps F-H, K, O

4946: §18.70

4947(a)(1): §9.43

4947(a)(2): §§18.15, 18.79, 18.119, 18A.22

4947(a)(2)(A): Apps G-H

4947(b)(3): §§18.79-18.80, 19.49

4947(b)(3)(A): §18A.23, App K

4947(b)(3)(B): §18.15

6034A(c): §3.69C

6038A(e)(2): §3.69B

6038A(e)(4): §3.69B

6048: §§3.22, 3.69F, 3.69H

6048(a): §3.69H

6048(a)(1): §3.69D

6048(a)(2): §3.69D

6048(a)(3)(A): §3.69E

6048(a)(3)(B): §3.69E

6048(a)(4): §3.69G

6048(b): §§3.69, 3.69H

6048(b)(1): §§3.69A, 3.69H

6048(b)(2)(A)-(B): §3.69B

6048(b)(2)(C): §3.69B

6048(c): §3.69H

6048(c)(1): §3.73

6048(d)(5): §3.69C

6151: §2.87

6161: §2.88

6163(a): §2.90

6163(b): §2.90

6165: §2.89

6166: §§2.39A, 2.45-2.46, 2.88-2.89, 18.21

6166(b)(1): §2.89

6166(b)(7): §2.89

6166(b)(9): §2.89

6166(b)(10): §2.89

6166(g)(1): §2.89

6166(g)(3): §2.89

6211-6216: §3.69H

6324: §2.89

6324(b): §§2.31-2.32

6324A: §2.89

6501(a): §2.46A

6501(c)(9): §2.46A

6511(a): §18.33

6601(j): §2.89

6621(a)(2): §3.74

6654(e)(1): §3.16

6654(l)(2): §3.16

6662(d)(2)(B)(i): §1.7A

6662(d)(2)(C): §1.7A

6662(h): §1.7A

6677: §3.69

6677(a): §3.69H

6677(b): §3.69H

6677(c): §3.69H

6677(d): §3.69H

6677(e): §3.69H

6694(a)(2): §1.7A

6707A: §18.36A

7422(j): §2.89

7430: §2.23E

7477: §2.46A

7520: §§2.22, 2.42, 2.68, 3.25, 3.44B, 3.51, 6.1, 6.4, 6.8-6.9, 6.11, 6.16-6.18, 6.22, 6.34, 6.36-6.37, 6.39, 12.65, 14.1-14.4, 14.6, 14.13, 15.1-15.2, 15.4-15.5, 15.6C, 15.10, 15.12, 15.16, 15.18, 15.38, 16.1, 16.13, 17.7-17.8, 17.50, 17.54, 17.62, 17.65, 17.95, 17.112, 18.6A, 18.23, 18.25-18.26, 18.36A, 18A.1, 18A.5, 18A.8, 18A.10-18A.11, 18A.13-18A.17, 18A.20, 18A.28, Apps K-L, P

7520(a): §§6.9, 6.20, 6.27, 18.27

7602: §3.69B

7603: §3.69B

7604: §3.69B

7701(a)(1): §§18.7-18.8, 18.12, 18.16

7701(a)(30)(E): §3.68

7701(a)(30)(E)(i): §§3.68-3.68A

7701(a)(30)(E)(ii): §§3.68, 3.68D

7701(a)(31)(B): §3.68

7701(a)(36): §1.7A

7701(b)(2)(A): §3.70

7872: §§2.10, 3.44B, 3.44E, 9.8, 11.17, 13A.9

7872(c)(2): §2.10

7872(d)(1): §2.10

7872(f): §§2.10, 3.44B

ACTS BY POPULAR NAME

Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA): §19.20

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001): §18.11A

Employee Retirement Income Security Act of 1974 (ERISA): §19.117

Philanthropy Protection Act of 1995: §18.119

Proposition 13: §17.112

Resource Conservation and Recovery Act of 1976 (RCRA): §19.20

Securities Act of 1933: §§18.17, 19.105, 19.108

§5: §19.108

§12(1): §19.108

§13: §19.108

Securities Exchange Act of 1934

§10(b): §19.105

§12: §19.107

§13(d): §19.107

§16: §19.105, 19.107

Supplemental Appropriations Act: §§3.44C, 15.5

Tax Reform Act of 1969: §18.102, 18.104, 18A.3

Tax Reform Act of 1986: §18A.3

SESSION LAWS

Pub L 107-16, 115 Stat 38: §18.11A

Pub L 104-62, 109 Stat 682: §18.119

Pub L 99-514, 100 Stat 2085: §18A.3

Pub L 91-172, 83 Stat 487: §18A.3

PROPOSED LEGISLATION

HR 4899: §§3.44C, 15.5

CONGRESSIONAL REPORTS

S Rep No. 104-281: §2.28

Regulations

CODE OF FEDERAL REGULATIONS

Title 12

9.1-9.20: §10.13

9.11(a): §10.44

9.18(a)(1): §10.44

Title 17

230.100-230.904: §19.105

230.144: §§18.17, 19.105, 19.108

230.144(d)-(e): §19.108

230.144(e)-(f): §19.108

230.405: §19.108

240.10b-5: §19.105

240.13d-3: §19.107

240.16a-1(a)(1): §19.107

240.16a-8(a)(1): §19.107

240.16a-8(a)(2): §19.107

Title 20

404.350(a): §13.16

416.200-416.269: §13.8

416.401-416.435: §13.7

416.1124(c)(6): §13.10

416.1124(c)(12): §13.10

416.1201: §13.17

416.1210(a): §13.9

416.1210(b): §13.9

416.1216: §13.9

416.1218: §13.9

Title 31

Part 10 (Circular 230): §1.7A

10.2(a)(4): §1.7A

10.34(a): §1.7A

10.34(b): §1.7A

10.34(c): §1.7A

10.34(e): §1.7A

10.35(b)(2): §1.7A

10.35(b)(3): §1.7A

10.35(c): §1.7A

TREASURY REGULATIONS

1.167(h)-1(b): §19.19

1.170A-1(d): §18.121

1.170A-6(c)(2)(i): §§3.49, 18A.1, 18A.20

1.170A-6(c)(2)(i)(A): §18A.20

1.170A-6(c)(2)(i)(D): §18A.23, App K

1.170A-6(c)(2)(i)(E): §18A.20

1.170A-6(c)(2)(ii): §18A.1

1.170A-6(c)(4): §§3.50, 18A.5

1.170A-7(b)(3): §18.123

1.170A-7(b)(4): §18.123

1.170A-13: §§18.17, 18.20

1.170A-13(c)(3): App G

1.170A-13(c)(5): App G

1.512(a)-1—1.512(c)-1: §18.34

1.514(c)-1(b): §18.35

1.611-1(c)(4): §19.19

1.641(b)-2(b): §12.19

1.641(b)-3(b): §§3.6, 3.21

1.641(b)-3(d): §3.21

1.641(c)-1(d)(2)(ii): §3.5

1.642(c)-1(b): §3.5

1.642(c)-3(b)(2): §§3.10, 18A.6

1.642(c)-5: §§6.12-6.13A

1.642(c)-5(b)(1): §18.109

1.642(c)-5(b)(2): §18.110

1.642(c)-5(b)(3): §18.111

1.642(c)-5(b)(4): §18.112

1.642(c)-5(b)(5): §18.113

1.642(c)-5(b)(6): §18.114

1.642(c)-5(b)(7): §18.115

1.642(c)-5(b)(8): §18.116

1.642(c)-6A(d): §6.12

1.642(c)-6A(e): §6.13

1.642(c)-6A(f): §6.13A

1.642(h)-1(a): §3.21

1.642(h)-1(b): §3.21

1.642(h)-2: §3.21

1.643(a)-3(a): §§3.10, 3.12

1.643(a)-3(b): §§3.12, 9.43

1.643(a)-4: §3.12

1.643(a)-5(b): §§3.10, 18A.6

1.643(a)-8: §18.31

1.643(b)-1: §§2.39A, 2.39C, 2.79-2.80, 3.10, 3.12, 3.18A, 9.43, 10.110, 10.116A, 19.11, 19.44

1.643(h)-1: §3.73

1.651(a)-1: §3.11

1.651(a)-2(b): §3.11

1.651(a)-2(d): §3.12

1.652(b)-2(b): §3.10

1.661(a)-2(a)(1): §3.18A

1.661(a)-2(b): §3.18A

1.661(a)-2(c): §3.18A

1.661(a)-2(f): §§3.18A, 3.46

1.662(a)-2(a): §3.18A

1.662(a)-2(b): §3.18A

1.662(a)-2(c): §3.18D

1.662(a)-2(e), Example (1): §§3.18A, 3.18C-3.18D

1.662(a)-2(e), Examples (1)-(2): §3.18D

1.662(a)-2(e), Example (2): §§3.18A, 3.18C

1.662(a)-3(a): §3.18B

1.662(a)-3(b): §3.18D

1.662(a)-4: §§3.18B, 5.20-5.22

1.663(a)-1: §3.18B

1.663(a)-2: §§3.18A-3.18B

1.663(c)-1: §§3.18E, 5.31

1.663(c)-1(a): §3.18E

1.663(c)-1(b)—1.663(c)-1(c): §3.18E

1.663(c)-3: §§4.1, 4.20

1.663(c)-3(e): §3.18E

1.664-1—1.664-3: §18.37

1.664-1(a)(1): §18.45

1.664-1(a)(1)(iii)(a): §18.3

1.664-1(a)(2): §§18.4, 18.46, 18.53

1.664-1(a)(3): §§18.5, 18.82, 18.107, 19.49

1.664-1(a)(4): §§18.6, 18.14, 18.40, 18.89

1.664-1(a)(5): §18.6

1.664-1(a)(5)(i): §18.45

1.664-1(a)(5)(i)-(ii): §18.78, App F

1.664-1(a)(5)(ii): §18.78, App F

1.664-1(a)(5)(iv): §18.70

1.664-1(a)(7)(i): §18.17

1.664-1(a)(7)(ii): §18.17

1.664-1(a)(7)(iii): §18.17, App G

1.664-1(c)-(d): §18.31

1.664-1(d): §§3.47, 18.32

1.664-1(d)(1): §18.31

1.664-1(d)(1)(ii): §18.31

1.664-1(d)(1)(iv): §18.32

1.664-1(d)(4): §18.31

1.664-1(d)(5): §18.13

1.664-1(e): §3.48

1.664-2: §§18.3-18.4

1.664-2(a)(1)(i)(a): §18.45

1.664-2(a)(1)(i)(b): §18.45

1.664-2(a)(1)(i)(c): §18.45

1.664-2(a)(1)(iii): §§15.9, 15.26, 17.99, 18.70

1.664-2(a)(1)(iv): §18.62

1.664-2(a)(1)(iv)(a): §18.62

1.664-2(a)(1)(iv)(b): §18.62

1.664-2(a)(2)(i): §18.46

1.664-2(a)(2)(ii): §18.46

1.664-2(a)(2)(iii): §§18.46, 18.70

1.664-2(a)(3): §18.45

1.664-2(a)(3)(i): §18.94

1.664-2(a)(3)(ii): §18.94

1.664-2(a)(4): §§18.11, 18.21, 18.45, 18.86, 18.96, 18.98, 18.99A

1.664-2(a)(5): §§18.16, 18.45

1.664-2(a)(5)(i): §§18.45, 18.62

1.664-2(a)(6)(i): §§18.19, 18.64

1.664-2(a)(6)(ii): §18.81

1.664-2(a)(6)(iv): §18.65

1.664-2(b): §§18.72-18.73

1.664-2(c): §§18.25, 18.47

1.664-3: §§18.3-18.4

1.664-3(a)(1)(i)(a): §18.53

1.664-3(a)(1)(i)(b): §§18.9, 18.58

1.664-3(a)(1)(i)(b)(3): §§10.116A, 18.9, 18.58

1.664-3(a)(1)(i)(c): §18.9A, App G

1.664-3(a)(1)(i)(g): §18.45

1.664-3(a)(1)(i)(h): §18.45

1.664-3(a)(1)(i)(k): §18.45

1.664-3(a)(1)(ii): §§18.53-18.54

1.664-3(a)(1)(iii): §§16.6, 16.24, 18.70

1.664-3(a)(1)(iv): §18.60

1.664-3(a)(1)(v): §§16.25, 18.62

1.664-3(a)(1)(v)(a)(3): §18.60

1.664-3(a)(2)(ii): §§18.53-18.54, 18.96

1.664-3(a)(3): §18.45

1.664-3(a)(3)(i): §18.94

1.664-3(a)(3)(ii): §18.94

1.664-3(a)(4): §§18.11, 18.21, 18.45, 18.86, 18.96, 18.98, 18.99A

1.664-3(a)(5): §§18.16, 18.45

1.664-3(a)(5)(i): §§18.45, 18.62

1.664-3(a)(6)(i): §§18.19, 18.64

1.664-3(a)(6)(ii): §18.81

1.664-3(a)(6)(iv): §18.65

1.664-3(b): §§18.72, 18.76

1.664-3(b)(1): §18.72

1.664-3(b)(1)(iii): §18.60

1.664-3(b)(2): §18.72

1.664-3(d): App G

1.664-4: §§18.36A, 18.60

1.664-4(a): §18.26

1.664-4(a)(3): §§18.26, 18.46, 18.53

1.664-4(b): §18.28

1.664-4(c): §18.28

1.664-4(e): §§6.5, 18.24

1.664-4(e)(6): §§6.5, 6.30, 6.32

1.664-4A(d): §6.12

1.664-4A(d)(6): §6.30

1.664-4A(e): §6.13

1.664-4A(e)(6): §6.30

1.664-4A(f): §6.13A

1.664-4A(f)(6): §6.30

1.671-2(e): §3.22

1.671-4(a): §§3.39, 3.39D

1.671-4(b)(2): §17.111

1.671-4(b)(2)(i)(A): §§3.39A-3.39B

1.671-4(b)(2)(ii)-(iii): §§3.39A-3.39B

1.671-4(b)(3): §3.39C

1.671-4(b)(6)-(7): §3.39

1.672(f)-1(a)(1): §3.72

1.674(b)-1(b)(1): §9.38A

1.674(b)-1(b)(3): §9.38C

1.674(b)-1(b)(4): §9.38D

1.674(b)-1(b)(5)(i): §§3.32, 9.16, 9.19-9.20, 9.30, 10.10

1.674(b)-1(b)(5)(ii)-(iii), Example (3): §9.20

1.674(b)-1(b)(6): §§3.33, 9.35, 12.113

1.674(b)-1(b)(6)(ii): §12.113

1.674(b)-1(b)(7): §9.30

1.674(b)-1(b)(8): §9.38F

1.674(c)-1: §3.40

1.674(d)-2(a): §§3.35-3.36, 3.40

1.674(d)-2(b): §§3.40, 9.14

1.675-1(a): §3.41A

1.675-1(b)(4): §§3.41, 10.99

1.675-1(c): §10.82

1.676(a)-1: §5.17

1.677(a)-1(d): §§18.14, 19.53

1.677(b)-1(d): §19.53

1.677(b)-1(e): §3.37

1.679-1(b): §3.70

1.679-2(a)(1): §3.70

1.679-2(a)(4): §3.70

1.679-3(b): §3.70

1.679-4(b): §3.70

1.684-1(a)(1): §3.75

1.684-1(a)(2): §3.75

1.684-1(d), Example (4): §3.75

1.684-3: §3.75

1.691(a)-4(b): §18.14

1.704-1(e)(1)(ii)-(iv): §19.77

1.704-1(e)(1)(iii)-(iv): §19.77

1.704-1(e)(1)(v): §19.77

1.704-1(e)(2)(ii)(a): §19.78

1.704-1(e)(2)(ii)(b): §19.78

1.704-1(e)(2)(ii)(d): §19.78

1.704-1(e)(2)(vii): §19.77

1.704-1(e)(2)(vii)-(viii): §19.77

1.704-1(e)(2)(ix): §19.78

1.1001-1(e): §§2.33, 19.55

1.1001-2(c), Example (5): §§3.44B, 19.55

1.1011-2: §19.55

1.1014-3(a): §§2.46, 2.67

1.1031(a)-1(c): §19.64

1.1234-1(b): §19.13

1.1361-1(e)(2): §3.53

1.1361-1(h)(1)(i): §§3.53, 19.97

1.1361-1(h)(1)(ii): §19.97

1.1361-1(h)(3)(i)(A): §3.53

1.1361-1(h)(3)(i)(C): §3.61

1.1361-1(h)(3)(i)(F): §3.65

1.1361-1(j)(1)(iii): §3.60

1.1361-1(j)(3): §3.60

1.1361-1(j)(6): §3.61

1.1361-1(j)(6)(ii): §3.61

1.1361-1(j)(7): §3.61

1.1361-1(j)(8): §§3.62, 19.101

1.1361-1(j)(9): §§3.60-3.61

1.1361-1(j)(12): §§3.57, 3.64, 19.102A

1.1361-1(k)(1), Example (4)(i): §19.99

1.1361-1(m): §§3.56, 3.66

1.1361-1(m)(2): §3.65

1.1361-1(m)(4): §3.65

1.1361-1(m)(7): §§3.57, 3.64, 19.102A

1.1362-6(b)(2)(iv): §§3.61, 3.65

1.6011-4(b)(2): §1.7A

1.6011-4(b)(6): §18.36A

1.6081-4: §3.6

1.6662-4(g)(2)(ii): §1.7A

1.6664-4(f): §1.7A

1.7520-3(b)(2)(i): §6.36

1.7520-3(b)(2)(ii): §6.36

1.7520-3(b)(2)(iii): §6.36

1.7520-3(b)(3): §6.36

20.2001-1(b): §2.46A

20.2031-1(b): §2.21

20.2031-1(h): §19.76

20.2031-2(h): §19.76

20.2031-7: §19.61

20.2031-7(d): §§6.5, 18.24

20.2031-7(d)(2)(iii)-(iv): §6.21

20.2031-7(d)(6): §§6.5, 6.21, 6.28, 18.25

20.2031-7(d)(7): §18.123

20.2031-7A(d): §6.12

20.2031-7A(d)(6): §§6.12, 6.15

20.2031-7A(e): §6.13

20.2031-7A(e)(4): §§6.13, 6.15

20.2031-7A(f): §6.13A

20.2031-7A(f)(4): §§6.13A, 6.15

20.2032-1(b)(2): §2.72

20.2032-1(b)(3): §2.72

20.2032-1(d)(4): §2.72

20.2036-1(b)(2): §§2.53, 5.24, 12.52, 12.54

20.2036-1(b)(3): §§2.62, 10.6

20.2036-1(c): §§14.4, 15.4, 16.3, 18.23

20.2036-1(c)(2): §16.29

20.2036-1(c)(2)(ii): §15.4

20.2037-1(a)(2): §9.61

20.2037-1(c)(2): §12.51

20.2038-1(a): §§2.60, 9.12, 10.6, 12.110

20.2038-1(a)(3): §9.12

20.2039-1(e)(1): §15.4

20.2041-1(b)(1): §§10.21, 10.111

20.2041-1(b)(1)-(2): §12.48

20.2041-1(c): §5.24

20.2041-1(c)(1): §§9.52, 10.6, 12.54

20.2041-1(c)(2): §§9.10, 9.16, 9.52, 10.25, 11.6

20.2041-3(d)(4): §§12.89, 12.105

20.2041-3(d)(5): §12.89

20.2042-1(b)(1): §11.3

20.2042-1(c)(2): §§10.4, 11.6

20.2042-1(c)(6): §11.3

20.2044-1(d)(2): §10.114

20.2055-2(e)(2)(v): §18.67

20.2056(b)-5(f)(1): §2.79

20.2056(b)-5(f)(3): §19.19

20.2056(b)-5(f)(4): §§10.61, 19.98, App I

20.2056(b)-5(f)(7): §10.123

20.2056(b)-6(g): §18.123

20.2056(b)-6(g), Example (13): §18.107

20.2056(b)-7(d)(1): §§2.39C, 2.80, 9.41

20.2056(b)-7(d)(4): §10.114

20.2056(b)-7(d)(5): §18.107

20.2056(b)-7(h), Example (5): §2.79

20.2056(c)-2(b)(1): §2.76

20.2056A-0—20.2056A-13: §2.81B, App J

20.2056A-2(d)(1)(i): §§2.81, 2.81C, App J

20.2056A-2(d)(1)(i)(A): §2.81C, App J

20.2056A-2(d)(1)(i)(B): §2.81C, App J

20.2056A-2(d)(1)(i)(C): §2.81C, App J

20.2056A-2(d)(1)(ii): §2.81

20.2056A-2(d)(1)(iii): §2.81

20.2056A-2(d)(1)(v): §2.81

20.2056A-2(d)(2): §2.81D, App J

20.2056A-3(a): §2.80

20.2056A-4: §2.81

20.2056A-4(b)(1): §2.80

20.2056A-4(b)(3): §2.81A, App J

20.2056A-4(c)-(d): App J

20.2056A-5(c)(2): §2.80

20.2056A-7(a): §2.82

20.2056A-9: §2.81E, App J

20.2056A-10(a)(1): §2.83

20.2056A-10(a)(2): §2.83

20.2056A-10(b): §2.83

20.2702-2(a)(3): §14.2

20.7520-3(b)(2)(ii): §14.6

20.7520-3(b)(3)(i): §2.86

20.7520-3(b)(3)(ii): §2.57

20.7520-3(b)(3)(iii): §2.86

25.2503-3: §12.3

25.2503-3(a): §§2.35, 11.11, 12.101

25.2503-3(c), Example (1): §12.64

25.2503-3(c), Example (2): §2.35

25.2503-3(c), Example (3): §§12.42, 12.49

25.2503-4(b): §12.46

25.2503-4(b)(1): §12.39

25.2503-4(b)(2): §12.43

25.2503-4(b)(3): §12.47

25.2503-6(b)(2): §12.14

25.2503-6(c): §12.14

25.2511-1(c)(2): §9.68

25.2511-1(g)(1): §2.8

25.2511-1(g)(2): §9.52

25.2511-1(h)(1): §2.23D

25.2511-1(h)(4): §12.17

25.2511-2: §§2.39D, 5.16, 12.101

25.2511-2(a)-(b): §9.13

25.2511-2(b): §§2.15-2.16, 4.10, 5.16, 9.66, 12.103, 13.37, 14.15, 15.18, 16.15, 17.33, 17.69

25.2511-2(c): §§2.15-2.16, 5.16, 12.15, 12.57

25.2511-2(d): §2.16

25.2511-2(e): §2.18

25.2511-2(f): §§2.15, 2.19

25.2511-2(g): §2.19

25.2512-1: §2.21

25.2512-2(e): §2.23A

25.2512-2(f): §2.23B

25.2512-5(d): §18.123

25.2512-5A(d): §6.12

25.2512-5A(e): §6.13

25.2512-5A(f): §6.13A

25.2512-6(a): §11.10

25.2512-6(a), Example (1): §11.10

25.2512-8: §2.33

25.2513-1(a): §17.38

25.2513-1(b)(4): §§2.43, 17.38

25.2513-2(a)(1): §2.43

25.2514-1: §2.11

25.2514-1(b)(1)-(2): §12.48

25.2514-1(b)(2): §9.56

25.2514-1(c)(2): §2.12

25.2518-1(c)(1): §9.68

25.2518-2(d)(2): §10.91

25.2518-2(e): §10.91

25.2518-3(b): §9.68

25.2519-1(c)(1): §2.39D

25.2519-1(c)(4): §2.39D

25.2522(a)-2(b): §18.46

25.2522(c)-3(b)(1): §19.49

25.2522(c)-3(c)(2)(ii): §2.42

25.2522(c)-3(c)(2)(iii): §2.42

25.2522(c)-3(c)(2)(vii): §16.6

25.2522(c)-3(d)(1): §2.42

25.2522(c)-3(d)(2): §2.42

25.2523(e)-1(f)(1): §§2.39A, 19.11, 19.44

25.2523(e)-1(f)(4): §19.44

25.2523(e)-1(f)(4)-(5): §19.44

25.2523(e)-1(f)(7): §10.123

25.2523(f)-1(b)(4): App I

25.2523(f)-1(c)(1): §2.39C

25.2523(f)-1(c)(1)(ii): §10.114

25.2523(f)-1(c)(1)(iii): §18.107

25.2523(f)-1(f), Example (2): §19.44

25.2523(f)-1(f), Example (11): §§1.2, 2.39A

25.2701-1(b)(2): §2.26

25.2701-1(c)(1)-(2): §19.75

25.2701-1(c)(3): §19.75

25.2701-1(c)(4): §19.75

25.2701-2(a)(1): §2.26

25.2701-2(a)(2): §2.26

25.2701-2(b)(2): §19.75

25.2701-2(b)(5): §19.75

25.2701-2(c)(2): §19.75

25.2701-2(c)(5): §§2.26, 19.75

25.2701-3(b): §2.26

25.2701-6(a)(1): §19.75

25.2701-6(a)(4): §19.75

25.2702-1(c)(3): §18.58

25.2702-2(a)(6): §§15.9, 15.12, 16.6, 16.9

25.2702-2(c): §2.28

25.2702-3: §§17.31-17.32, 17.74, App P

25.2702-3(b): §§15.9, 15.12, 15.18, 15.36, App L

25.2702-3(b)-(d): §15.7

25.2702-3(b)(1): §15.9

25.2702-3(b)(1)(i): §§15.25, 17.96

25.2702-3(b)(1)(ii): §§15.9, 15.26

25.2702-3(b)(1)(ii)(A)-(B): §15.1

25.2702-3(b)(1)(iii): §§14.8, 15.11, 15.28, 16.8

25.2702-3(b)(2): §§15.9, 15.26, 17.99

25.2702-3(b)(3): §§15.9, 15.27, 17.98, App L

25.2702-3(b)(4): §§15.8-15.9, 15.25, 17.96, 17.100

25.2702-3(b)(5): §§15.9, 15.21, App L

25.2702-3(c)-(d): §§16.4, 16.6, 16.15, 16.34

25.2702-3(c)(1): §16.6

25.2702-3(c)(1)(i): §16.22

25.2702-3(c)(1)(ii): §§16.1, 16.23

25.2702-3(c)(1)(iii): §16.26

25.2702-3(c)(2): §§16.6, 16.24

25.2702-3(c)(3): §§16.6, 16.25

25.2702-3(c)(4): §§16.5-16.6, 16.22

25.2702-3(d): §§15.9, 15.18, 15.36, App L

25.2702-3(d)(1): §§15.9, 16.6

25.2702-3(d)(2): §§15.6, 15.9, 15.12, 16.6, 16.9

25.2702-3(d)(3): §§15.9, 15.29, 16.6, 16.27, 17.101, App L

25.2702-3(d)(4): §§15.9, 16.6

25.2702-3(d)(5): §§15.9, 15.30, 16.6, 16.28, 17.102, App L

25.2702-3(d)(6): §§15.8-15.9, 16.5-16.6

25.2702-3(e), Example 1: §15.15A

25.2702-3(e), Example 5: §16.13

25.2702-3(e), Examples 5-6: §§15.9, 15.6

25.2702-3(e), Examples 8-9: §§15.6, 15.12, 16.9

25.2702-4(b): §2.27

25.2702-4(c): §2.27

25.2702-5: §§14.6, 17.2, 17.111

25.2702-5(a)(2): §§17.25, 17.74, App P

25.2702-5(b): §2.28

25.2702-5(b)(1): §§14.10, 15.13, 16.10, 17.42, 17.88-17.89, 19.66, App P

25.2702-5(c): §§2.28, 17.25, 17.74, 17.107, App P

25.2702-5(c)(1): §§17.30, 17.69, 17.77

25.2702-5(c)(2)(i): §17.77

25.2702-5(c)(2)(i)(B): §17.26

25.2702-5(c)(2)(i)(C): §17.28

25.2702-5(c)(2)(ii): §17.26

25.2702-5(c)(2)(iii): §§17.26-17.27

25.2702-5(c)(2)(iv): §§17.28, 17.79

25.2702-5(c)(3): §§17.31, 17.80

25.2702-5(c)(4): §§17.31, 17.34, 17.82

25.2702-5(c)(5): §§17.31, 17.73

25.2702-5(c)(5)(i)-(ii): §17.77

25.2702-5(c)(5)(ii)(A)(1): §17.78

25.2702-5(c)(5)(ii)(A)(2): §§17.33, 17.81

25.2702-5(c)(5)(ii)(C): §17.84, App P

25.2702-5(c)(5)(ii)(D): §17.85, App P

25.2702-5(c)(6): §17.31

25.2702-5(c)(7): §§17.30-17.31

25.2702-5(c)(7)(i): §17.86

25.2702-5(c)(7)(ii): §17.84

25.2702-5(c)(7)(iii): §17.85

25.2702-5(c)(8): §§17.31, 17.93, App P

25.2702-5(c)(8)(i)(B): §17.111

25.2702-5(c)(8)(ii)(A): §§17.96, 17.98-17.102

25.2702-5(c)(8)(ii)(B): §17.95

25.2702-5(c)(8)(ii)(C)(2)-(3): §17.97

25.2702-5(c)(9): §§14.10, 15.13, 16.10, 17.42, 17.66, 17.88-17.89, 19.66, App P

25.2703-1(b)(1): §§2.29, 19.76

25.2703-1(b)(3): §§2.29, 19.76

25.2703-1(b)(4): §2.29

25.2703-1(c): §19.76

25.2703-2: §§2.29, 19.76

25.2704-1(a)(2)(iv): §2.30

25.2704-1(a)(2)(v): §2.30

25.2704-1(c): §2.30

25.2704-1(d): §2.30

25.2704-2(b): §2.30

25.6019-3(b): §2.33

25.7520-3(b)(2)(v), Example (3): §15.8

25.7520-3(b)(2)(v), Example (4): §16.5

25.7520-3(b)(3): §§15.4, 15.12

26.2601-1(b)(1)(v)(A): §12.108

26.2612-1(c)(1): §4.10

26.2632-1(b)(1): §4.22

26.2632-1(b)(2): §4.26A

26.2632-1(b)(3): §4.26A

26.2632-1(b)(4)(i): §§4.23, 4.25, 11.17-11.18

26.2632-1(b)(4)(ii): §4.24

26.2632-1(b)(4)(iii), Example 4: §4.25

26.2632-1(c): §11.16

26.2632-1(c)(1): §11.16

26.2632-1(c)(1)(ii): §4.29

26.2632-1(c)(1)(iii): §4.29

26.2632-1(c)(2): §17.57

26.2632-1(c)(2)(ii): §11.16

26.2632-1(c)(2)(ii)(B): §§4.29, 4.41, 11.16

26.2632-1(c)(3)(iii): §4.29

26.2632-1(c)(5), Example (2): §4.29

26.2632-1(d)(1): §§4.25-4.26

26.2642-2(a)(2): §4.25

26.2642-4: §4.30

26.2642-4(a)(3): §4.29

26.2642-6(d): §4.20

26.2642-6(h): §4.20

26.2651-1(a)(2)(iii): §4.16

26.2651-1(a)(3): §4.16

26.2652-1(a)(2): §4.8

26.2652-1(a)(4): §4.4

26.2652-1(a)(5), Example 1: §4.8

26.2652-1(a)(5), Example 5: §§4.1, 4.8, 4.10, 4.22, 12.89, 12.107

26.2654-1(a)(1): §§4.1, 5.29

26.2654-1(a)(1)(i): §§4.20, 12.108

26.2654-1(a)(1)(iii): §4.20

26.2654-1(a)(2): §4.20

26.2654-1(a)(5), Example 8: §§4.20, 5.29

26.2662-1(b)(1): §4.32

26.2662-1(b)(2): §4.32

26.2662-1(b)(3): §4.31

26.2662-1(b)(3)(ii)(B): §4.31

26.2662-1(c)(1): §§4.31-4.32

53.4941(d)-2(a)(2): §18.35

53.4941(d)-2(f)(2): §18A.22

53.4942(a)-2: §18A.22

301.6109-1(a)(2): §17.111

301.6501(c)-1(f): §2.46A

301.7477-1(d)(4): §2.46A

301.7701-2: §3.4

301.7701-7(a)(1)(i): §3.68A

301.7701-7(a)(1)(ii): §3.68D

301.7701-7(c)(1): §3.68B

301.7701-7(c)(2): §3.68B

301.7701-7(c)(4): §3.68B

301.7701-7(c)(4)(ii): §3.68C

301.7701-7(d)(1): §3.68D

301.7701-7(d)(2): §3.68E

301.7701-7(d)(3): §3.68F

301.7701-15(b): §1.7A

TEMPORARY TREASURY REGULATIONS

1.170A-12T: §18.123

1.642(c)-6T(e)(5): §6.15

1.664-4T(e): §6.5

1.664-4T(e)(2)(ii): §6.1

1.664-4T(e)(7): §§6.5, 6.30

1.6081-6T: §3.6

1.7520-1T(c)(2): §6.6

20.2031-7T: §6.6

20.2031-7T(d): §§6.4-6.5, 12.65, 18.24-18.25

20.2031-7T(d)(1): §6.22

20.2031-7T(d)(2)(ii): §6.19, 6.25

20.2031-7T(d)(2)(iii): §6.18, 6.23

20.2031-7T(d)(2)(iii)-(iv): §6.15

20.2031-7T(d)(2)(iv): §§6.17, 6.19, 6.26

20.2031-7T(d)(3)(ii): §6.1

20.2031-7T(d)(4): §6.7

20.2031-7T(d)(7): §§6.5, 6.10, 6.15-6.16, 17.4, 17.54, 18.26

20.7520-1T(a)(1): §6.4

25.2512-5T(d): §6.4, 12.65

25.2512-5T(d)(3): §6.1

25.7520-3T(b)(2)(v), Example 5: §6.37

PROPOSED TREASURY REGULATIONS

1.67-4: §3.5

1.72-6(e): §13A.14

1.642(c)-3(b)(2): §18A.6

1.643(a)-5(b): §18A.6

1.664-1(c)(1): §18.35

1.1001-1(j): §13A.14

20.2036-2(a): §19.103

20.2036-2(c): §§2.61, 19.103

26.2642-7: §4.21

Regulatory Actions

TREASURY DECISIONS

8743: §§17.35, 17.109

9448: §6.5

IRS NOTICES OF PROPOSED RULEMAKING

REG-101258-03: §3.10

Rules

SECURITIES AND EXCHANGE COMMISSION

Exchange Act Rules

10b-5: §§19.105-19.106

Securities Act Rules

144: §§18.17, 19.105, 19.108

405: §19.108

Rulings

REVENUE RULINGS

2008-41: §18.17A

2008-35: §2.23C

2008-22: §§2.61, 3.41, 15.4

2007-13: §11.12

2006-34: §2.89

2004-64: §§3.24, 12.99, 13A.6

2004-5: §3.5

2003-123: §2.72

2002-20: §18.16

96-3: §2.57

95-95: §9.40

95-58: §§2.62, 9.12, 9.14, 9.40, 9.52, 10.6, 10.29, 11.6, 11.20, 12.53

93-12: §§2.23B, 2.23D, 2.24

92-107: §18.113

92-57: §§18.3, 18.37-18.38, 18.70, 18.78

92-48: §18.14

90-110: §10.91

89-55: §3.58

89-45: §3.54

88-81: §§18.3, 18.37, 18.70, 18.78

88-27: §18A.20

87-98: §20.51

87-37: §18.123

86-82: §3.27

86-60: §18.2

86-41: §§2.20, 3.44B

85-100: §2.75

85-88: §§4.10, 12.91

85-45: §17.41

85-23: §18.46

85-13: §§3.44B, 13A.6, 15.11, 16.8, 17.41, 19.62

84-179: §11.6

84-162: §18.120

84-97: §18.123

84-25: §2.15

83-158: §18.123

83-147: §11.3

83-108: §§12.83, 12.86

82-165: §§18.37-18.38, 18.60-18.61, 18.93

82-128: §§18.23, 18.37-18.38, 18.84-18.85

82-105: §§15.31, 18.23

81-15: §2.56

81-7: §§12.82-12.83

81-6: §3.38

80-281: §18.121

80-255: §9.8

80-123: §§18.37, 18.45, 18.70, 18.91

80-104: §18.54

80-38: §18.66

79-428: §18.62

79-421: §9.52

79-368: §§18.20, 18.66

79-327: §9.56

79-243: §18.96

79-154: §9.52

79-61: §18.107

79-47: §2.35

79-46: §3.41

78-409: §2.50

78-398: §9.52

78-303: §18.123

78-283: §§18.47, 18.70

78-197: §18.20

77-460: §12.32

77-454: §§6.36, 15.16

77-402: §3.44B

77-385: §§18.23, 18.65-18.66

77-378: §2.15

77-374: §§18.6A, 18.7, 18.25, 18.45-18.46, 18.53, 19.49

77-285: §§18.18, 18.94

77-275: §2.16

77-182: §10.29

77-158: §3.26

77-73: §§18.94-18.95

77-58: §§18.79, 18.123

76-503: §3.26

76-490: §11.11

76-473: §18.123

76-371: §§18.19, 18.65

76-310: §18.58

76-309: §18.42

76-307: §18.66

76-291: §18.54

76-273: §18.23

76-179: §12.70

76-165: §18.123

76-103: §§2.15, 2.51

76-8: §§18.19, 18.65

76-7: §§18.19, 18.65

75-440: §20.23

75-420: §18.123

75-415: §12.64

75-351: §§12.46, 12.105

75-72: §2.32

75-38: §18.80

74-491: §18.23

74-481: §18.76

74-403: §18.70

74-386: §18.62

74-368: §18.80

74-149: §§18.21, 18.96

74-53: §18.20

74-43: §12.43

74-19: §18.54

73-610: §19.49

73-405: §12.81

73-287: §12.43

73-143: §2.59

72-395: §§18.37-18.38, 18.46, 18.48, 18.53, 18.61, 18.89-18.90, 18.93, 18.96-18.97

70-513: §10.52

70-348: §12.32

70-272: §20.79

69-346: §2.20

69-345: §§12.39-12.40

69-148: §12.17

68-670: §12.69

68-80: §20.51

67-396: §2.15

67-270: §§12.39-12.40

67-241: §§12.100, 19.97

66-283: §20.51

66-39: §10.62

65-144: §§20.23, 20.39

60-88: §20.79

59-357: §12.32

58-65: §§12.12, 12.19

57-564: §2.31

56-484: §§3.37, 12.35

54-516: §19.53

54-400: §12.12

54-344: §12.49

54-246: §12.51

54-9: §19.60

REVENUE PROCEDURES

2010-3, §4.01: §§11.14, 15.5, 18.39, 18.64

2007-46: §18A.19

2007-45: §18A.19

2005-56: §§18.91-18.92, App G

2005-55: §18.39, App G

2005-54: §18.39, App G

2005-53: §18.39, App G

2005-52: §§18.37-18.39, 18.44, 18.105, App G

2005-52, §3: §18.39

2005-25: §11.10

2005-24: §§11.3, 18.6B

2005-24, §3.03: §18.6B

2004-46: §4.21

2003-57: App H

2003-56: §18.39, App H

2003-55: §18.39, App H

2003-54: §18.39, App H

2003-53: §§18.37-18.39, 18.44, 18.105, App H

2003-53, §3: §18.39

2003-43: §§3.61, 3.65

2003-42: §§17.69, 17.74

2001-38: §20.80

96-54: §§2.81, 2.81C, App J

88-53: §18.117

Internal Revenue Service

INTERNAL REVENUE SERVICE LETTER RULINGS

200944002: §1.8

200923024: §3.44B

200906008: §3.5

200905027: §3.5

200848008: §17.36

200848003: §17.36

200846003: §9.68

200846001: §15.4

200840018: §2.72

200839029: §§2.26, 19.75

200838026: §9.68

200834013: §18.2

200822011: §§17.27, 17.43

200821030: §2.80

200814011: §17.58

200801009: §2.39D

200719002: §2.83

200717002: §4.21

200714025: §18.79

200712010: §2.80

200709011: §3.41

200702016: §3.5

200649027: §18.9

200649023: §10.91

200648028: §§2.23A, 2.71

200648025: §§3.10, 18A.6

200647001: §3.26

200636091: §4.21

200633011: §18.2

200629016: §4.21

200626043: §17.27

200625011: §19.76

200622005: §18.105

200620003: §4.21

200617020: §18.14

200616022: §2.43

200606027: §11.12

200606006: §12.100

200603002: §11.13

200602002: §4.14

200543037: §4.20

200529006: §2.89

200519032: §4.21

200518061: §11.12

200518005: §11.6

200508001: §4.4

200506018: §4.20

200502014: §3.26

200452010: §2.79

200451024: §2.83

200451001: §4.21

200441022: §4.20

200434012: §3.41

200426008: §5.12

200422051: §2.43

200418005: §2.72

200418002: §2.71

200404037: §3.59

200404009: §18A.27

200344021: §3.5

200343002: §2.72

200341002: §19.49

200340012: §2.89

200338015: §3.75

200338006: §18.9

200321010: §18.20

200316031: §4.21

200314021: §18.36A

200314009: §11.6

200247013: §3.26

200245053: §3.44B

200245018: §4.21

200242017: §4.21

200241039: §17.27

200232105: §18.105

200228019: §11.12

200227017: §11.17

200220014: §17.32

200219102: §18.31

200218008: §18.9

200152018: §§18.2, 18.121

200150003: §4.5

200148028: §3.26

200147044: §3.59

200147039: §2.63

200140080: §3.5

200138028: §19.75

200130030: §2.43

200129018: §2.89

200123055: §11.3

200114026: §4.15

200108032: §18A.6

200107015: §§15.6C, 18A.10

200034019: §18.65

200030018: §§3.24, 3.40

200029033: §18A.22

200029031: §18.18

200022035: §§3.38, 12.100

200022018: §3.41

200022014: §18.6A

200011058: §3.54

200010036: §3.41

199929040: §4.4

199922007: §2.61

199917068: §18A.6

199915058: §18A.6

199908002: §18A.6

9808035: §18A.6

9739024: §17.27

9731009: §2.39A

9714025: §17.109

9710006: §3.24

9626041: §17.35

9620017: §19.76

9609015: §17.26

9547004: §18.12

9544018: §17.26

9543049: §19.97

9535047: §12.100

9535026: §19.62

9532001: §12.83

9448035: §17.32

9448018: §19.97

9444033: §19.97

9442017: §18.5

9437034: §13.37

9436005: §2.24

9413045: §3.24

9402011: §17.41

9352017: §3.41

9345035: §3.41

9323002: §11.9

9321050: §3.44

9253038: §18.14

9249014: §17.111

9247024: §3.41

9244013: §18.23

9237020: §18.14

9226037: §§3.38, 3.43, 19.97

9146002: §2.50

9141008: §12.93

9045002: §12.93

9037011: §3.53

9030005: §12.93

9015049: §18.14

9014008: §§3.58-3.59

8952014: §3.59

8922014: §3.59

8921056: §3.59

8921013: §3.59

8831020: §3.59

8823028: §3.54

8819020: §18A.6

8810004: §18.123

8810002: §2.77

8727072: §18A.6

8727003: §12.93

8701007: §12.100

8517052: §§12.57, 12.100

8507017: §12.43

8445004: §12.92

8430006: §18.96

8330004: §9.52

8320007: §12.48

8308033: §12.100

8204105: §9.39

8142061: §12.57

8134135: §12.92

8103069: §12.92

8045010: §18.121

8039023: §12.43

8008105: §18A.28

8008040: §12.92

7942073: §18.100

7916006: §20.39

7905088: §20.23

7803029: §19.49

7802037: §19.49

GENERAL COUNSEL MEMORANDUM

39780: §2.61

LEGAL MEMORANDUMS

200218003: §2.86

200848020: §18.105

200923024: §3.44

PROGRAM MANAGER TECHNICAL ADVICE

2009-046: §2.89

FIELD ATTORNEY ADVICE

20062701F: §3.29

ACTIONS ON DECISIONS

1996-010: §12.95

1992-09: §12.95

1990-026: §2.20

NOTICES

2010-32: §3.5

2010-19: §18.11A

2009-18: §6.5

2009-5: §1.7A

2009-1: §12.37A

2008-99: §18.36A

2007-90: §2.89

2007-50: §2.72

2006-15: §18.6B

2004-36: §18A.22

2004-35: §18A.22

2003-72: §15.6

2001-50: §4.21

97-49: §3.66

97-34: §§3.69, 3.69B, 3.69E-3.69F

87-32: §§3.16, 3.17A

PUBLICATIONS

1457: §§6.37, 18.27, 18.107, 18.123

UNIFORM ACTS

Uniform Gifts to Minors Act: §12.33

Uniform Transfers/Gifts to Minors Act: Apps A, N

OUT-OF-STATE STATUTESAND ACTS

MONTANA

Mont Code Ann §72-2-222(3)(b): §18.6B

NEW YORK

Estate Powers & Trust Law

§3-3.7: §20.46

§3-3.7(a): §20.45

§3-5.1: §20.57

§3-5.1(h): §20.57

§5-1.1(d)(7) (former): §20.59

§5-1.1-A: §20.56

§5-1.1-A(c)(6): §20.56, 20.59

§7-1.10: §20.12

§8-1.1(e): §20.70

Tax Law

§601: §20.94

§605(b): §20.82, 20.94

§611-616: §20.94

§620: §20.94

§631-639: §20.94

§951(a): §20.83

§952(a): §20.83

§954(a): §20.83

§960(a): §20.83

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Source: Estate Planning/Drafting California Irrevocable Trusts/Table of Cases

Table of Cases

A

Ablamis v Roper (9th Cir 1991) 937 F2d 1450: §19.117

Abner W. Mitchell, Estate of (1970) 55 TC 576, acq 1971-2 Cum Bull 3: §2.53

Abraham, Ida, Estate of, TC Memo 2004-39, aff'd (1st Cir 2005) 408 F3d 26: §2.48

Adams v U.S. (ND Tex 2001) 2001-2 USTC ¶60,418, 88 AFTR2d 6057: §2.23E

Addison v Addison (1965) 62 C2d 558, 43 CR 97: §20.48

Adolph K. Krause (1972) 57 TC 890, aff'd (6th Cir 1974) 497 F2d 1109, cert denied (1975) 419 US 1108, 42 L Ed 2d 804, 95 S Ct 780: §§5.12, 19.77

Agnes K. May (1947) 8 TC 860, acq 1947-2 Cum Bull 3: §5.20

Ahmanson Found. v U.S. (9th Cir 1981) 674 F2d 761: §2.71

Albert Fratini, Estate of, TC Memo 1998-308: §2.67

Albert Strangi, Estate of (2000) 115 TC 478, aff'd in part and rev'd in part on other grounds sub nom Gulig v Commissioner (5th Cir 2002) 293 F3d 279: §2.23D

Albert Strangi, Estate of, TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468: §§2.23D, 2.48

Alden B. Oakes (1965) 44 TC 524, nonacq 1967-1 Cum Bull 3: §19.60

Aldo H. Fontana, Estate of (2002) 118 TC 318: §2.23B

Alexander, John A., Estate of (1983) 81 TC 757: §2.60

Alfred L. Hoedeman, Esq., SEC No-Action Letter (Aug. 26, 1991) 1991 SEC No-Act Lexis 1030: §19.108

Alice Spaulding Paolozzi, Estate of (1954) 23 TC 182, acq 1955-1 Cum Bull 6, withdrawn 1957-2 Cum Bull 8, reinstated 1962-1 Cum Bull 4: §2.15

Allen v Nunnally (5th Cir 1950) 180 F2d 318: §10.25

Alvin Hill, Estate of (1975) 64 TC 867, acq 1976-2 Cum Bull 2, aff'd without published opinion (5th Cir 1978) 568 F2d 1365: §8.6

Amelie, Pearl I., Estate of, TC Memo 2006-76: §19.76

America Online, Inc. v Superior Court (2001) 90 CA4th 1, 108 CR2d 699: §§20.30, 20.38

Amy G. v M.W. (2006) 142 CA4th 1, 47 CR3d 297: §10.133B

Anders Jordahl, Estate of (1975) 65 TC 92, acq 1977-1 Cum Bull 1: §§2.61, 3.41

Andrew K. Ludwick, TC Memo 2010-104: §§2.23E, 17.29

Ann Jackson Family Found. (1991) 97 TC 534, aff'd (9th Cir 1994) 15 F3d 917: §18A.22

Anna Mirowski, Estate of, TC Memo 2008-74: §2.48

Anne W. Morgens, Estate of (2009) 133 TC No. 17: §2.39D

Anne Y. Petter, Estate of, TC Memo 2009-280: §2.20

Annette S. Morgan, Estate of (1962) 37 TC 981, aff'd (6th Cir 1963) 316 F2d 238, cert denied (1963) 375 US 825: §2.31

Anthony v U.S. (5th Cir 2008) 520 F3d 374: §2.22

Anthony F. Di Marco, Estate of (1986) 87 TC 653, acq in result 1990-2 Cum Bull 1: §2.20

Appalachian Ins. Co. v Superior Court (1984) 162 CA3d 427, 208 CR 627: §20.30

Application Group, Inc. v Hunter Group, Inc. (1998) 61 CA4th 881, 72 CR2d 73: §20.38

Application of City Bank Farmers Trust Co. (Sup Ct 1957) 166 NYS2d 772: §20.32

Artemus D. Davis, Estate of (1998) 110 TC 530: §2.23C

Astleford, Jane Z., TC Memo 2008-128: §2.23D

Atkinson, Estate of v Commissioner (11th Cir 2002) 309 F3d 1290, cert denied (2003) 540 US 946, 157 L Ed 2d 276, 124 S Ct 388: §18.6

Audrey J. Walton (2000) 115 TC 589, acq 2003-44 Int Rev Bull 964: §§3.44C, 15.6, 15.9, 16.1, 16.9, 16.13, App L

Auerbach v Assessment Appeals Bd. (2006) 39 C4th 153, 45 CR3d 774: §14.11

Auker, Eldon L., Estate of, TC Memo 1998-185: §2.23A

Avery v Bender (Vt 1964) 204 A2d 314: §20.27

Azarian v Ettinger (Sup Ct 1982) 450 NYS2d 115: §20.30

B

Baine P. Kerr (1999) 113 TC 449, aff'd (5th Cir 2002) 292 F3d 490: §2.30

Baird, John L., Estate of, TC Memo 2001-258, rev'd on other grounds (5th Cir 2005) 416 F3d 422: §2.23E

Balding, Hazel E. (1992) 98 TC 368: §5.12

Balian v Balian (2009) 179 CA4th 1505, 102 CR3d 470: §13.16

Barge, Bonnie I., Estate of, TC Memo 1997-188: §2.23E

Barlow, Roy D., Estate of (1971) 55 TC 666, acq 1972-2 Cum Bull 1: §2.50

Barnes v Brandup (SD NY 1981) 506 F Supp 396: §20.29

Barnes, Louise B., TC Memo 1998-413: §2.23B

Barudin, James, Estate of, TC Memo 1996-395: §2.23B

Beach v Rome Trust Co. (2d Cir 1959) 269 F2d 367: §20.29

Bensberg, State ex rel v Hartmann (Mo 1929) 19 SW2d 637: §20.27

Benson, Marion B. (1983) 80 TC 789: §2.55

Bergquist, Bradley J. (2008) 131 TC 8: §1.7A

Bermingham v Wilcox (1898) 120 C 467, 52 P 822: §10.38

Bernard Madorin (1985) 84 TC 667: §3.44B

Bernard Mandelbaum, Estate of, TC Memo 1995-255, aff'd (3d Cir 1996) 91 F3d 124 (unpublished opinion): §2.23B

Bianca Gross, TC Memo 2008-221: §2.23D

Bigelow, Estate of v Commissioner (9th Cir 2007) 503 F3d 955: §2.48

Bilafer v Bilafer (2008) 161 CA4th 363, 73 CR3d 880: §8.6

Birdsell v Coumbe (In re Coumbe) (BAP 9th Cir 2003) 304 BR 378: §10.123

Bischoff, Bruno, Estate of (1977) 69 TC 32: §5.12

Biscoe v U.S. (D Mass 1957) 148 F Supp 224: §5.15

Black, Samuel P., Estate of (2009) 133 TC No. 15: §2.48

Blackford, Eliza W., Estate of (1981) 77 TC 1246, acq in part in result 1983-2 Cum Bull 1: §18.123

Blackman v Hale (1970) 1 C3d 548, 83 CR 194: §10.8

Blake v Commissioner (2d Cir 1982) 697 F2d 473: §18.20

Bloch, Harry, Jr., Estate of (1982) 78 TC 850: §§5.23, 11.6

Blodgett v Silberman (1928) 277 US 1, 72 L Ed 749, 48 S Ct 410: §20.77

Blount, George C., Estate of, TC Memo 2004-116, aff'd in part and rev'd in part on other grounds (11th Cir 2005) 428 F3d 1338: §19.76

Blumenthal, Commissioner v (1935) 296 US 552, 80 L Ed 390, 56 S Ct 305: §19.53

Boggs v Boggs (1997) 520 US 833, 138 L Ed 2d 45, 117 S Ct 1754: §19.117

Bongard, Wayne C., Estate of (2005) 124 TC 95: §2.48

Bonnie I. Barge, Estate of, TC Memo 1997-188: §2.23E

Bosch, Estate of, Commissioner v (1967) 387 US 456, 18 L Ed 2d 886, 87 S Ct 1776: §18.105

Botsford v Haskins & Sells (1978) 81 CA3d 780, 146 CR 752: §10.84

Bowles v Superior Court (1955) 44 C2d 574, 283 P2d 704: §20.27

Bradley J. Bergquist (2008) 131 TC 8: §1.7A

Branco v UCFW-Northern Cal. Employers Joint Pension Plan (9th Cir 2002) 279 F3d 1154: §19.117

Brandegee, Commissioner v (1st Cir 1941) 123 F2d 58: §19.56

Brandeis v Atkins (Mass 1910) 90 NE 861: §20.17

Braun, Frederick C., Jr., TC Memo 1984-285: §§3.37, 5.21

Bright, Estate of v U.S. (5th Cir 1981) 658 F2d 999: §2.70

Brill, Jesse E., SEC No-Action Letter (Aug. 22, 1979) 1979 SEC No-Act Lexis 3489, CCH Fed Sec L Rep ¶82,431: §19.108

Brooke v Norfolk (1928) 277 US 27, 72 L Ed 767, 48 S Ct 422: §20.98

Brooke v U.S. (9th Cir 1972) 468 F2d 1155: §19.60

Brown v Memorial Nat'l Home Found. (1958) 162 CA2d 513, 329 P2d 118, superseded by statute on other grounds in Patton v Sherwood (2007) 152 CA4th 339, 61 CR3d 289: §20.70

Brownstone v U.S. (2d Cir 2006) 465 F3d 525: §3.5

Bruno Bischoff, Estate of (1977) 69 TC 32: §5.12

Bruzewicz v U.S. (ND Ill 2009) 604 F Supp 2d 1197: §2.72

Buckmaster v U.S. (10th Cir 1993) 984 F2d 379: §3.18B

Budd, Ralph, Estate of (1968) 49 TC 468, acq 1973-2 Cum Bull 1: §§5.15, 9.22, 9.44, 10.4, 10.82, 10.111

Bunney, Michael G. (2000) 114 TC 259: §19.117

Burden, Estate of (2007) 146 CA4th 1021, 53 CR3d 390: §10.133

Burkett v Cappovilla (2003) 112 CA4th 1444, 5 CR3d 817: §9.46

Burnet v Guggenheim (1933) 288 US 280, 77 L Ed 748, 53 S Ct 369: §§2.15-2.16

Busch, William, Estate of, TC Memo 2000-3: §2.23E

Bush v Commissioner (1941) 45 BTA 609, acq 1942-1 Cum Bull 3, remanded on other grounds (2d Cir 1943) 133 F2d 1005: §19.53

Byrum, U.S. v (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382: §§2.61, 9.12, 10.21, 10.52, 19.47

C

CMR Mortgage Fund, LLC v Canpartners Realty Holding Co. IV LLC (In re CMR Mortg. Fund, LLC) (Bankr ND Cal 2009) 416 BR 720: §20.34

California v Texas (1982) 457 US 164, 72 L Ed 2d 755, 102 S Ct 2335: §20.78

Camp v Commissioner (1st Cir 1952) 195 F2d 999: §2.18

Campbell v Albers (Ill App 1942) 39 NE2d 672: §20.33

Campbell, William Peyton, TC Memo 1979-495: §9.53

Campbell-Kawannanakoa v Campbell (1907) 152 C 201, 92 P 184: §20.10

Canadyne-Georgia Corp. v NationsBank (11th Cir 1999) 183 F3d 1269: §19.20

Carl V. Van Anda, Estate of (1949) 12 TC 1158, aff'd (2d Cir 1951) 192 F2d 391: §2.8

Carrieres, Jean C. (1975) 64 TC 959, acq 1976-2 Cum Bull 1, aff'd (9th Cir 1977) 552 F2d 1350: §5.12

Carter's Trust, In re (Sup Ct 1958) 178 NYS2d 569: §20.32

Cary v Carman (Sup Ct 1921) 190 NYS 193: §20.18

Caso v First Colony Life Ins. Co. (May 7, 2003, G030353) 2003 Cal App Unpub Lexis 4528, 2003 WL 21019625: §11.9A

Castleberry, Winston C., Estate of (1977) 68 TC 682, rev'd (5th Cir 1980) 610 F2d 1282: §20.49

Century Elec. Co. v Commissioner (8th Cir 1951) 192 F2d 155, cert denied (1952) 342 US 954: §19.64

Cerf v Commissioner (3d Cir 1944) 141 F2d 564: §2.18

Cervin, Estate of v Commissioner (5th Cir 1997) 111 F3d 1252: §2.70

Charlene B. Schurtz, Estate of, TC Memo 2010-21: §2.48

Charles E. Reichardt, Estate of (2000) 114 TC 144: §2.50

Charles H. Ward (1986) 87 TC 78: §3.44B

Charles J. Wyly, Sr., Estate of (1977) 69 TC 227, rev'd (5th Cir 1980) 610 F2d 1282: §20.49

Charles Porter Schutt, Estate of, TC Memo 2005-126: §§2.29, 2.48

Chawla v Transamerica Occidental Life Ins. Co. (4th Cir 2006) 440 F3d 639: §11.9A

Chenoweth, Dean A. (1987) 88 TC 1577: §2.71

Christ, Estate of v Commissioner (9th Cir 1973) 480 F2d 171: §2.68

Christiansen, Helen, Estate of (2008) 130 TC 1, aff'd (8th Cir 2009) 586 F3d 1061: §2.20

Christopher Stone, TC Memo 1987-454: §5.21

Chrysler, Jack F., Estate of (1965) 44 TC 55, rev'd on other grounds (2d Cir 1966) 361 F2d 508: §§5.24, 12.52, 12.54

Church v U.S. (WD Tex 2000) 2000-1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 2001-2 USTC ¶60,415, 88 AFTR2d 2001: §2.23D

Cidulka, Joseph, Estate of, TC Memo 1996-149: §12.95

Clara S. Roeder Winkler, Estate of, TC Memo 1989-231: §2.24

Clarissa W. Lappo, TC Memo 2003-258: §2.23D

Clark, Estate of (1968) 288 NYS2d 993, 236 NE2d 152: §§20.57, 20.59

Claude C. Focardi, Estate of, TC Memo 2006-56: §§15.12, 16.9

Clifton B. Russell (1945) 5 TC 974: §19.53

Coberly v Superior Court (1965) 231 CA2d 685, 42 CR 64: §§10.10, 10.38

Cocke v Duke Univ. (NC 1963) 131 SE2d 909: §20.27

Cohen, Estate of (Sur Ct 1945) 58 NYS2d 924: §20.71

Colorado v Cooke (Colo 1962) 370 P2d 896: §20.87

Colyear, Estate of (1964) 230 CA2d 558, 41 CR 88: §19.85

Commissioner v _____ (*see* name of respondent)

Concetta H. Rector, Estate of, TC Memo 2007-367: §2.48

Cook v Commissioner (5th Cir 2003) 349 F3d 850: §2.22

Cook v Commissioner (7th Cir 2001) 269 F3d 854: §§15.12, 16.9

Copley v Copley (1981) 126 CA3d 248, 178 CR 842: §19.80

Corbett v Benioff (1932) 126 CA 772, 14 P2d 1028: §10.38

Costanza, Estate of v Commssioner (6th Cir 2003) 320 F3d 595: §2.8

Craig R. Sheaffer, Estate of, TC Memo 1966-126: §19.54

Crane v Commissioner (1947) 331 US 1, 91 L Ed 2d 1301, 67 S Ct 1047: §3.44B

Crichton, Estate of (1967) 281 NYS2d 811, 228 NE2d 799: §20.57

Cristofani, Maria, Estate of (1991) 97 TC 74, acq 1992-1 Cum Bull 1, acq 1996-2 Cum Bull 1: §§12.80, 12.86, 12.94-12.95

Crittenden Trust v U.S. (ED Wis 1952) 52-2 USTC ¶10,870, 44 AFTR 1208: §5.25

Crowley, Milner & Co. v Commissioner (6th Cir 1982) 689 F2d 635: §19.64

Crummey v Commissioner (9th Cir 1968) 397 F2d 82: §§2.15, 2.36, 4.1, 4.4, 4.8, 4.10, 4.15-4.16, 4.22, 4.29, 4.34, 4.41, 11.11, 11.13-11.14, 12.3, 12.80-12.81, 12.94, 17.34

Culbertson v U.S. (1949) 337 US 733, 93 L Ed 1659, 69 S Ct 1210: §19.77

Curry v McCanless (1939) 307 US 357, 83 L Ed 1339, 59 S Ct 900: §§20.75, 20.96

Cyril I. Magnin, Estate of, TC Memo 2001-31: §2.68

D

Dallas, Robert, TC Memo 2006-212: §2.23C

Daily, Elma Middleton, Estate of, TC Memo 2001-263: §2.23C

D'Ambrosio, Estate of v Commissioner (3d Cir 1996) 101 F3d 309: §2.68

Daniel D. Palmer (1974) 62 TC 684, aff'd (8th Cir 1975) 523 F2d 1308, acq 1978-1 Cum Bull 2: §18.20

Davenport, Estate of, U.S. v (ND Okla 2001) 159 F Supp 2d 1330, rev'd on other grounds sub nom U.S. v Botefuhr (10th Cir 2002) 309 F3d 1263: §2.31

Davenport, U.S. v (5th Cir 2007) 484 F3d 321, cert denied (2007) 552 US 1076: §2.31

Davis v U.S. (D NH 2007) 491 F Supp 2d 192: §2.22

Davis, Artemus D., Estate of (1998) 110 TC 530: §2.23C

Davison v Duke Univ. (NC 1973) 194 SE2d 761: §20.27

de Oliveira v U.S. (9th Cir 1985) 767 F2d 1344: §9.52

Dean A. Chenoweth (1987) 88 TC 1577: §2.71

DeBaun v First W. Bank (1975) 46 CA3d 686, 120 CR 354: §10.71

Department of Revenue v Gruenwald (Or App 1970) 467 P2d 660: §20.77

Deputy, Helen A., Estate of, TC Memo 2003-176: §2.23B

Desmond, William J., Estate of, TC Memo 1999-76: §2.23B

Di Marco, Anthony F., Estate of (1986) 87 TC 653, acq in result 1990-2 Cum Bull 1: §2.20

Dickman v Commissioner (1984) 465 US 330, 79 L Ed 2d 343, 104 S Ct 1086: §§15.11, 16.8

Diedrich v Commissioner (1982) 457 US 191, 72 L Ed 2d 777, 102 S Ct 2414: §2.32

Dingwell v Seymour (1928) 91 CA 483, 267 P 327: §20.71

DiSanto, Frank M., Estate of, TC Memo 1999-421: §2.71

Disbrow, Lorraine C., Estate of, TC Memo 2006-34: §2.50

Doetsch v Doetsch (7th Cir 1963) 312 F2d 323: §20.84

Donald J. Janda, TC Memo 2001-24: §2.23B

Donald W. Gruettner, Esq., SEC No-Action Letter (Jul. 7, 1975) 1975 SEC No-Act Lexis 1346: §19.108

Donny D. Doster, Estate of, TC Memo 2002-2: §2.88

Doris F. Kahn, Estate of (2005) 125 TC 227: §2.23C

Dorothy B. Foote, Estate of, TC Memo 1999-37: §2.23A

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K

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Pierre, Suzanne J., TC Memo 2010-106: §2.23D

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Ranghild Elton, TC Memo 2000-9: §10.84

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W

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Table of Forms

Accumulation trust

Addition to partially distributed trust augments undistributed portions, 9.33

Distribution if no issue, 9.33

Distribution to deceased child's spouse, 9.32

Special power of invasion, 9.37

Standard provisions, 9.32

Acknowledgment, 8.12

Additions to trust

Authorization, 10.122; Apps A-E, App F, Art 1

Authorization when trust has been subdivided or partially or wholly distributed, 10.122

Definition of proportionately, 10.122

Administration of trust

Accumulation trust (see Accumulation trust, above)

Additions to trust (see Additions to trust, above)

Annuity trust (see Annuity trust administration, below)

Beneficiary as trustee, 9.51

Construction of terminology (see Construction of trust terminology, below)

Distribution of disclaimed property, 10.138

Distributions (see Distributions, below)

Enumeration of trustee's powers, 10.58; App A, Art 4; Apps C-D, App E, Art 4; App F, Art 9

Introduction to trustee's powers, 10.57; App B, Art 4

Investment powers (see Investment powers of trustee, below)

Management powers (see Management powers of trustee, below)

Multistate trusts (see Multistate trusts, below)

No-contest clause, 10.136; App A, Art 5; App E, Art 6

Notice to trustee of births, deaths, and other events affecting interests, 10.120; App B, Art 5

Perpetuities savings clause, 9.59; Apps A-B, App C, Art 5; App D, App E, Art 6

Pipe dream trust clause, 5.14

Specifying law to govern validity, construction, and administration of trust, 10.126; Apps A-B, App C, Art 5; App D, App E, Art 6

Spendthrift clause, 10.124; Apps A-B, App C, Art 5; App D, App E, Art 6

Spendthrift settlor clause, 9.65

Sprinkling power or trust (see Sprinkling power or trust, below)

Successor trustee (see Successor or substitute trustee, below)

Survivorship clause, 9.48

Unitrust, 9.43

Annuity trust administration

Adjustment for inflation, 9.42

Charitable remainder trust (see Charitable remainder trust, below)

Distribution of principal (ascertainable standard), 9.42

Bonds

Power of trustee to purchase bonds at discount, 19.29; App B, Art 4

Power of trustee to purchase bonds at premium, 19.28; App B, Art 4

Trustee's bond (performance), 10.49; App B, Art 3; App F, Art 7

Business interests

Allocation of income and losses, allocating proceeds of liquidation, 19.95

Allocation of income and losses, definition of business conducted by trustee, 19.93

Allocation of net cash receipts, 19.94

Authority of trustee to consent to corporate transactions, 19.83

Authority of trustee to incorporate, continue to operate business in corporate or unincorporated form, and form corporations, 19.82

Authority of trustee to invest in partnerships, 19.81

Authority of trustee to retain specified business interest, 19.84

Compensation of trustee, as officer not to interfere with trustee's compensation, 19.89

Compensation of trustee, reasonable for services in connection with business interest, 19.88

Qualification of trust as QSST, 19.100

Reimbursement of trustee for expenses related to business, 19.91

Stock in S corporation, trustee making distributions to pay capital gains tax, 19.102

Stock of controlled corporation, empowering trustee to vote stock, 19.104

Charitable lead annuity trust (CLAT)

Annuity trust or unitrust mandatory clause (private foundation prohibitions), 18A.23

Charitable deduction savings clause, 18A.25

Payment of guaranteed annuity, 18A.21

Sample form for nongrantor CLAT, App K

Charitable remainder trust

Additional contributions to annuity trust: additional contributions prohibited, 18.74

Additional contributions to annuity trust: assets from testamentary trust are one contribution, and no additional contributions permitted, 18.75

Additional contributions to unitrust: additional contributions at death, 18.78; App F, Art 5

Adjustment for incorrect valuation, 18.71; App F, Art 4

Allocation among class of noncharitable beneficiaries, 18.95

Annuity trust: joint lifetimes and survivor recipients, introduction, 18.49

Annuity trust: payment from income, then principal, 18.52

Annuity trust, partial distributions to charitable organization, 18.99; App F, Art 3

Annuity trust, payment after first death, 18.51

Annuity trust, payment during joint lifetimes, 18.50

Annuity trust, payment of sum certain (one life), 18.48

Annuity trusts for one and two lives, App H

Beneficiaries: trustee chooses successor organization (joint and survivor), App F, Art 3

Beneficiaries, charitable remainder and alternative, 18.67

Created in revocable trust, 18.90

Formula for determining unitrust amount if additional contributions permitted, 18.77; App F, Art 5

Governing law, 18.88; App F, Art 10

Income-only unitrust, 18.59

Investment of trust assets, no restrictions on trustee, 18.83; App F, Art 8

Irrevocability, 18.41

Joint and survivor charitable remainder annuity trust, App O

Payments restricted to direction within trust instrument, 18.86; App F, Art 8

Power to amend charitable remainder beneficiary designation, 18.68

Private foundation transactions prohibitions, 18.81; App F, Art 8

Proration of annuity or unitrust amount, 18.63; App F, Art 2

Restricted purpose of distributions, 18.69

Savings clause, 18.43

Taxable year, 18.87; App F, Art 10

Taxes not payable from trust, 18.85; App F, Art 8

Testamentary CRT deferred payments, 18.92

Testamentary power to revoke trust or unitrust, 18.97

Unitrust, App F

Unitrust: joint and survivor recipients, 18.56; App F, Art 2

Unitrust: payment from income, then principal, 18.57; App F, Art 2

Unitrust: payment of fixed percentage for one life, 18.55

Unitrust: valuation date not occurring on first day of each taxable year, 18.61

Unitrust, partial distributions to charitable organization, 18.99A

Unitrusts for one and two lives, App G

Commingling undivided interests

Authorization of broad discretion to commingle, 10.43

Authorization of commingling only between shares created under trust instrument, 10.43; App C, Art 5; App D, Art 6

Compensation of trustee

Percentage of net value of principal plus reasonable compensation (individual trustee), 10.51A

Reasonable compensation (cotrustees), 10.51B

Reasonable compensation (individual trustee), 10.51; App A, Art 4; App B, Art 3; Apps C-D, App E, Art 4; App F, Art 7

Special trustee, 10.20

Construction of trust terminology

Distribution among beneficiaries, 10.130

Education, 10.132; App B, Art 5

Gender and number, 10.128; App B, Art 5

Issue and children, applicability of California's intestate succession law, 10.134; App A, Art 5; App E, Art 6

Issue and children, lineal descendants, 10.134A; App B, Art 5

Shall and may, 10.131

Spouse, husband, or wife, 10.135; App A, Art 5; App E, Art 6

Spouse or registered domestic partner, 10.135A

Trustees and fiduciaries, 10.129

Cotrustees' or special trustees' authority to act

Corporate cotrustee to have custody of assets, 10.17

Corporate trustee to expend no more than fixed amount, 10.18

Delegation of powers, 10.15

Other cotrustee incapacitated, action when, 10.16

Remaining cotrustee acts as sole trustee and settlor designates succession thereafter, 10.34

Special trustee appointment, compensation and effect of powers on trustee, 10.20

Special trustee, appointment of, 10.19

Unanimity not required, 10.14

Cotrustees' or special trustees' powers

Corporate trustee's right to propose purchases and sales, 10.22

Distributions to beneficiary-trustee by special trustee, 10.26; App A, Art 3

Distributions to beneficiary-trustee, trustee to appoint special trustee to make, 10.26A

Invasion of principal power vested solely in individual trustee, 10.24

Investment power vested solely in individual trustee, 10.23

Custodianships under California Uniform Transfers to Minors Act

Creation of custodianship by transferor, 12.28

Successor custodian, designation of, 12.28-12.29

Declaration of trust or trust agreement, introductory clause

Agreement of trust, 8.2, Apps A-F

Declaration of trust, nonsettlor as trustee, 8.3

Declaration of trust, settlor as trustee, 8.3

Transfer of additional property to trust, 8.4

Depletion (wasting assets), intellectual property, and retirement plans

Allocating to income given percentage of receipts, trustee requirement, 19.113

Reserve for depreciation, depletion, amortization, establishment of, 19.111

Designation of successor trustee

Basic clause, 10.33; App A, Art 4; App B, Art 3; Apps C-D, App E, Art 4; App F, Art 7

Empowering beneficiaries to designate successor, 10.37

Empowering trustee to designate successor, 10.36; App A, Art 4

Remaining cotrustee acts as sole trustee and settlor designates succession thereafter, 10.34

Settlor designates successor trustees when corporate fiduciary unwilling or unable to serve, 10.35

Distributions

Annual distributions of income, 10.137

Broad powers of distribution (standard clause), 10.107

Creation of power of appointment, 9.55

CUTMA custodian, distribution to, 9.49A

Outright on trust termination on settlor's or surviving spouse's death, 9.5

Outright to minors and others, preventing, 9.47

Outright to multiple beneficiaries on settlor's or surviving settlor's death, 9.5

Power to distribute if power of appointment not exercised, 10.139

Remainder to charitable remainder, 9.49; App A, Art 3

Remainder to contingent beneficiaries or settlors' heirs, 9.49

Separate shares, distribution of all income required but distribution of principal permitted, 9.21A

Separate shares, distribution of all income required but distribution of principal to deceased child's spouse permitted, 9.21A

Separate trusts: minor beneficiaries (see Separate trusts for each minor beneficiary, below)

Single trust distribution of all income required, distribution of principal permitted, 9.21

Single trust distribution of all income required, distribution to spouse of deceased child, 9.21

Termination of trust power to withhold payment if conflicting claims arise, 10.109; App B, Art 4

When trust is small, 9.7

Dynasty trusts

Deed of trust with assignment of rents, 13A.20

Generation-skipping dynasty trust, 13A.15, App N

Secured annually renewable demand promissory note, 13A.18

Secured installment promissory note, 13A.17

Security agreement for limited liability company units, 13A.19

Unsecured installment promissory note, 13A.16

Encumbered property

Allocation of payments, 19.52

Allocation of sale proceeds of property acquired by foreclosure, 19.73

Power of trustee to foreclose and bid on property, 19.71

Power of trustee to subordinate encumbrance on property, 19.69

Exculpating trustee

Nonliability for cotrustees' acts, 10.40; App B, Art 3

Nonliability of trustees, 10.39; App B, Art 3

Successor trustee's nonliability for predecessor's acts, 10.41; App B, Art 6

GRAT client memorandum, 15.38

Investment powers of trustee

Agents, power of individual trustee to employ investment counsel, 10.78; App B, Art 4

Agents, power of trustee to employ, 10.77; App B, Art 4

Bonds (see Bonds, above)

Broad investment powers under prudent investor rule, 10.60; App B, Art 4

Diversification of assets not required, 10.66

Establish margin accounts and buy or sell options, puts, and calls, 10.60

Lease, including oil and mineral development (standard clause), 10.70; App B, Art 4

Limited investment powers, 10.61

No compensation to income beneficiary on disposition of underproductive property holdings, 10.64

Retain cash, 10.64

Retain property and operate business (standard clause), 10.63; App B, Art 4

Retain unproductive or underproductive property, 10.64; App B, Art 4

Securities, authority to hold trust property as nominee or in broker's name, 10.75; App B, Art 4

Securities, management (standard clause), 10.72; App B, Art 4

Securities, register shares for sale (closely held or controlled public corporation), 10.73; App B, Art 4

Sell, exchange, manage, encumber, and grant options on property (standard clause), 10.68; App B, Art 4

Irrevocability of trust, 8.7; Apps A-E, App F, Art 1

Life insurance powers or trust

Power to invest in life insurance (trustee not obligated to pay premium), 11.19; Apps D-E, Art 5

Power to remove and replace trustee, 11.20; App A, Art 4; Apps C-D, App E, Art 4

Trust assets includable in settlor's estate distributed to surviving spouse, 11.8

Trust for children, irrevocable, App D

Trust for spouse and issue, App E

Management powers of trustee

Accounting by trustee, 10.118; App A, Art 4; App E, Art 4

Allocations: Broad power to determine principal and income (standard clause), 10.112B

Allocations: Expenses among successive beneficiaries, 10.116; App B, Art 4

Allocations: Revised Uniform Principal and Income Act to govern, 10.112A

Allocations: Tax-sensitive trustee power to make allocations with limited discretion, 10.112C

Allocations: Undistributed income payable to successive beneficiaries, 10.114; App B, Art 4

Bonds (see Bonds, above)

Borrow (standard clause), 10.80; App B, Art 4

Business interests operations (see Business interests, above)

Certain power vested in special trustee, 10.100

Disclaim, release, restrict administrative powers held, 10.92

Distributions (see Distributions, above)

Initiate and defend litigation and compromise (standard clause), 10.85; App B, Art 4

Insure (standard clause), 10.87; App B, Art 4

Lend to, buy from, and sell to trust individually, 10.83

Lend to settlor's probate estate, 10.89

Make loans (standard clause), 10.81

Move situs of trust, 10.104

Payments to disabled or minor beneficiary, 10.105; App A, Art 3

Personal property-related issues (see Personal property-related issues, below)

Prohibiting trustee from exercising certain powers, 10.100; App B, Art 4

Purchase property from settlor's probate estate, 10.90

Real property-related issues (see Real property-related issues, below)

Separate trusts, consolidating administration of trusts, 10.103

Separate trusts, physical division not required but permitted (standard clause), 10.102

Taxation, power to adjust for tax consequences, 10.94

Taxation, power to consider tax consequences of distributions, 10.96, App B, Art 4

Taxation, power to make income currently distributable, App B, Art 4

Taxation, power to pay estate taxes, 10.97

Minors' trust: *Crummey* trust or power

Hanging *Crummey* withdrawal power, 12.98

Notice to beneficiary, 12.85

Withdrawal provision with "5 or 5" limitations, 12.97; App A, Art 2; App E, Art 2

Withdrawal provision without excess lapse protection, 12.96; Apps C-D, Art 2

Minors' trust: fully qualifying under IRC §2503(c)

Child's power to terminate trust after attaining specified age, 12.61; App B, Art 2

Discretionary payment of income and principal before child attains age 18 or 21, 12.59; App B, Art 2

Distribution according to beneficiary's power of appointment, 12.62A; App B, Art 2

Distribution to child's estate, 12.62

Division of trust estate, 12.58; App B, Art 3

Outright distribution to living child at age 18 or 21, 12.60

Minors' trust: incentive trust (non-IRC §2503 trust)

Child not in compliance with incentive provisions at specified ages, 12.121

Conditions for distributions, 12.117

Manner of distribution to child exercising withdrawal rights and when child dies without exercising withdrawal right, 12.120

Medical emergency distributions, 12.118

Right of withdrawals at specified ages when child has complied with incentive provisions, 12.119

Minors' trust: income interests only qualifying under IRC §2503(b)

Discretionary early distribution of principal, 12.79

Distribution of balance if beneficiary dies before age 21, 12.78

Distribution of post-age-21 income, 12.77

Payment of pre-age-21 income at age 21, 12.76

Multistate trusts

Appointment of trustee for real property, 20.44

Choice-of-forum, 20.31

Choice of law, all real and personal property in one state, 20.39

Choice of law for community property, 20.52

Choice of law, real property in several states and personal property, 20.40

Exercise of power of appointment: choice of law governing, 20.64

Exercise of power of appointment: standard clause, 20.63

Governed by law of place of administration, 20.24

Savings clause for unforeseen tax consequences, 20.25

Trustee may apply principle of validation, 20.5

Name of trust, 8.5; Apps A-E, App F, Art 1

Notice of proposed action, 10.109C

Personal property-related issues

Allocations to income consistent with tax treatment, 19.26

Power of trustee to abandon property, 19.33

Power of trustee to make specialized investments, 19.31

Power of trustee to purchase bonds (see Bonds, above)

Qualified personal residence trust (QPRT)

Client memorandum, 17.110

Diagrams for husband and wife, 17.112

Drafting QPRT, 17.70-17.109

Letter transmitting draft QPRT to client (sample), 17.111

Sample QPRT, App P

Real property-related issues

Allocation of forfeited option money, 19.14

Allocation of gains or losses differs from statute, 19.12

Allocation of taxes and assessments, 19.16

Compensation of managers and brokers, 19.9

Creation of depreciation allowance to allocate extraordinary repairs or expenses to income, 19.18

Power of trustee to employ property managers to assist, 19.7

Power of trustee to employ real estate brokers, 19.8

Power of trustee to monitor property and comply with environmental laws, 19.21

Power of trustee to subdivide and sell property, 19.5

Special trustee appointment and power to accept real property, 19.22

Removal of trustee

Court removal of incapacitated trustee, 10.31; App B, Art 3

Incapacity or illness, removal due to, 10.31; App B, Art 3

Removal and replacement, 10.30; App F, Art 7

Successor trustee (see Successor or substitute trustee, below)

Resignation of trustee, administrative power, 10.28; App F, Art 7

Sample trusts

Charitable lead annuity trust (CLAT), App K

Charitable remainder annuity trust, App O

Charitable remainder annuity trusts for one and two lives, App H

Charitable remainder unitrust, App F

Charitable remainder unitrusts for one and two lives, App G

Family pot trust: independent trustee (long term), App A

Generation-skipping dynasty trust, 13A.15, App N

Grantor retained annuity trust (GRAT), App L

Grantor retained annuity trust (GRAT), 15.19-15.37

Grantor retained income trust (GRIT), 14.16-14.29

Grantor retained unitrust (GRUT), 16.16-16.35

Inter vivos QTIP trusts, 2.39B, App I

Inter vivos unitrust QTIP trust, 2.39C

Life insurance trust for children, App D

Life insurance trust for spouse and issue, App E

Minors' trust: independent trustee, App B

Multiple vested interest trust for skip persons, App C

Multiple vested interest trusts for skip persons, App C

QDOT trust, 2.81A-2.81G, App J

Self-dealing and conflicts of interest

Authorization of self-dealing, 10.45

Certificate of independent review (of trustee choice by client), 10.31A

Conflicts of interest self-dealing (broad powers), 10.46

Nonliability of trustee or special trustee for conflicts of interest, 10.47

Separate trust for each minor beneficiary

Standard administrative clause, 9.26

Accumulation of income during child's minority, 9.27

Distribution after child reaches age 21, 9.28; App B, Art 2; App C, Art 3

Distribution during child's minority does not discharge settlor's obligation to support minor, 9.27; App C, Art 3

Distribution during child's minority, trustee has discretion to distribute income or principal, 9.27; App C, App D, Art 3

Settlor's power to control trust investments

Binding decisions by independent investment counsel named by settlor, 10.56

Consultant, nonbinding recommendations by, 10.56A

Directing investments, 10.54

Personal to settlor, 10.55

Veto power of settlor over investments, 10.53

Signatures

Agreement of trust, 8.8; Apps A-B, App C, Art 5; App D, App E, Art 6; App F, Art 10

Declaration of trust, 8.9

Spouse's consent to transfer, 8.10

Sprinkling power or trust

Power exercised by special trustee, 9.11-9.11A; App A, Art 3; App E, Art 3

Power exercised by special trustee, limited to sprinkling income, 9.11

Power granted to special trustee to add beneficiaries of named class, 9.11A

Trust (income only, ascertainable standard), 9.17

Trust (income only, ascertainable standard), distribution to deceased child's spouse, 9.17

Trust, 9.9

Trust, distribution to deceased child's spouse, 9.9

Successor or substitute trustee

Removal and replacement (see Removal of trustee, above)

Settlor may substitute trustees: trustee may resign and appoint substitute trustee, 9.15; App B, Art 3

Settlor may substitute trustees, 9.15

Third party special needs trust

Backstop termination clause for third party SNT, 13.49

Distribution provisions

Public benefits, requirements for seeking, 13.45

Special needs, distribution for, 13.43

Trust Advisory Committee, 13.44

Trust estate to supplement public benefits, 13.46

Expenses of third party SNT, payment of, 13.50

Irrevocability, limited power of amendment for third party SNT, 13.40

Purpose of, 13.41

Sample form for third party special needs trust, App M

Termination of third party SNT, Death of beneficiary, 13.48

Title of third party SNT, 13.39

Underproductive property

Allocation of ordinary expenses, definition of ordinary expenses, 19.42

Allocation of ordinary expenses to principal, 19.41

Allocation of sale proceeds, 19.38

Allocation of sale proceeds, no special adjustments for underproductive property, 19.39

Authorizing trustee to acquire and retain, 19.35

Beneficiaries to occupy residential real estate, power of trustee to permit, 19.36

Tax considerations, full beneficial enjoyment accorded to spouse, 19.45

Tax considerations, power of spouse to compel conversion to productive property, 19.46

Tax considerations, powers exercisable only in trustee's fiduciary capacity, 19.48

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Index

A B C D E F G H I J K L M N O P Q R S T U V W X Y Z

References are to chapter section numbers

The symbol "" after a section number indicates that a form appears in the section.

Abandonment

Tangible personal property, 19.32, 19.33

Acceleration

Assuring nonacceleration of transferred property's debt, 19.50

Accounts and Accounting

Guardian's accounting, 12.19

Litigation special needs trust, court requiring periodic accountings of, 13.33

Multistate trusts, 20.28

Obligation of trustee, 10.117, 10.118

Trustee's authority to employ accountants, 10.76, 10.77

Accumulation Power or Trust

Generally, 2.60

Basic form, 9.32

Bond discount, 19.29

Child minority, distribution of income and principal or accumulation of income during, 9.27

Description, 9.31

Distribution if no issue, 9.33

Herr trust variant of IRC §2305(b) trust, 12.68-12.71

Hybrid trust, 9.39-9.40

Minor's incentive trust property, 12.114

Special trustee

Desirability, 9.36

Power of invasion, 9.37

Spendthrift clause, 10.123

Tax considerations

Estate and gift tax, 9.34

Foreign trust accumulation distributions, 3.74

Income tax, 9.31-9.32, 9.35-9.36

IRC §674 less significant exceptions, 9.38

Throwback tax rules, 10.95, 10.96

Acknowledgment

Basic clause, 8.12

Purpose, 8.11

Actuarial Tables

See also **Mortality**

IRS valuation tables. See **Valuation**

Reversionary interest valuation, 2.57

Additions to Trust

Allocating proceeds of liquidation in business operations, 19.95

Basic clause authorizing, 10.122

Charitable remainder trust. See **Charitable Remainder Trust (CRT)**

Declaration transferring, 8.4

Definition of proportionately, 10.122

GRAT additions, 15.9, 15.11

GRUT additions, 16.5

Pooled income fund, 18.107

Purpose of clause, 10.121

QPRT additions. See **Qualified Personal Residence Trust**

Subdivided or partially or wholly distributed trust, 10.122

Administration of Trust

Generally, 20.19

Accountings. See **Accounts and Accounting**

Beneficial enjoyment of trust, effect on, 2.61

Bond requirement. See **Bonds and Undertakings**

Compensation. See **Salaries and Compensation**

Drafting considerations, 10.1

Governing law. See **Governing Law**

Investments. See **Investments**

Jurisdiction, 10.104, 20.19-20.23

Management of trust property. See **Management of Trust Property**

Multiple trusts. See **Multiple Trusts or Skips**

Multistate trusts. See **Multistate Trusts**

Settlor's control power. See **Settlor**

Situs issues. See **Multistate Trusts**

Standard of care, 10.38, 10.110

Trustees

Generally. See **Trustees**

Commingling. See **Commingling**

Cotrustees. See **Cotrustees**

Powers. See **Powers of Trustee**

Self-dealing. See **Self-Dealing**

Agency

Attorneys. See **Attorneys**

Authority or power of trustee to employ

Agents or investment counsel, 10.76, 10.77-10.78

Managers and brokers, 19.6, 19.7-19.8

Brokers. See **Brokers and Dealers**

Compensation, 10.77, 19.6, 19.9

Delegation of powers to agent, 10.15, 10.77

Foreign trust, appointment of United States agent for, 3.69B

Investments. See **Investments**

Liability for agent's acts, 10.59, 19.10, 19.86

Professional advisers. See **Professional Advisors**

Agriculture. See Farms and Ranches

Allocation

Generally, 10.110-10.111

Bond premiums, amortization of, 10.112, 19.27

Business enterprise. See **Operation of Business**

Charitable remainder trust

Annuity or unitrust amount, 18.62, 18.63

Sprinkling powers, 18.94, 18.95

Corporate distributions, 19.25

Deferred compensation, 10.111

GST exemption. See **Generation-Skipping Transfer (GST) Tax**

Insurance trust liability for estate tax, 11.7

Management power limitation, 2.59, 19.11

Multistate trusts death taxes, 20.84-20.85

Natural resources, 19.110, 19.113

Power of trustee

Broad power to determine principal and income, 10.112B

Make adjustments, 10.93, 10.94, 19.11, 19.37-19.37A

Purpose of allocation clauses, 10.110

Tax considerations, 10.111

Tax-sensitive trustee allocations with limited discretion, 10.112C

Uniform Principal and Income Act to govern, 10.112A

Real property

Depreciation, depletion, or obsolescence, 19.19

Foreclosed property, 19.72, 19.73

Gains or losses from sale, exchange, or transfer, 19.11, 19.12

Interest payments on encumbered property, 19.51, 19.52

Option money, 19.13, 19.14

Rental expenses, 19.17, 19.18

Rental income, 19.11

Taxes and assessments, 19.15, 19.16

Underproductive property (see Underproductive property, below)

Rental income, 19.11, 19.110

Specialized investments, 19.31

Standard of care, 10.38, 10.110

State death taxes, 2.84

Stock distributions and rights, 19.26

Successive beneficiaries' rights

Allocation of expenses, 10.115, 10.116

Income allocation, generally, 10.113

Undistributed income payable to successive beneficiary, 10.114

Tax considerations, 10.111

Trust property acquired through foreclosure, 19.72, 19.73

Underproductive property

Expenses, 19.40, 19.41-19.42

Sale proceeds, 19.37, 19.38-19.39

UPAIA considerations, 10.110

Uniform Principal and Income Act (UPAIA), generally, 10.110-10.111, 10.112-1

Wasting asset transfers. See **Wasting Asset Transfers**

Alternative Dispute Resolution (ADR). See Arbitration

Amendments and Modifications

Annuity trust inflation adjustment, 9.42

Buy-sell agreements, obtaining IRS ruling before modifying, 2.29

Charitable remainder trust. See **Charitable Remainder Trust (CRT)**

Reformation of trust. See **Reformation of Trust**

Settlor's uncontrolled power as power to amend trust, 5.15

Small trust, 9.6

Third party special needs trust, limited power of amendment for, 13.40

Trustee's accounting obligation, 10.117

Unitrust inflation adjustment, 9.43

Amortization

Bond premiums, 10.112, 19.27, 19.28

Reserve account, 19.110, 19.111

Reserve or allowance, trustee establishing, 19.19

Annual Exclusion. See Gifts and Gift Tax

Annuity and Annuity Trust

Basic form, 9.42

Beneficiaries, annuities as first-tier or second-tier distributions to, 3.18D

Charitable

Charitable lead annuity trust. See **Charitable Lead Annuity Trust (CLAT)**

Gift annuity. See **Charitable Gifts and Deduction**

Lead trust. See **Charitable Lead Trust (CLT)**

Remainder annuity trust (CRAT). See **Charitable Remainder Trust (CRT)**

Definition, 6.2, 15.1

Dynasty trust, leveraging with private annuity agreement, 13A.14

Estate tax, 2.55, 2.66

Gift tax, 2.14, 2.16

Grantor retained trust. See **Grantor Retained Annuity Trust (GRAT)**

Historical perspective and purpose, 9.41

QPRT conversion to annuity. See **Qualified Personal Residence Trust (QPRT)**

Qualified interest criteria, 2.27-2.28

Retained annuity as qualified interest, 15.9

Settlor as trustee, 9.42

Valuation. See **Valuation**

Apportionment. See Allocation

Appraisal

Charitable remainder trust asset, 18.17, 18.20

Appreciated Property

Charitable remainder trust property, 18.14, 18.20, 18.31

Distribution of appreciated assets by trust or estate as sale or exchange, 3.18A

Donor's tax base, effect on, 2.3, 2.45-2.46

GRAT property, 3.24, 15.4, 15.11

GRIT property, 14.3

GRUT property, 16.2, 16.8

Joint tenancy, consideration element, 2.68

Minor's incentive trust property, 12.114

Nonproductive property as prudent investment, 19.34

Arbitration

Choice of form clause, 20.31

Ascertainable Standard, Limitation for Distributions. See Distributions

Assessments. See Property Tax and Assessments

Asset Protection Trust, 1.8

Assignment

Copyright, 19.115

Dynasty trust, deed of trust with assignment of rents, 13A.20

GST assignments, 4.5

Multistate trusts interests, 20.60

Attachment

Multistate trusts interests, 20.60

Attorneys

Advising client about irrevocability, 8.6

Certificate of Independent Review, attorney's assurance that client's independent choice of trustee not tainted by undue influence or fraud, 10.31A

Investment counsel, 10.56, 10.76, 10.78

Liability of attorney for client's fraudulent conveyance of assets, potential for, 1.8

Trustee, drafting attorney as, 10.9

Using out-of-state counsel, 20.7

Attorneys' Fees

IRS's failure to concede reasonable discount for community property interest as grounds for fee award to estate, 2.70

Bad Faith

Custodian's, 12.25

Nonexculpation of trustee's conduct, 10.38

Bankruptcy

Qualified personal residence trust (QPRT), trustee's time limit for attacking transfer of residence to, 17.14

Spendthrift trusts, effect of beneficiary's bankruptcy on, 10.123

Banks and Banking

Comptroller of Currency investment regulations, 10.44

Joint accounts, 12.17-12.18

Payable on death (POD) or Totten trust accounts, 12.15-12.16

Power of trustee to retain cash without investment, 10.62, 10.64

Basic Trust Clauses. See Drafting Trusts

Basis

See also **Valuation**

Appreciated property. See **Appreciated Property**

Decedents dying in 2010, step-up in basis for property, 2.46

Encumbered property transferred by settlor, 19.55, 19.62

Gift of appreciated property to elderly relatives to obtain new basis on death, 2.45

GRAT property, 15.11-15.13

GRIT property, 14.8, 14.10

GRUT property, 16.8, 16.10

Leaseback property sold to trust, 19.62-19.63, 19.66

Minors' trust under IRC §2503(c) property, 12.44, 12.50-12.51

QPRT or PRT residence, 14.10, 19.66

Qualified personal residence trust (QPRT), effect on basis if grantor dies in 2010, 17.16

Stock, stepped-up basis after decedent's death, 2.91

Surviving joint tenant's stepped-up basis, 12.17

Surviving spouse's loss of step-up basis, disadvantage of gift, 2.46

Beneficiaries

Accounting obligation of trustee, 10.117, 10.118

Ascertainable standard limitation on grantor-trustee's distribution power, 2.52

By right of representation or per capita, 9.5, 9.21

Charitable remainder trust. See **Charitable Remainder Trust (CRT)**

Completed gifts to beneficiaries. See **Gifts and Gift Tax**

Crummey withdrawal power. See ***Crummey* Trust or Withdrawal Power**

Disabled beneficiary. See **Disabled Persons**

Disclaimer of interest, 2.20, 9.68

Distributions. See **Distributions**

Estate tax, 5.5

Foreign trusts. See **Foreign Trusts**

Loans to beneficiary from trustee, 10.81, 19.67

Minors. See **Minors; Separate Trusts for Minor Beneficiaries**

Multiple, 9.3

Multistate trusts interests

Assignment, attachment, or disclaimers, 20.60

Property taxes, 20.98

State death taxation, 20.87

Payable on death (POD) or Totten trust account, 12.15-12.16

Power of appointment. See **Powers of Appointment**

Power to designate successor trustee, 10.37

Present trust interest, determining existence of, 4.8

Reconciling beneficiary needs with trust management concerns, 1.5

Remainder interests. See **Remainder Interests**

Settlor as beneficiary, 11.4

Single trust. See **Single Trust With Discretion To Distribute Principal**

Special needs trust. See **Special Needs Trust (SNT)**

Special trustee's power to add beneficiaries of named class, 5.10, 9.11A

Successive beneficiary

Allocation rights. See **Allocation**

Charitable remainder trust, 18.65, 18.67-18.68

Survivorship prerequisite, 2.66, 2.77, 9.2, 9.46

Trustee as beneficiary. See **Beneficiary-Trustee**

U.S. beneficiary, exceptions to treating trust as having, 3.70

Beneficiary-Trustee

Generally, 9.50, 10.6

Breach of trust by trustee, effect of, 10.29

Charitable remainder trust, 18.18

Duty to act fairly towards beneficiary, 10.44

General power of appointment, 9.10

Lifetime distributions, 9.51

Pooled income fund, 18.115

Power of appointment. See **Powers of Appointment**

Power to terminate trust, 9.6

Special trustee payments to. See **Special Trustees**

Tax considerations

Estate tax. See **Estate Tax**

Gift tax, 9.52

Income tax, 9.53

Tax-sensitive trustee

Avoiding adverse tax consequences, 10.99, 10.100

Limited administrative powers, generally, 10.11, 10.91

Power to allocate income and principal, 10.112

Binding Decisions

Investment counsel, recommendations by, 10.56

Births

Notice requirement, 10.119, 10.120

Blockage Discounts. See Discounts

Bona Fide Transaction or Requirement. See Good Faith

Bonds and Undertakings

Discount purchasing

Amortizing discount, 19.27

Power of trustee to purchase bonds at discount, 19.29

Investment power of trustee, 19.27

Issuer of stock's underwriter, 19.108

Performance of trustee's duties, 10.48, 10.49

Premiums for bonds

Control and marketability, 19.27

Trustee bond and amortizing, 10.112, 19.27, 19.28

Resignation of trustee, effect on surety, 10.27

Boot, 19.64

Borrowing. See Loans

Brokers and Dealers

Compensation, 19.9

Prudent investor rule application, 10.60

Stock broker, 19.108

Trustee liability for agent's acts, exoneration, 19.10

Trustee's power to employ brokers, 19.6, 19.7-19.8

Trustee's power to hold securities in nominee's, broker's, or street name, 10.74, 10.75

Burden of Proof

See also **Evidence**

Validity of IRS's value determination, burden of proof on taxpayer to rebut, 2.23B

Business Enterprise Operations. See Operation of Business

Buy-Sell Agreement Property

Special valuation rules, 2.25, 2.29, 19.76

California Uniform Transfers to Minors Act (CUTMA). See Custodianship

Capacity. See Incompetent Persons

Capital Gains and Losses. See Gains and Losses

Capitalization

Recapitalizations of transferred interests, 2.25-2.26

Valuation of corporation, effect of capitalization-of-income approach on, 2.23B

Cash

Power of trustee

Borrow money, 10.79, 10.80

Retain cash without investment, 10.62, 10.64

QPRT. See **Qualified Personal Residence Trust (QPRT)**

C Corporations

Valuation discounts, 2.23C

Certificates and Certification

Client's choice of trustee as free from fraud or undue influence, attorney's certification of confirmation of, 10.31A

Drafting attorney serving as trustee, independent review, 10.9

Charitable Gifts and Deduction

Generally, 2.40

Benefits of using nongrantor CLAT

Generally, 18A.13

Example of nongrantor CLAT, 18A.14-18A.16

Leveraging benefits to remaindermen, benefits of, 18A.15

Low present value remainder, benefits of, 18A.16

Projected results of CLAT, factors in assessing, 18A.17

Charitable gift annuity

Charitable lead annuity trust. See **Charitable Lead Annuity Trust (CLAT)**

Charitable remainder trust compared, 18.119

Contractual gift to charity, 18.118

Estate and gift taxes, 18.121

Income tax considerations, 18.120

Charitable lead annuity trust (CLAT), deduction for charitable interest in, 18A.20

Charitable remainder trust. See **Charitable Remainder Trust (CRT)**

Combined with unlimited marital deduction, 2.41

Decedent's estate

Generally, 2.74

Charitable remainder trust, 18.21-18.23, 18.66

Discounts and premiums problems, 2.71

Encumbered property, 19.55

Independent trustee's power to add charitable beneficiaries, effect of, 5.9

Intermediate tier distribution to beneficiary, charitable deduction as, 3.18C

Lead trust. See **Charitable Lead Trust (CLT)**

Maximizing deduction

IRS Table B, 6.27

IRS Table S, 6.20

Unitrust, 18.27, 18.60

Multistate charitable trusts. See **Multistate Trusts**

Pooled income fund. See **Pooled Income Fund (PIF)**

Power to control beneficial enjoyment of corpus or income irrevocably payable to charitable organizations, effect of, 9.38D

Private foundation, 18.20, 18.66

Remainder interests

Charitable remainder trust. See **Charitable Remainder Trust (CRT)**

Not in trust, 2.42, 2.74

Personal residence or farm with retained interest, 18.123

Underproductive property, 19.49

Valuation. See **Valuation**

Charitable Lead Annuity Trust (CLAT)

See also **Charitable Lead Trust (CLT)**

Generally, 1.2

Comparison of nongrantor CLATs and alternatives, 18A.2

Deduction for charitable interest in CLAT, 18A.20

Defined, 18A.1

Distributions. See **Distributions**

Drafting requirements

Generally, 18A.19

Annuity trust or unitrust mandatory clause (private foundation prohibitions), 18A.23

Charitable deduction savings clause, 18A.24, 18A.25

Guaranteed annuity interest, requirement that CLAT provide charity with, 18A.20

Guaranteed annuity, payment of, 18A.21

Measuring lives for charitable lead interest, regulations living class of persons eligible as, 18A.20

Miscellaneous provisions, 18A.26

Private foundation prohibitions, 18A.22

Estate tax deduction

Transfer to CLAT, 18A.1, 18A.7

Value of charitable annuity, deduction for, 18A.7

Generation-skipping transfer tax

Annuity inclusion rules, example of, 18A.11

Annuity inclusion rules, implications of, 18A.12

Normal inclusion ratio calculation, 18A.9

Special CLAT inclusion ratio rules, 18A.10-18A.12

Gift tax deduction for transfer to CLAT, 18A.1, 18A.8

Grantor trust status, avoidance of, 18A.27

Historical overview of CLATs, 18A.3

Income tax deduction

Charitable distributions by trust, deduction for, 18A.6

Deductions for charitable gifts, timing rules affecting, 3.5

Grantor's transfers to qualifying charitable lead trust, deduction for, 18A.5

Limits on, 18A.1

Private foundations (see Drafting requirements, above)

Sample form for nongrantor CLAT, App K

Trustee, selection of, 18A.18

Charitable Lead Trust (CLT)

See also **Charitable Lead Annuity Trust (CLAT)**

Defined, 6.2, 18A.1

Encumbered property, 19.55

Estate tax deduction entitlement, 2.74, 18.22

Gift tax deduction entitlement, 2.40

GST tax, 4.28

Income tax, grantor and nongrantor CLTs, 3.49-3.51

Limits on utility of CLT, 18A.1

Noncharitable remainderman's power to select charitable recipients, 18A.22

Nonqualified charitable lead trust, 18A.28

Underproductive property, 19.49

Charitable Lead Unitrust (CLUT)

Defined, 18A.1

Generation-skipping transfer taxes, advantages of CLAT over CLUT, 18A.12

Charitable Remainder Trust (CRT)

Generally, 1.2, 18.2

Accelerated charitable trust, 18.9B

Additions after initial contribution

Generally, 18.72

Annuity trust, 18.73, 18.74-18.75

Unitrust, 18.76, 18.77-18.78

Allocation among class of noncharitable beneficiaries in trustee's discretion, 18.95

Alternatives

Charitable gift annuity. See **Charitable Gifts and Deduction**

Pooled income fund. See **Pooled Income Fund (PIF)**

QTIP trust for spouse with charitable remainder, 18.122

Qualified personal residence trust. See **Qualified Personal Residence Trust (QPRT)**

Remainder interest in personal residence or farm with retained estate, 18.123

Amendment and modification

Generally, 18.42, 18.65

Reformation (see Reformation, below)

Annuity trust (CRAT)

Generally, 18.6A-18.7

Additions after initial contribution, 18.72-18.73, 18.74-18.75

Computing charitable deduction amount, 18.25, 18.46

Definition, 6.2

Differences between annuity trust and unitrust, overview, 18.10

GRAT distinguished, 15.1

Payments (see Annuity trust payments, below)

Proration of amount, 18.62, 18.63

Sample CRAT for one and two lives, App H

Sample joint and survivor CRAT, App O

Valuation of assets, 18.17, 18.47, 18.70

Annuity trust payments

Generally, 18.25, 18.45-18.46

Asset valuation basis, 18.17, 18.47

From income then principal, 18.52

Joint and survivor recipients, 18.49-18.51

Sum certain for one life, 18.48

Appreciated property, 18.14, 18.31

Basic characteristics

Generally, 8.2

Deduction must be allowable, 18.3

Must be annuity trust or unitrust, 18.4

Must function exclusively as CRT since its creation, 18.6

Provisions restricting or controlling trustee prohibited, 18.5

Beneficiaries

Death of beneficiary, reformation of trust after, 18.102

Distributions to (see Distribution, below)

Needs, 18.15

Payments (see Distribution, below)

Selection, 18.19, 18.65, 18.67

Settlor's power to revoke recipient's interest, 18.96, 18.97

Sprinkling powers, 18.94, 18.95

Successor beneficiaries, 18.67-18.68

Trustee, beneficiary as, 18.18

Business operation assets. See **Operation of Business**

Charitable deduction

Generally, 18.17, 18.24

Annuity trust, 18.25, 18.46

Commercial software, 18.30

Estate tax deduction, 2.74, 18.21-18.23, 18.66

Charitable gift annuity compared, 18.119

Charitable remainder QTIP trust compared, 18.122

Choosing trust form

Beneficiary needs, 18.15

Donor considerations, 18.12

Nature of funding asset, 18.13-18.14

Created at death

Generally, 18.6

Revocable trust, 18.89, 18.90

Testamentary CRT, 18.91, 18.92

Distribution

Generally, 18.16, 18.45

Adjustments for incorrect asset valuation (see Distribution adjustments, below)

Alternative charitable organization requirement, 18.65

Annuity trust (see Annuity trust payments, above)

Computation of payment, 18.17

Consideration requirement for payment, 18.86

Division of trust into separate trusts for individual recipients, 18.17A

Gift tax consequences of payment, 18.21, 18.84

Income-only unitrust payment, 18.58, 18.59

Income tax consequences. See **Income Tax**

Partial distributions before all noncharitable interests terminated, 18.98, 18.99-18.99A

Power to amend designation, 18.68

Proration of payment amount, 18.62, 18.63

Restricted purpose, 18.69

Successor beneficiaries, 18.67

Termination of noncharitable interest requirement, 18.64

Testamentary trust payment, 18.91, 18.92

Unitrust (see Unitrust payments, below)

Distribution adjustments

Generally, 18.70, 18.71

Deferred payments, 18.92

IRS Table K factors, applying, 6.29

Testamentary CRT, 18.91

Drafting

General sources, 18.37

Basic approach of regulations and rulings, 18.38

Choosing trust form (see Choosing trust form, above)

Mandatory clauses, overview, 18.44

Optional clauses, overview, 18.93

Planning considerations, 18.11, 18.89-18.90

Sample forms available, 18.39

Encumbered property, 19.55

Flip unitrust, 18.9A

Governing law. See **Governing Law**

Income-only unitrust

Generally, 18.9, 18.15

Income tax, 18.32

Payments, 18.58, 18.59

Irrevocability, 18.41

Multistate. See **Multistate Trusts**

No contest clause, 18.100

Pooled income fund comparison, 18.2, 18.107

Power of trustee, beneficiary designation, 18.66, 18.67-18.68

Private foundation issues. See **Private Foundation**

Prohibited transactions

Excise tax, 18.36

Payment of certain taxes from trust, 18.84, 18.85

Rules and exceptions, 18.79-18.80

Sample form, 18.81

Purpose, 18.1, 18.19

Qualification and disqualification

No contest clause, disqualification effect, 18.100

Requirements, 18.40, 18.42, 19.49

Tax payments causing disqualification, 18.84, 18.85

Reformation

Generally, 18.37, 18.42, 18.101

Categories, 18.102

Deadlines for reforming trust, 18.103-18.104

Requirements, 18.105

Savings clause, 18.42, 18.43

Settlor power to revoke, 18.96, 18.97

Spousal waiver of right to trust property on donor's death, 18.6B

Sprinkling powers, generally, 18.18, 18.94, 18.95

Tax issues

Estate tax deduction entitlement, 2.74, 18.21-18.23, 18.66

Excise taxation on prohibited transactions, 18.36

Gift tax deduction entitlement, 2.40, 2.42, 18.21, 18.66, 18.84, 18.96

Income tax. See **Income Tax**

QTIP trust, 18.122

Taxable year, 18.87

Tax payments from trust, prohibition, 18.84, 18.85

Termination of CRUT, tax treatment of, 18.36A

Testamentary transfers or trusts. See **Testamentary Transfers or Trusts**

Time issues. See **Time**

Trustee

Duty to value trust assets, 18.17

Investment restrictions, 18.5, 18.82, 18.83

Power to amend beneficiary designation, 18.68

Selection, 18.18

Sprinkling powers, 18.94, 18.95

Types

Choice (see Choosing trust form, above)

CRAT (see Annuity trust (CRAT), above)

CRUT (see Unitrust (CRUT), below)

Differences between CRAT and CRUT, 18.10

Unitrust (CRUT)

Additions after initial contribution, 18.72, 18.76, 18.77-18.78

Computing deduction, 18.26-18.29, 18.60

Definition, 6.2

Differences between annuity trust and unitrust, overview, 18.10

Income only unitrust, valuation of unitrust interest in, 18.58

Payments (see Unitrust payments, below)

Remainder following single life, 6.30-6.31, 18.53, 18.55

Remainder following term of years, 6.32-6.33

Remainder following two measuring lives, 6.34-6.35, 18.54, 18.56

Sample charitable remainder unitrust, App F

Sample charitable remainder unitrusts for one and two lives, App G

Types, standard and income-only, 18.8-18.9

Valuation if other than first day of trust's taxable year, 18.60, 18.61

Unitrust payments

Fixed percentage, 18.53, 18.55

From income then principal, 18.57

Joint recipients, 18.54, 18.56

Proration of amount, 18.62, 18.63

Unlimited marital deduction entitlement, 2.41

Valuation. See **Valuation**

Charts, Checklists, Questionnaires, and Tables

Actuarial tables. See **Actuarial Tables**

Calculation of tax credit applicable to each exclusion amount, table, 2.6

Charitable remainder trusts, mandatory clauses, 18.44

Computations of gift and estate taxation, 2.7

Discretionary powers of distribution, guidelines for exercising, 9.63

Electing small business trust (ESBT), basic requirements, 3.65

Estate planning software, desirable features, 6.39

Gifts, making

Advantages, 2.45

Considerations, 2.44

Disadvantages, 2.46

Grantor retained annuity trust (GRAT)

Calculating value of GRAT gift, 15.16

Required governing instrument provisions, 15.9

Selecting GRAT term, 15.4

When to use GRAT, questions for determining, 15.17

Zeroed-out GRAT illustration, 15.6

Grantor retained income trust (GRIT)

Calculating value of GRIT gift, 14.13

Selecting GRIT term, 14.4

When to use GRIT, questions for determining, 14.14

Grantor retained unitrust (GRUT)

Calculating value of GRUT gift, 16.13

Required governing instrument provisions, 16.6

Selecting GRUT term, 16.3

When to use GRUT, questions for determining, 16.14

Income tax rates applicable to trusts, 3.7

IRS valuation tables. See **Valuation**

Joint tenancy, 2.67

Life insurance, questions to ask if policy appears less expensive than competing policies

Blended insurance, 11.46

Second-to-die insurance, 11.47

Term insurance, 11.44

Variable insurance, 11.48

Whole life insurance, 11.45

Multistate trusts, drafting checklist, 20.101

Outline for generic irrevocable trust, 7.8

Qualified personal residence trust (QPRT), summary of alternatives to, 17.68

Qualified subchapter S trust (QSST), basic requirements, 3.58

S corporation stock, trusts eligible to hold, 3.52

Special needs trusts, chart summarizing, 13.27

Support of minors' obligation, major Family Code provisions, 5.20

Types of irrevocable trusts, 1.2

Checks

Action needed to complete gift by check, 2.15

Children and Grandchildren. See Minors

Child Support

Scope of support obligation, parents and adult children, 5.22

Spendthrift trust's beneficiary's child support obligations, potential permeability of trust for, 10.123

Choice of Forum. See Multistate Trusts

Choice of Laws. See Governing Law; Multistate Trusts

Citizenship

See also **Foreign Trusts**

Estate tax, noncitizen surviving spouses

Generally, 2.80

Acquisition of citizenship, 2.83

Credit for prior transfer property, 2.82

Qualified domestic trust requirements, 2.75, 2.81

Gift tax, noncitizen spousal gifts, 2.39, 18.21

Qualified domestic trust (QDOT), citizenship requirements for trustee. See **Qualified Domestic Trust (QDOT)**

Taxation of transfers to foreign trusts, importance of donor's citizenship to determining, 3.75

Claims of Creditors. See Debts

CLAT. See Charitable Lead Annuity Trust (CLAT)

Closely Held Businesses

Active business and passive rental, importance of distinguishing between, 2.89

Charitable remainder trust, 18.14-18.15

Control defined, 19.75

Disadvantage of gift, 2.46

Discounts for gifts of stock and real estate, 2.23B, 2.23D

Estate tax payments, extending or deferring, 2.89

IRC §704(e) and §§2701-2704 taxation

Generally, 19.74-19.75

Buy-sell and other restrictive agreements limitation, 19.76

Family partnership income tax rules, 19.77-19.78

Partnership interests, generally, 19.79

Valuation of business, effect of limited marketability and minority interest discount on, 2.23D

Power of trustee to acquire or retain

Generally, 19.80

Consenting to corporation transactions, 19.83

Incorporating or continuing business operations, 19.82

Investing in partnerships, 19.81

Retaining specific business interest, 19.84

Related or subordinate party rules and family partnership rules distinguished, 19.77

Retained voting rights of transferred stock, 2.56, 10.52, 19.103, 19.104

Sample family pot trust, App A

Special valuation rules on exclusion from value of gross estate, 2.72

Transfers within 3 years of death, 2.64, 2.72

Underproductive property aspect, 19.35

Commingling

See also **Conflicts of Interest; Self-Dealing**

Generally, 10.42

Authorization, 10.43

Pooled income fund property, 18.111

Self-dealing distinguished, 10.44

Community Property

See also **Separate Property**

Charitable remainder trust, 18.12

Dividing into separate property and reciprocal trusts, 5.12

Estate tax. See **Estate Tax**

Funding permanent trust, 5.10-5.11

GRAT, 15.12

GRIT, 14.9

GRUT, 16.9

GST tax, 4.4

Life insurance trust funding, 11.4, 11.7

Minority-interest discounting for estate tax purposes, 2.70

Minors' trust under IRC §2503(c) funding, 12.51

Multistate trusts transfers. See **Multistate Trusts**

Qualified personal residence trust (QPRT), partitioning community property residence into separate interests held as tenants in common, 17.29

Relinquishment of vested interest, effect on estate tax, 2.68

Retirement plan benefits, 19.117

Surviving spouse's basis in property, 2.46

Commutation of Trust Interest

GRAT, 15.9, 15.30

GRUT, 16.6, 16.28

Compensation. See Salaries and Compensation

Competency. See Incompetent Persons

Complex Trusts

Generally, 3.14-3.15

Beneficiaries' tier taxation

Generally, 3.18

First-tier distributions, 3.18A

Intermediate tier, 3.18C

Second-tier distributions, 3.18B

Variable tier, 3.18D

Estimated tax payments, 3.16-3.17B

Separate share rule, 3.18E

Compliance With Laws

Environmental protection, 19.20, 19.21

Compromise. See Settlement

Comptroller of Currency

Common trust funds investment regulations, 10.44

Computers and Computer Software

Desirable features for estate planning software, 6.39

Electronic spreadsheets, 6.40

Life insurance illustration software, 11.25

Selecting estate planning programs, generally, 6.38

Valuing interests by software, 2.22, 2.32, 18.30

Condition Precedent

Receipt of gift conditioned on payment of gift tax, 2.32

Survival, condition for transfer, 4.16, 4.40, 6.26

Conflicts of Interest

See also **Commingling; Self-Dealing**

Authorizing trustee, 10.46

Delaying distribution until conflicts resolved, 10.108, 10.109

Exonerating trustee or special trustee, 10.47

Consent

Adverse party's consent to joint power-holder's change reducing gift interest, 2.18

Corporate transactions, authorizing trustee's consent, 19.83

Cotrustees' decisions, 10.13, 10.14

Qualified subchapter S corporation trust, effect of successive beneficiary refusing to consent to election, 3.61

Spousal split-gifts, 2.43

Spouse's consent to transfer, 8.10

Conservatorship. See Guardianship and Conservatorship

Consideration

Charitable remainder trust payments, 18.86

Grantor trusts, 3.22

Received in exchange for transfer

Estate tax consequences, 2.68

Gift tax consequences, 2.8, 2.33, 11.12

Sale of trust assets requirement, 10.82

Transfer-for-value rule, 11.12

Constitutional Law

State death taxes, 20.73

Construction and Interpretation

See also **Definitions**

Alternate valuation date for estate assets, 2.72

Annual gift tax exclusion inflation adjustment, increase of IRC §2523(i) limit, 2.39

Charitable deduction, 2.40

Charitable remainder annuity trust (CRAT), 18.7

Charitable remainder income-only unitrust, 18.9

Charitable remainder trust, 1.2, 18.2

Charitable remainder unitrust (CRUT), 18.8

Commonly used trust terms. See **Drafting Trusts**

Completed transfer, 2.15

Crummey trust, 12.80

Decedent's gross estate, 2.47

Estate tax inclusion period (ETIP) rule, 4.29, 11.16

Family partnership test for income tax rules, 19.77

5 or 5 amount (lapsed power), 12.89-12.91

Foreign situs trust, 3.68

General power of appointment, 2.11-2.13

GST tax transferor, 4.4

Herr trust, 12.68-12.70

Inclusion ratio concept (GST tax), 4.18, 4.30

Insider trading rule, 19.107

Inter vivos QTIP trusts, effect of California law on marital deduction arising from, 2.39A, 2.79

Investment powers of trustee, potential conflict between statutes limiting and expanding, 19.27

Joint tenancy, 12.17

Lapsed voting or liquidation right, 2.30

Layering nonexempt trusts, 4.37

Levine holding, 12.70-12.71

Life insurance terminology

Blended whole life/term insurance, 11.38, 11.46

Illustration questionnaire, 11.43, 11.49

Interest-sensitive whole life insurance, 11.37

Joint lives insurance, 11.39, 11.47

Limited-pay whole life insurance, 11.36

Substituting versus backdating application, 11.9, 11.9B

Term insurance, 11.30, 11.44

Universal life insurance, 11.40

Variable life insurance, 11.41, 11.48

Variable/universal life insurance, 11.42

Whole life insurance, 11.35, 11.45

Management functions of trustees, importance of drafting for clarity of, 10.76

Minor's incentive trust, 12.111

Multistate trusts. See **Multistate Trusts**

Naked *Crummey* powers, 12.93-12.95

Permanent trust, 1.2, 5.1

Pipe dream trust, 5.14

Pooled income fund, 18.106-18.107

Prudent investor rule, 10.59

Reciprocal trust doctrine, 2.54, 5.12

Relationship between revocable and irrevocable trusts, 1.3

Retained right to income, 2.53

"Shall" or "may" terminology, 10.131

Simple trust, 3.11

Spendthrift clause, 10.123

Sprinkling trust, 9.8

Substantial owner of interest, 19.78

Tax-sensitive trustee, 10.11

Terminable interest rule (marital deduction), 2.76-2.79

Throwback rule (tax), 10.95

Trust as association taxable as corporation, 3.4

Unlimited marital deduction, 2.39

Valuation of corporation with discount for marketability and minority interest, six-factor matrix for measuring, 2.23B

Consultants. See Professional Advisors

Contingent Interests. See Condition Precedent

Control Premium. See Premiums

Conversion of QPRT into GRAT. See Qualified Personal Residence Trust (QPRT)

Copyright. See Intellectual Property

Corporate Trustees

See also **Trustees**

Generally, 10.7-10.8

Beneficiary's power to remove, 10.29, 10.30

Bond premium or discount, amortization problems, 19.27

Charitable remainder trust, 18.18

Commingling undivided interests, 10.42, 10.43

Compensation, 10.50

Custody of assets, 10.17

Investment advisor, 10.21, 10.22-10.23

Limited authority, 10.18

Multistate trusts, 20.42

Prudent investor limitation, 10.60

Self-dealing authority, 10.45

Unanimity requirement for decisions, 10.14

Unwilling or unable to serve, 19.36

Corporations

Allocation to income of corporate distributions of money, 19.25

Compensating trustee/officer, 19.87, 19.89

Control defined, 19.75

Controlled corporation defined, 2.56, 19.103

Corporate trustee. See **Corporate Trustees**

Family-held. See **Closely Held Businesses**

Liquidation. See **Liquidation**

S corporations. See **S Corporations**

Stock issues. See **Securities**

Trust as association taxable as corporation, 3.4

Valuation

Minority interest, capitalization-of-income approach preferable for measuring, 2.23B

Transferred interest, 2.23B, 2.25-2.26, 2.30

Cotrustees

See also **Trustees**

Generally, 10.8, 10.12

Authority to act

Generally, 10.13

Appointment of special trustee, 10.19, 10.20

Compensation, 10.20, 10.50, 10.51B

Custody of assets, corporate cotrustee, 10.17

Delegation of powers, 10.15

Expenditures limitation, corporate cotrustee, 10.18

Incapacitation of other cotrustee, 10.16

Remaining cotrustee as sole trustee until settlor designates succession, 10.34

Unanimity not required, 10.14

Exonerating cotrustee from other cotrustee's acts, 10.38, 10.40

Income and principal powers

Individual cotrustee with sole power to invade principal, 10.24

Special trustee making payments to beneficiary-trustee, 10.25-10.26

Investment powers

Generally, 10.21

Individual trustee's sole power, 10.23

Purchase and sale proposals, 10.22

Multistate trusts, 20.42

Power to distribute income to self or other cotrustee, 9.53

CRAT or CRUT. See Charitable Remainder Trust (CRT)

Creditors

Claims of. See **Debts**

QPRT, advantages if dealing with creditors. See **Qualified Personal Residence Trust (QPRT)**

Creditors' Claims. See Debt

Credit, Tax. See Tax Credit

Cristofani Ruling, 12.94-12.95

CRT. See Charitable Remainder Trust (CRT)

Crummey Trust or Withdrawal Power

Amount of withdrawal right, generally, 12.86

Lapsed power. See **Lapsed Powers**

Life insurance trust, 11.11, 11.13-11.14, App E

Liquid assets to satisfy power, 12.92

Minors. See **Minors' *Crummey* Trust or Withdrawal Power**

Multiple trust problems, 12.91

Naked *Crummey* powers, 12.93-12.95

Nonmarital spousal trust satisfying present-interest requirement by use of *Crummey* withdrawal powers, 2.36A

Notification. See **Notice and Notification**

Ownership of trust by single beneficiary, 3.54

Period of withdrawal right, 12.86

Present interest, transferred assets as, 2.36, 11.14

Safe harbor, 4.1, 4.10, 12.95

Spouse's *Crummey* power, 12.88

Sprinkling trust, 12.110

Survival condition precedent conflict, 4.16

Tax consequences

Estate tax, 12.105-12.106

Gift tax, 12.101-12.104, 12.109

GST tax. See **Generation-Skipping Transfer (GST) Tax**

Income tax, 12.99-12.100

Time issues. See **Time**

Custodianship

Generally, 9.4

Advantages, 12.36

Combination of IRC §2503(c) trust with, 12.71

Disadvantages, 12.37

Distribution to California Uniform Transfer to Minors Act (CUTMA) custodian, alternative to minor's receipt of trust funds or items, 9.49A

Establishment requirements, 12.23

Estate of minor, distribution, 12.45

Liability of custodian, 12.25

Minors' trust under IRC §2503(c) compared, 12.63

Powers of custodian, 12.24

Qualify tuition programs, 12.37A

Substitute custodian designation, 12.26

Successor custodian designation

Generally, 12.27

Current custodian, designation of successor custodian by, 12.29

Transfer declaration clause, 12.28

Taxation of gifts to minors under custodianship

Estate tax, 12.32-12.33

Gift tax, 12.3, 12.31

GST tax, 12.34

Income tax, 12.35

Termination, generally, 12.30

Transferor's declaration creating custodianship, 12.28

CUTMA (California Uniform Transfers to Minors Act). See Custodianship

Damages

Securities Act violations, 19.106-19.107

Death

Administrative expenses of estate, 2.73, 11.3

Benefits

Gross estate property, 2.63

Maintaining adequate reserves, 11.24

Charitable remainder trust created at death. See **Charitable Remainder Trust (CRT)**

Dynasty trust's grantor status ending on settlor's death, 13A.12

Estate tax. See **Estate Tax**

Multistate trusts death taxes. See **Multistate Trusts**

Notice requirement, 10.119, 10.120

Separate shares, distribution to deceased child's spouse, 9.21A

Single trust, distribution to deceased child's spouse, 9.21

Special needs trust, termination on death of beneficiary. See **Special Needs Trust (SNT)**

Sprinkling trust distribution to deceased child's spouse, 9.9, 9.17

Testamentary transfers or trust. See **Testamentary Transfers or Trust**

Transfers within 3 years. See **Transfers Within 3 Years of Death**

Debts

Charitable remainder trust debt-financed income, 18.33

Creditor claims

Foreign trusts as protection against, 1.8

Multistate trusts interests, 20.60

Transferred assets available to, 2.51

Encumbered property issues. See **Encumbered Property**

Foreclosure. See **Foreclosure**

Foreign trusts, 3.70

Income tax on debt forgiveness, 10.81

Installment payments. See **Installment Payments**

Loans. See **Loans**

Medi-Cal recipients, recovery for payments to. See **Medi-Cal and Medicaid**

Mortgages and trust deeds. See **Mortgages and Trust Deeds**

Recourse debt, tax implications, 19.55, 19.57, 19.61

Spendthrift clause's effect on beneficiary's debts, 10.123

Declarations

Custodianship, transferor's declaration creating, 12.28

Emancipation of minor, 12.13

GRAT declaration of trust, 15.19

GRIT declaration of trust, 14.16

GRUT declaration of trust, 16.16

Nonsettlor's declaration of trust, 8.3

Settlor's declaration of trust, 8.3

Signatures for declaration of trust, 8.9

Trust format, declaration versus agreement, 8.1

Deductions. See Charitable Gifts and Deduction; Income Tax; Marital Deduction

Deeds

Completed transfer of grant deed requirements, 2.15

Trust deeds. See **Mortgages and Trust Deeds**

Defective Grantor Trusts. See Income Tax

Definitions

See also **Construction and Interpretation**

Accelerated charitable trust, 18.9B

Adverse party, 2.16, 10.7

Applicable family member, 2.26

Blockage discount, 2.23

Boot, 19.64

By right of representation, 9.21

Charitable lead annuity trust (CLAT), 18A.1

Charitable lead or remainder trusts, 2.40, 6.2, 18A.1

Charitable lead unitrust (CLUT), 18A.1

Clifford trust, 5.17

Common law GRIT, 17.7

Completed transfer, 2.15

Complex trust, 3.14

Control, 19.75, 19.108

Controlled corporation, 2.56, 19.103

Control securities, 19.108

Corporate recapitalization, 2.25

Covered opinion, 1.7A

Debt-financed property, 18.34

Decedent's gross estate, 2.47

Direct skip (GST), 4.8

Distribution by representation or per capita, 10.130

Dynasty trust, 13A.1-13A.2

Education, 10.132

Encumbrance, 19.50

Equalization clause, 17.45

Family attribution (decedent's stock), 2.70

Family pot trust, 19.99

Farm, 2.42, 18.123

Flip unitrust, 18.9A

Funding trust, 10.140

Future interest, 2.39

General power of appointment, 2.11-2.13

Generation assignment (GST), 4.5

Gift, 2.8

Grantor-retained annuity trust (GRAT) or unitrust (GRUT), 2.27, 6.2, 15.1, 16.1

Grantor-retained interest trust (GRIT), 6.2

Gratuitous transfer, 3.69F

Guaranteed annuity interest, 18A.20

Income, 2.80, 10.116A, 19.99

Independent trustee, 10.7, 18.17

Insurable interest, 11.9A

Intentionally defective grantor trust, 13A.6

Inventory value, 19.37

Issue and children, 10.133, 10.134

Kiddie tax, 12.5

Life insurance terminology

Annual renewable term contract, 11.31

Decreasing term contract, 11.33

Incidents of ownership, 11.6

Level term contract, 11.32

Life insurance illustration, 11.43

Life insurance trust, 11.1

Modified term contract, 11.34

Reciprocal trust doctrine, 11.5

Related or subordinate party, 11.6

Return of premium (ROP) term insurance, 11.30

Surplus of insurance carrier, 11.22

Term insurance, 11.30

Transfer-for-value rule, 11.12

Liquidation right, 2.30

Litigation special needs trust, 13.4

Maintenance, 18.113

Market absorption, 2.23

Medicare, 13.16

Member of family, 6.24

Members of family (GRIT, GRAT, or GRUT settlor), 14.2, 15.1, 16.1

Naked *Crummey* power, 12.93

No-contest clause, 10.136

Payable on death account (POD), 12.15

Postponed child, 12.112

Powers limited by ascertainable standard, 2.12

Premium (valuation purposes), 2.23

Present value of remainder, 18A.16

Private letter ruling, 18.12

Proportionately (additions to trust), 10.122

QSST, 14.8

Qualified interest, 2.27

Qualified personal residence trust (QPRT), 2.28, 6.2, 17.1, 17.30

Qualified trust, 10.95

Reciprocal trust doctrine, 2.37A, 11.5

Recourse debt defined, 19.55

Related or subordinate party, 3.36

Reportable event, 3.69E

Residence terminology

Personal residence, 2.42

Personal residence trust (PRT), 2.28

Qualified personal residence trust (QPRT), 2.28, 6.2

Restricted securities, 19.108

Settlor, 11.4

Simple trust, 3.11

Skip person, 4.5

Social Security, 13.16

Spouse, husband, or wife, 10.135

Spouse or registered domestic partner, 10.135A

Step transaction, 19.57

Substantial adverse interest, 2.18

Substantial modification of rights or restrictions agreement, 19.77

Taxable distribution (GST), 4.9

Taxable termination (GST), 4.12

Tax-exclusive and tax-inclusive tax base, 2.4, 4.6

Tax-sensitive trustee, 10.38, 10.99

Terminal illness, 6.36

Testamentary transfer, 2.48

Third party SNT, 13.3

Totten trust account, 12.15

Trust, 4.2

Underproductive property's ordinary expenses, 19.42

United States person, 3.70

Unrelated business taxable income, 18.34

Valuation freezing, 1.6, 2.3

Voting right, 2.30

Zeroed out GRAT, 15.5

Delaware Tax Trap, 4.39

Depletion of Asset. See Wasting Asset Transfers

Depreciation

Allocation of reserve, 19.19

Allowance from income, general property depreciation, 19.15

Assets subject to depletion, 19.109

Distribution of depreciated assets by trust or estate as sale or exchange, 3.18A

Farm or residence with remainder interest, 2.42

GRUT property, 16.2

Leaseback of settlor's transferred property, 19.59, 19.62-19.63

Rental property, 19.17

Reserve for depreciation, 19.110, 19.111

Tangible personal property, 19.32

Destruction of Property

Qualified personal residence trust (QPRT), provision covering destruction of personal residence, 17.85

Disabled Persons

See also **Incompetent Persons**

Beneficiary

Notification of *Crummey* withdrawal right, 12.83-12.84, 12.85

Trustee's distribution power, 10.105

Medi-Cal benefits. See **Medi-Cal and Medicaid**

Social Security disability, 13.16

Special needs trust

Generally. See **Special Needs Trust (SNT)**

Litigation. See **Litigation Special Needs Trust (LSNT)**

SSI benefits. See **Supplemental Security Income (SSI)**

Disclaimers

Beneficiary's disclaimers under federal and state law, 2.20, 9.68

Distribution of disclaimed property, 10.138

Multistate trusts interests, 20.60

Trustee's disclaimer of administrative powers, 10.91, 10.92

Disclosure

Taxable gift transfers, disclosure to IRS, 2.46A

Discounts

Blockage discounts

Generally, 2.23A

Defined, 2.23

Bonds. See **Bonds and Undertakings**

Dynasty trust, using valuation discounts to enhance value of, 13A.7

Joint tenancy asset, no fractional-share discount, 2.67

Minority-interest discount. See **Minority-Interest Discount**

Valuation of gifts

Generally, 2.23-2.24, 2.70-2.71

GRAT interest, 15.10

GRIT interest, 14.7

GRUT interest, 16.5, 16.7

Minors' IRC §2503(b) trust property, 12.65

Distributable Net Income (DNI)

Generally, 3.10

Capital gains, inclusion of DNI in, 3.12

Distributions

See also **Income and Principal**

Allocation. See **Allocation**

Annuity. See **Annuity**

Ascertainable standard limitation

Annuity trust principal, 9.42

Defined, 2.12

Grantor-trustee, 2.52

Income only sprinkling trust. See **Sprinkling Trust or Power**

Independent trustee, 2.19

Power to designate possession or enjoyment, 2.58, 2.60

Power to distribute income or principal, 2.59

Single trust with discretion to distribute principal, 9.20-9.22

Beneficiary-trustee power, 10.6, 10.25

Charitable lead annuity trust

Distributions for private purposes during life of charitable annuity, exceptions to general rule forbidding, 18A.20

Income tax deduction for charitable distributions, 18A.6

Other charities, effect of noncharitable remainder beneficiaries appointing distributions to other, 18A.27

Charitable remainder trust. See **Charitable Remainder Trust (CRT)**

Complex trusts, beneficiaries' tier taxation. See **Complex Trusts**

Conservatorship. See **Guardianship and Conservatorship**

Crummey withdrawal right. See ***Crummey* Trust or Withdrawal Power**

Custodianship. See **Custodianship**

Disabled beneficiary, trustee's power, 10.105

Drafting distribution provisions. See **Drafting Trusts**

Foreign trusts. See **Foreign Trusts**

Generation-skipping. See **Generation-Skipping Transfer (GST) Tax**

GRAT. See **Grantor Retained Annuity Trust (GRAT)**

GRIT. See **Grantor Retained Income Trust (GRIT)**

GRUT. See **Grantor Retained Unitrust (GRUT)**

Guidelines for exercising discretion, 9.63

Hybrid trust, 9.39-9.40

Methods, per capita and by representation, 10.130

Minors. See **Minors**

Multiple beneficiaries, 9.4

Multiple trusts, effect on distributions, 5.31

Perpetuities. See **Perpetuities**

Pooled income fund, 18.107, 18.115

Power of trustee

Beneficiary-trustee power, 10.6, 10.25

Broad powers and distribution, 10.107

Consider tax consequences, 10.95, 10.96

Cotrustee's power to distribute to self or other cotrustee, 9.53

Disabled beneficiary or minor, 10.105

GRIT, 14.22-14.25

Power of appointment not exercised, power of distribution if, 10.139

QSST distributions, trustee paying capital gains tax, 19.102

Termination of trust's relationship to distribution power, 2.59

Power of trustee on termination of trust

Delay distribution until resolution of claims or liability, 10.108, 10.109

GRIT, 14.25

Issues to consider, 10.106

Nonprorata distribution, standard clauses, 10.107

Preventing outright distributions to minors and others, 9.8, 9.47

QPRT. See **Qualified Personal Residence Trust (QPRT)**

QSST distributions

Generally, 19.99, 19.101, 19.102A

Trustee's power to pay capital gains tax, 19.102

Qualified domestic trust (QDOT), 2.81, 2.81F

Redeemed stock to pay estate tax, 2.91

Reimbursement trust clause issues, 14.8

Remainders, 9.46

Retirement plans, 19.117

Self-dealing. See **Self-Dealing**

Settlor's uncontrolled power, 5.15

Single trust with discretion to distribute principal. See **Single Trust With Discretion To Distribute Principal**

Special needs trust. See **Special Needs Trust (SNT)**

Special trustee distributions to beneficiary-trustee, 9.36, 9.37, 10.25, 10.26

Spendthrift. See **Spendthrift Trust**

Sprinkling trust. See **Sprinkling Trust or Power**

Stock

Publicly traded, 19.25

QSST, 19.99, 19.101, 19.102

Support obligations. See **Support and Maintenance**

Survivorship prerequisite, 2.66, 2.77, 9.2, 9.46

Termination of small trust, 9.6, 9.7

Termination of trust, power of trustee (see Power of trustee on termination of trust, above)

Termination of trust, settlor's or surviving spouse's death

Generally, 9.1

Minor beneficiaries, 9.4

Multiple beneficiaries, 9.3

Outright distribution to multiple beneficiaries, settlor's or surviving settlor's death, 9.5

Outright distribution to one adult beneficiary, settlor's or surviving settlor's death, 9.5

Survivorship requirement, 9.2

Third party special needs trust, distribution provisions for. See **Special Needs Trust (SNT)**

Unitrust, 9.43

Valuation issues. See **Valuation**

Dividends

Allocating stock dividends, 10.114, 19.26

Domestic Partners

Child of domestic partnership, presumptions regarding, 10.133A-10.133B

Defined, 10.135A

Domicile

Multistate trusts, death taxes, 20.78

Personal property rights, 20.12, 20.21

Residence. See **Residence**

Drafting Trusts

Generally, 10.127

Acknowledgment, purpose and clause, 8.11, 8.12

Declaration of trust or trust agreement clauses

Generally, 8.1

Declaration of trust, nonsettlor as trustee, 8.3

Declaration of trust, settlor as trustee, 8.3

Signature, 8.9

Transfer document, 8.4

Trust agreement, 8.2

Distribution clauses

Annual distributions of income, 10.137

Appointment power not exercised or beneficiary has lifetime power, distribution power if, 10.139

By representation, 10.130

Per capita, 10.130

Distribution of disclaimed property, 10.138

Dynasty trusts. See **Dynasty Generation-Skipping Trust**

Education defined, 10.132

Gender and number, 10.128

Governing law. See **Governing Law**

Irrevocability, 8.6, 8.7

Issue and children definition clauses

Generally, 10.133

Conclusive marital presumption for children of spouses or registered domestic partners, 10.133B

Issue and children, applicability of California intestate succession laws, 10.134

Issue and children, lineal descendents, 10.134A

Natural parent-child relationship under Uniform Parentage Act, 10.133A

Name of trust. See **Name of Trust**

No-contest clause, 10.136

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Shall and may terminology, 10.131

Signature clause

Agreement of trust, 8.8

Declaration of trust, 8.9

Spouse, husband, or wife, 10.135

Spouse or registered domestic partner, 10.135A

Spouse's consent to transfer, 8.10

Structuring trust instrument

Generally, 7.1

Comparison to revocable trusts, 7.5, 8.6

Declaration versus agreement format, 8.1

Drafting suggestions, 7.2, 8.6

Outline organization, 7.8

Required formalities, 7.3

Sensitive powers consideration, 7.6

State trust law, generally, 7.7

Tax-mandated clauses consideration, 7.4

Trustees and fiduciaries, 10.129

Duress. See Undue Influence

Duty of Trustee. See Trustees

Dynasty Generation-Skipping Trust

Generally, 13A.1

Advantages of dynasty trust over GRAT or qualified personal residence trust, 13A.2

Deed of trust with assignment of rents, 13A.20

Division of dynasty trust into separate trusts after death of settlor, 13A.4

Drafting considerations

Discretionary accumulation trust, drafting dynasty trust as, 13A.3

Intentionally defective grantor trust, advantages of drafting dynasty trust as, 13A.6

Generation-skipping dynasty trust, 13A.15

Generation-skipping transfer exemption, effect of allocating to trust, 13A.2

Installment promissory note

Secured installment promissory note, 13A.17

Unsecured installment promissory note, 13A.16

Installment sale to dynasty trust, example of, 13A.13

Leveraging trust to enhance value of trust

Generally, 13A.8

Annual exclusion gifts of remaining LLC units to issue, 13A.11

Death of settlor, grantor trust status ending on, 13A.12

Examples of leverage intentionally defective grantor GST-exempt dynasty trust, 13A.9-13A.12

Income tax treatment of trust, 13A.10

Private annuity alternative to promissory note, 13A.14

Promissory notes

Installment promissory note (see Installment promissory note, above)

Private annuity as alternative to, 13A.14

Secured annually renewable demand promissory note, 13A.18

Rule against perpetuities, effect on dynasty trusts, 13A.5

Sample of generation-skipping dynasty trust, App N

Security agreement for limited liability company units, 13A.19

Valuation of trust

Discounts, using to enhance value of trust, 13A.7

Leveraging trust (see Leveraging trust to enhance value of trust, above)

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001), 18.11A

Education Expenses

Coverdell education savings accounts, 12.37B

Defined, 10.132

Direct payments under IRC §2503(e), 12.14

Gift and estate tax exclusion, 2.38

GST tax considerations, 4.14, 4.38

Parental support obligation, 5.21

Qualifying tuition programs, special tax treatment for gifts to, 12.37A

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

Elderly Persons

Medi-Cal and Medicaid benefits. See **Medi-Cal and Medicaid**

Special needs trust. See **Special Needs Trust (SNT)**

SSI benefits. See **Supplemental Security Income (SSI)**

Electing Small Business Trust (ESBT)

General and special rules, 3.64, 3.67

Late election, relief from, 3.65

Qualification requirements, 3.65

S corporation stock (QSSTs), 3.57, 3.66, 14.8, 15.11, 19.102A

Elections

Beneficiary-trustee distribution power, 10.6

Court supervised custodianship, 12.32

ESBT. See **Electing Small Business Trust (ESBT)**

Foreign trusts, election to be treated as domestic trust, 3.68

GRIT real property transfer, 14.11

Income-only unitrust, 18.60

QSST status, 3.61, 19.99

Spousal election

QDOT, 2.83

QTIP, 2.79, 4.4, 18.123

Split-gift, 2.43, 4.4

Trustee's power to adjust for tax consequences, 10.93, 10.94

Employee Stock Ownership Plan (ESOPs)

Power to control beneficial enjoyment of corpus or income irrevocably payable to ESOP, effect of, 9.38D

Employment of Managers and Agents. See Management of Trust Property

Encumbered Property

Allocation, UPAIA considerations, 10.110

Charitable remainder trust interest, 18.14

Foreclosure. See **Foreclosure**

Interest payments

Allocation, 19.51, 19.52

Settlor's obligation, 19.50

Tax implications (see Tax implications of transfer and payments, below)

Mortgages and trust deeds. See **Mortgages and Trust Deeds**

Power of trustee to encumber property, 10.67, 10.68, 19.56

Settlor's obligations. See **Settlor**

Tax implications of transfer and payments

Capital gains tax, 19.55

Estate tax, 19.57

Gift tax, 19.55-19.56

Income tax, 19.53-19.55

Settlor's leaseback transaction, 19.61-19.62

Tax liens

Federal estate tax installment payments, 2.89

Federal gift tax, 2.31

Trustee's power, 19.4, 19.5

Environmental Protection

Authorizing trustee to monitor property and comply with laws, 19.21

Liability of fiduciary, 19.20

Special trustee's powers and acceptance of property, 19.22

Equitable Conversion

Reinvesting real property sale proceeds, 20.11, 20.20

ESBT. See Electing Small Business Trust (ESBT)

Estate Planning

Charitable remainder trust, 18.11, 18.37-18.39, 18.44

Computer software for valuation purposes. See **Computers and Computer Software**

Construction and interpretation. See **Construction and Interpretation**

Drafting trust provisions. See **Drafting Trusts**

Gifts in contemplation of death

Generally, 2.4, 2.64

Transfers within 3 years. See **Transfers Within 3 Years of Death**

GRATs, 15.17

GRITs, 14.12, 14.14

GRUTs, 16.12, 16.14

Life insurance selection. See **Life Insurance Trust**

Minors, common planning devices, 12.1

Objectives in creating irrevocable trusts

Generally, 1.4

Asset protection, 1.8

Obtaining tax savings, 1.6-1.7

Reconciling beneficiary needs with management concerns, 1.5

Overview of trust planning, 1.1

Prudent investor rule, 10.59

QPRTs. See **Qualified Personal Residence Trust (QPRT)**

Relationship between revocable and irrevocable trusts, 1.3

Structuring trust document. See **Drafting Trusts**

Types of irrevocable trusts, 1.2

Estate Tax

General drafting considerations, 1.6, 2.1, 7.6

Accumulation trust, 9.34

Allocating income and principal, 10.110

Annuity or annuity trust, 2.55, 2.66

Beneficiaries, 5.5

Beneficiary-trustee

Generally, 9.52

Administrative powers, 10.6

Distributions by special trustee, 10.25

Charitable lead annuity trust. See **Charitable Lead Annuity Trust (CLAT)**

Charitable remainder trust, 2.74, 18.6, 18.21-18.23, 18.66

Community property

Character of decedent's interest in trust property, effect on taxation, 20.81

Gifts by agent under power of attorney, inclusion in decedent's estate, 2.34

Minority-interest discounting for estate tax purposes, 2.70

Relinquishment of vested interest, effect on estate tax, 2.68

Computing estate tax

Charitable deduction. See **Charitable Remainder Trust (CRT)**

Credits (see Credits, below)

Deductions to arrive at adjusted gross estate, 2.73

Exclusion to extent of consideration furnished, 2.68

Gross estate determinations, generally, 2.47

Illustrative computation, 2.7

Medical expenses and tuition exclusion, 2.38

Procedure, 2.6

Valuation. See **Valuation**

Creditors, transferred property available to, 2.51

Credits

Calculation of tax credit applicable to each exclusion amount, table, 2.6

Funding spousal credit shelter with wasting asset, 19.109

Gift taxes paid, 2.67, 2.85

Prior transfer property (PTP), 2.82, 2.86

State death taxes, 2.84

Dynasty trust's exemption from, 13A.1

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001), estate tax repeal under, 18.11A

Education expenses, estate tax exclusion, 2.38

Encumbered property

Tax liens, installment payments, 2.89

Transfers and payments, 19.57

Estate tax inclusion period (ETIP)

Crummey power, 12.88, 12.96

Life insurance trust making GSTs, 11.16

Rule explained, 4.29, 4.41

Executor-trustee fees, 10.50

Extension or deferral, 2.82, 2.88-2.90

Grantor trusts included in decedent's estate, 3.1

GRATs, 15.4, 15.13, 15.15-15.15A

GRITs, 14.12, 14.15

GRUTs, 16.12

GST exemption allocation, 4.25-4.27, 4.29, 4.41, 11.16

Hybrid trust, 9.40

Joint tenancy property, 2.67-2.68, 12.17

Lapsed power of appointment, 2.65

Life insurance, generally, 2.47, 2.61, 2.63, 2.67

Life insurance trust, 11.3, 11.7, 11.9-11.9B

Litigation special needs trust, estate tax consequences of funding and terminating, 13.37

Marital deduction. See **Marital Deduction**

Marital right relinquishment, 2.68

Medical expenses, estate tax exclusion, 2.38

Minority-interest discount, 2.70-2.71

Minors

Generally, 12.3-12.4, 12.12, 12.22

Crummey trust or withdrawal power, 12.105-12.106

Custodianship gifts, 12.32-12.33

Incentive trust, 12.115

IRC §2503(b) trust, 12.73

IRC §2503(c) trust, minor's death, 12.44-12.48

IRC §2503(c) trust, settlor's or beneficiary's death, 12.50-12.54

Multistate trusts. See **Multistate Trusts**

Noncitizen surviving spouse. See **Citizenship**

Payment

General rule, 2.87, 11.3

Advantages and disadvantages of gift, 2.45-2.46

Charitable remainder trust prohibition, 18.84, 18.85

Extension or installment (see Payment extension or installment, below)

Life insurance trust liability, 11.7

Standard and source of payment, 2.3-2.4

Stock redemption to pay taxes, 2.91

Trustee's authority, 10.97

Valuation issues. See **Valuation**

Payment extension or installment

Closely held business interest, 2.89

Reasonable cause basis, 2.88

Vested remainder interest, 2.90

Permanent trust

Beneficiaries' estate tax, 5.5

Settlors' estate tax, 5.4, 5.9

Pick-up tax, 20.80

Pipe dream trust, estate tax principles, 5.15-5.16

Pooled income fund (PIF), 2.74

Power of appointment, 9.56

Power of trustee

Buy from settlor's probate estate, 10.88, 10.90

Lend to probate estate, 10.88, 10.89

Retained rights, 2.59

Substitute decedent's own assets for trust property and insurance policies, 2.61

Pre-1977 gifts, 2.2

Prior transfer property (PTP), 2.82, 2.86

Qualified domestic trust (QDOT), 2.75, 2.80-2.81

Qualified personal residence trust (QPRT). See **Qualified Personal Residence Trust (QPRT)**

Qualified terminable interest trust, 2.79, 4.31

Removal of trustee, tax consequences, 2.62

Repeal of, 2.4, 18.11A

Retained enjoyment or control of property

Generally, 2.48, 2.61, 5.15, 5.24, 5.28, 10.4

Discretionary control over transferred property or trustee, 2.62

Life estate. See **Life Estates**

Reciprocal trust doctrine, 11.5

Reversionary interest, 2.16, 2.57, 9.61

Right to alter, revoke, or terminate transferred interest, 2.59-2.60

Right to designate person to possess or enjoy property, 2.58, 2.60

Voting rights, 2.56

Reversionary interests, 2.16, 2.57, 9.46, 9.61

Separate trust for each minor beneficiary, 9.28-9.29

Settlor-trustee's administrative powers, 10.4

Single trust with discretion to distribute principal, 9.22

Spendthrift trust, 2.51, 9.66

Spousal property gifts or transfers, 2.18, 2.67-2.68, 12.51

Sprinkling trust or power, 9.10, 9.12, 9.18

Stock redemption or dividends to pay estate tax, 2.91

Support and maintenance, 2.53, 5.24

Survivorship clause's tax effect, 9.46

Terminable interests, 2.75-2.79

Time issues. See **Time**

Transfers within 3 years of death. See **Transfers Within 3 Years of Death**

Underproductive property, 19.47, 19.48

Unitrust, 9.45

Valuation concerns. See **Valuation**

Wasting assets, 19.109

ETIP (Estate Tax Inclusion Period). See Estate Tax

Evidence

See also **Burden of Proof**

Presumptions and inferences. See **Presumptions and Inferences**

Reasonable cause for extension on estate tax payments, 2.88

Statute of Frauds, 19.2

Excise Tax

Charitable remainder trust prohibited transactions, 18.36

Foreign trusts, 3.71

Self-dealing between disqualified person and private foundation, excise tax on acts of, 18.36A

Exoneration or Exculpation of Trustee. See Trustees

Expenses and Expenditures

Allocation of expenses. See **Allocation**

Assuring nonacceleration of transferred property's debt, 19.50

Business enterprise expenses, 19.90, 19.91

Decedent's estate expenses

Deductions to arrive at adjusted gross estate, 2.73

Insurance trust proceeds paying, 11.3

Education. See **Education Expenses**

Encumbrances on transferred property, payments. See **Encumbered Property**

Life insurance

Lapse rates, 11.26

Overhead and management, 11.28

Premiums. See **Life Insurance**

Renewable term insurance, extra cost, 11.30

Variable whole life insurance, extra cost, 11.41

Medical expenses payments, gift and estate tax exclusion, 2.38

Minor's estate, 12.45

Premiums. See **Premiums**

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Reimbursement. See **Reimbursement**

Rental property expenditures, 19.17, 19.18, 19.59

Salaries and compensation. See **Salaries and Compensation**

Third party special needs trust's expenses, payment of, 13.50

Underproductive property expenses, 19.40, 19.41-19.42

Uniform Principal and Income Act (UPAIA), allocation of expenses between income and principal under, 10.115

Wasting asset

Allocating receipts, 19.110

Establishment of reserve account, 19.111

Fair Market Value. See Marketability

Family Businesses. See Closely Held Businesses

Family Limited Partnerships. See Limited Partnerships

Family Pot Trust

Defined, 19.99

Sample trust with independent trustee, App A

Farms and Ranches

Annual exclusion, present-interest requirement for, 2.35

Charitable deduction, estate tax, 2.74

Charitable remainder interest, 2.42, 18.123

Extension of time to pay estate taxes owed, 2.89

Retained leasehold interest, estate property, 2.50

Special use valuation

Decedent's estate, 2.72

Gift, disadvantages of, 2.46

Transfers within 3 years of death, 2.64, 2.72

Fees

See also **Salaries and Compensation**

Executor-trustee fees, 10.50

IRS's failure to concede reasonable discount for community property interest as grounds for attorney fee award to estate, 2.70

Trust investment adviser fees has miscellaneous itemized deductions, 3.5

Fiduciary Relationship

Allocating economic benefits of trust, 19.16

Corporate fiduciary as independent trustee, 10.8

Distribution to beneficiary, fiduciary accounting income as first tier of, 3.18A

Insured holding incidents of ownership, 11.6

Obligation to carry insurance, 10.86

Self-dealing. See **Self-Dealing**

Trustees. See **Trustees**

Voting rights in controlled corporation, 19.103

First Party SNTs. See Special Needs Trust (SNT)

Foreclosure

Allocation of proceeds on disposition of property acquired by foreclosure, 19.72, 19.73

Trustee's power, generally, 19.70, 19.71

Foreign Trusts

See also **Citizenship**

Generally, 3.68

Annual reporting requirements

Generally, 3.69A

Appointment of United States agent, 3.69B

Owner reporting requirements, 3.69C

Automatic migration rule, 3.68C, 3.68F

Control test

Generally, 3.68D

Automatic migration rule, 3.68F

12-month grace period after inadvertent change in trust residence, 3.68E

Court test

Generally, 3.68A

Automatic migration rule, 3.68C

Safe harbor for court test, 3.68B

Creditor's claims, protection against, 1.8

Nonconformance to IRC §679, 3.2

Reporting requirements

Generally, 3.69, 3.69D

Annual reporting requirements (see Annual reporting requirements, above)

Gratuitous transfer, 3.69F

Penalties for failure to comply with reporting requirements, 3.69, 3.69H

Reportable event, 3.69E

Responsible party, 3.69G

Situs of trust, tests for determining

Control test (see Control test, above)

Court test (see Court test, above)

Special grantor-trust rules, 3.70

Taxation

Avoidance or deferral, 3.74

Beneficiaries, 3.73

Excise tax, 3.71

Gain on transfers of appreciated property to foreign trusts, importance of donor's citizenship status as time of formation to, 3.75

Income tax, 3.69

When not taxed as grantor trust, 3.72

Time considerations. See **Time**

Fraud and Misrepresentation

QPRT, fraudulent transfers involving. See **Qualified Personal Residence Trust (QPRT)**

Removal of trustee, grounds, 10.9

Securities insider trading

Rule 10b-5, 19.106

Section 16, 19.107

Transfer without consideration as fraudulent, 1.8

Trustee choice by client, attorney's confirmation that fraud not prompting, 10.31A

Future Interests

Encumbered property transfers, 19.56

Gains and Losses

Accelerated charitable trust's sale of assets without incurring capital gains tax, 18.9B

Appreciated assets contributed to trust as deemed sale resulting in capital gains, 18.31

Boot factor, 19.64

Business enterprise allocations. See **Operation of Business**

Charitable remainder trust property, 18.13

Community property life insurance policy transfer, 11.4

Decedent's stock, 2.91

Distributable net income (DNI), inclusion of capital gains in, 3.12

Donee paying donor's gift tax liability, 2.32

Encumbered property transfers, 19.55

Foreign trust, recognition of gain on transfer of appreciated property, 3.75

GRAT, 15.11

GRIT, 14.3, 14.8

Inadequate consideration exchanged for gift, 2.33

Life insurance trust sale of policy, 11.12

Nonrecognition of capital loss, 19.65

Part gift-part sale transaction, 19.55

Pooled income fund, 18.107

QSST issues, 3.59, 19.101, 19.102

Real property

Allocation of taxes and assessments, 19.15, 19.16

Sale, exchange, or transfer, 19.11, 19.12, 19.13, 19.14

Sale of property to or from trust

Allocation of income and principal, 19.11, 19.12

Settlor's leaseback property. See **Rent**

S corporation shareholder, 19.97

Short term and long term capital gains, deemed distribution of, 3.47

Specialized investments, 19.31

Underproductive property sale proceeds, 19.37, 19.38-19.39

Generation-Skipping Transfer (GST) Tax

Generally, 4.2, 5.6-5.7, 9.60, 12.6

Allocation of exemption

Charitable lead annuity trusts' rules, 4.28

Deemed allocation, lifetime transfer to GST trust as, 4.26A

Estate tax inclusion period (ETIP) rule, 4.29, 4.41, 11.16

Life insurance trust. See **Life Insurance Trust**

Lifetime direct skips, procedure, 4.22

Need for action, 4.21

Other than direct skips, timely and late allocation procedure, 4.23-4.27

Relief for taxpayer for failure to attach notice of allocation to gift tax return, 4.23

Responsibility for allocating exemption, 4.42

Retroactive allocation to lifetime transfer, 4.26B

Using late or wait-and-see allocation strategy, 4.25, 4.40

Charitable lead annuity trust. See **Charitable Lead Annuity Trust (CLAT)**

Charitable remainder trust, 18.84

Computation rate and methods, 4.6, 4.18, 4.22, 4.30

Cost of living adjustments for post-1998 gifts, 4.1

Crummey withdrawal power

Generally, 4.1, 4.10

Allocating exemption to direct skips, 4.22

Avoiding ETIP creation, 4.41

Lapsed power, 4.4, 12.89

Life insurance trust, 11.11

Minors' trust, 12.108-12.109

Transfer to trust versus powerholder, 4.8

Custodial property, 12.34

Dangers for trust drafters

Generally, 4.1

Strategies for overcoming (see Strategies for overcoming dangers, below)

Direct skips, 4.6, 4.8, 4.22, 4.31

Distributions or terminations, 4.6, 4.9-4.12, 4.23, 4.32

Drafting considerations, 1.6, 7.6

Dynasty trust. See **Dynasty Generation-Skipping Trust**

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001), repeal of GST under, 18.11A

Exclusions

Limited annual exclusion, 4.15, 4.22

Tuition or medical expenses, 4.14, 4.38

Exemption

Allocation (see Allocation of exemption, above)

Amount of exemption, 4.17

Determining responsibility for allocating GST exemption, 4.42

Division of trust into multiple trusts, effect of, 4.20

Inclusion ratio concept, 4.18, 4.25, 4.29-4.30, 13A.2

Making trusts fully exempt or nonexempt, 4.35

Number of trusts determination, 4.20

Relevance and number of transferors, 4.19

Remainder beneficiary trust, parent allocating exemption to, 17.57

Generation assignments, 4.5

Life insurance trust. See **Life Insurance Trust**

Minors, gifts to

Crummey trust, 12.108-12.109

Custodianship, 12.34

Incentive trust, 12.116

IRC §2503(b) trust, 12.75

IRC §2503(c) trust, 12.55

Multiple skips or trusts

Generally, 4.1, 4.13, 4.15, 4.20, 4.34

Sample multiple vested interest trusts for skip persons (sensitive trustee permitted), App C

Payments (see Returns and payments, below)

Permanent trust tax purposes, 5.5-5.7

Power of appointment, 9.60

Predeceased ancestor rule, 4.16

Purpose, 4.3, 4.13

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Recalculation of inclusion ratio, 4.30

Reformation of trust due to scrivener error, 4.15

Remainder interest distribution, 9.46

Repeal of, 4.3, 18.11A

Returns and payments

Charitable remainder trust prohibition, 18.84, 18.85

Direct skips, 4.22, 4.31

Estate and gift tax payments in lieu of GST, 4.39

GST exemption, 4.21, 4.23-4.27

Taxable distributions and terminations, 4.11, 4.32

Trustee's responsibility, 10.98

Separate trust for each minor beneficiary, 9.29, 9.30A

Single trust with discretion to distribute principal, 9.24A

Sprinkling trust considerations, 9.8-9.9, 9.14A, 9.18

Strategies for overcoming dangers

Avoiding creation of ETIPs, 4.41

Determining responsibility for allocating GST exemption, 4.42

Layering nonexempt trusts, 4.37

Making trusts fully exempt or nonexempt, 4.35

Maximizing benefits of exempt trusts, 4.36

Maximizing use of annual exclusion, 4.34

Paying estate or gift tax instead of GST tax, 4.39

Paying medical expenses and tuition from nonexempt trusts, 4.38

Using late or wait-and-see allocation strategy, 4.25, 4.40

Tax rates for GST tax, 4.39

Transferor

Identification, 4.4

Relevance and number, 4.19

Unified credit, 4.1, 4.21

Gifts and Gift Tax

General drafting considerations, 1.6, 7.6

Accumulation trust, gift tax, 9.34

Advantages and disadvantages of giving, 2.45-2.46

Annual exclusion

Generally, 1.6, 2.34

Charitable lead annuity trust, no exclusion for gifts to remaindermen, 18A.8, 18A.17

Crummey powers. See ***Crummey* Trust or Withdrawal Power**

Dynasty trust, annual exclusion gifts of remaining LLC units to issue through use of, 13A.11

GST tax or exemption, 4.1, 4.15, 4.22, 4.34, 11.17

Minors' custodial property, 12.31

Minors, gifts to, 2.37, 12.3, 12.19

Minor's incentive trust, 12.114

Minors' trust, income only interests. See **Minors' Trust, IRC §2503(b)**

Minors' trust, IRC §2503(c) property, 12.42, 12.49

Noncitizen spousal gifts, 2.39

Present-interest requirement, 2.35

Qualified personal residence trust. See **Qualified Personal Residence Trust (QPRT)**

Qualified tuition programs, annual exclusion for gifts to, 12.37A

Reciprocal trust doctrine, disallowance of annual exclusion for gifts by multiple settlors to related beneficiaries under, 2.37A

Sprinkling trust gift, 9.13

Tax-sensitive trustee, 10.11

Annuity remainder interests, gift tax, 2.55

Beneficiary-trustee, gift tax considerations, 9.52

Charitable gifts. See **Charitable Gifts and Deduction**

Charitable lead trust, gift tax deduction for nongrantor, 18A.28

Complete versus incomplete transfers

Generally, 2.15, 12.11

Crummey withdrawal right. See ***Crummey* Trust or Withdrawal Power**

GRAT reimbursement clause's effect, 15.11

GRUT reimbursement clause's effect, 16.8

Noncharitable gift, completion of, 2.34

Power exercisable with third party, 2.18

Power held by trustee, 2.19

Power over disposition of transferred property, 2.16, 5.16

Sprinkling trust, 9.13

Subsequent incompetence of donor, 2.17

Trust, completion of transfer to, 2.8

Computing gift tax

Below-market ratio or interest-free loans, 2.10, 10.81

Illustrative computation, 2.7

Procedure, 2.5

Rates, 2.5

Valuation issues. See **Valuation**

Consideration for gift, tax consequences, 2.8, 2.33

Credits

Gift taxes paid, 2.67, 2.85

Unified credit. See **Tax Credit**

Crummey trust or withdrawal power, 12.101-12.104, 12.109

Deductions

Charitable deductions. See **Charitable Gifts and Deduction**

Marital deduction. See **Marital Deduction**

Definition of gift, 2.8

Depreciation of farm or residence during life estate or term of years, 2.42

Disclosure to IRS of taxable gift transfers, 2.46A

Encumbered property transfers, 19.55-19.57

Exclusions

Annual (see Annual exclusion, above)

Direct payments of tuition and medical expenses, 2.38

GRAT real property transfer, 15.14

GRIT real property transfer, 14.11

GRUT real property transfer, 16.11

Life insurance trust, 11.11

Lifetime gift tax exclusion, 12.114

Exemptions

Dynasty trust's exemption from gift taxes, 13A.1

GST tax or exemption, 4.1, 4.15, 4.22, 4.34, 11.17

Lifetime gift exemption, legislation limiting, 2.1

Future interests. See **Future Interests**

Gains and losses. See **Gains and Losses**

Generation-skipping. See **Generation-Skipping Transfer (GST) Tax**

Historical perspective of gifts made in contemplation of death, 2.4

Hybrid trust, 9.40

Income tax payment, 11.13

Indirect transfers, 2.9

Installment payments, 19.63

Joint interests. See **Joint Tenancy or Interest**

Leaseback property and payments, settlor's sale or transfer. See **Rent**

Life insurance policy transferred to trust, gift tax value and exclusion, 11.10-11.11, 11.13

Litigation special needs trust, gift tax consequences of funding and terminating, 13.37

Marital deduction. See **Marital Deduction**

Medi-Cal transfer rules disqualifying individuals for making gifts of assets to qualify for benefits, 13.15

Minors. See **Minors**

Multistate trusts property. See **Multistate Trusts**

Part gift-part sale transaction, 2.32-2.33, 19.55, 19.62

Partial property interest, 2.14

Payable on death (POD) or Totten trust accounts, 12.15-12.16

Payment of gift tax

Charitable remainder trust prohibition, 18.84, 18.85

Consideration paid in exchange for transfer, 2.33

Discharging support obligations, 5.25

Donee liability as condition of receiving gift, 2.32

Donor primarily liable, 2.31

Time, 2.46

Permanent trust tax purposes, 5.4-5.5

Personal residence gifted to trust. See **Personal Residence Trust (PRT); Qualified Personal Residence Trust (QPRT)**

Pipe dream trust, gift tax principles, 5.16

Pooled income fund. See **Pooled Income Fund (PIF)**

Powers of appointment. See **Powers of Appointment**

Pre-1977 gifts, 2.2

Presumption of gift, intrafamily transfers resulting in, 2.8

Purpose and scope of gift tax, generally, 2.1, 2.8

QPRT property. See **Qualified Personal Residence Trust (QPRT)**

Remainder interests. See **Remainder Interests**

Retained interests. See **Retained Interests**

Return

Qualified personal residence trust (QPRT), filing federal gift tax return after establishing, 17.23, 17.33

Split-gift, filing of return for, 2.43

Reversionary interests. See **Reversionary Interests**

Self-canceling installment note (SCIN), rebutting presumption of gift in case of sale of property to son in exchange for, 2.8

Separate trust for each minor beneficiary, 9.28-9.29

Settlor's leaseback of property sold to trust. See **Rent**

Single trust with discretion to distribute principal, 9.23

Spendthrift trust, 9.66

Spousal gift. See **Spouses**

Sprinkling trust, 9.13, 9.18

Standard and source of tax payment, 2.3-2.4

Substantial adverse interest to donor's joint interest, 2.18

Supplemental Security Income (SSI) transfer rules disqualifying individuals for making gifts of assets to qualify for benefits, 13.12, 13.18

Underproductive property. See **Underproductive Property**

Uniform Transfers to Minors Act gifts. See **Custodianship**

Unitrust, 9.45

Valuation issues. See **Valuation**

Wasting or depleted assets, 19.109

Whether to make gifts

General factors for consideration, 2.44

Advantages of gift, 2.45

Disadvantages of giving, 2.46

Within 3 years of death. See **Transfers Within 3 Years of Death**

Gifts and Gift Taxes

Qualified personal residence trust. See **Qualified Personal Residence Trust (QPRT)**

Good Faith

Settlor's leaseback of transferred property, payment to third party, 19.60

Statute of frauds, 19.2

Governing Law

Charitable remainder trust

Generally, 18.88

Recipients' income taxation, 18.31

GRAT clause, 15.35

GRIT clause, 14.28

GRUT clause, 16.33

Multistate trusts. See **Multistate Trusts**

Government Benefits. See Public Benefits

Grandchildren. See Minors

Grantor Retained Annuity Trust (GRAT)

See also **Retained Interests**

Generally, 1.2, 15.7

Alternatives to, 3.24

Amendment to conform existing GRAT to *Walton*, in effectiveness of, 15.6

Amount of annuity

Expression of amount, consequences, 15.3

Fixed annuity, 15.26

Varying annuity, 15.26

Assets, 15.8, 15.21, 15.37

Benefits, 15.2

Client memorandum, 15.38

Defined, 6.2, 15.1

Distributions

Amount (see Amount of annuity, above)

Commutation prohibited, 15.30

Expiration of term, 15.31

Income distributions, 15.28

Income limitations, 15.29

Introductory clause, 15.24

Payment for each taxable year, 15.25

Payment for each year of trust, 15.25

Short taxable year, 15.27

Termination, 15.32

Drafting considerations

Generally, 15.18

Determining when to use GRAT, 15.17

Required provisions, 15.7, 15.9

Selecting trust term, 15.4

Dynasty trust's advantages over, 13A.2

Fractional interests, 15.10

Loan by settlor to GRAT, 15.11

Objectives and design, 15.1

Provisions

Amount of annuity, 16.23

Declaration of transfer to trustee, 15.19

Distributions (see Distributions, above)

Governing law, 15.35

Irrevocability of trust, 15.22

Name of trust, 15.20

Property of trust, generally and description, 15.21, 15.37

Statement of settlor's intent, 15.36

Term of trust, 15.23

Trustee (see Trustee, below)

QPRT conversion to GRAT. See **Qualified Personal Residence Trust (QPRT)**

Sample, App L

S corporation shareholder, 19.97

Spousal interests, 15.12

Tax considerations

Death of settlor, effect of, 15.15A

Estate tax, 3.24, 15.13, 15.15-15.15A

Estate Tax Inclusion Period (ETIP) and Generation Skipping Tax (GST), conflict between through abuse of GRAT, 4.29

Income tax, 15.11

Real property tax, 15.14

Repurchase/exchange strategy for obtaining new basis, 15.13

Sale to grantor trust versus GRAT, 3.44C

Spousal interests, 15.12

Term of trust

Commutation, 15.9

Distribution on expiration of term, 15.31

ETIP problem for GRATs, 15.6B

Rolling GRATs, 15.6A

Sale of GRAT remainder interest, 15.6C

Selection considerations, 15.4

Settlor's failure to survive term of GRAT, inclusion of entire value of GRAT in settlor's estate, 15.4

Walton GRATs, 15.6

Zeroed out GRAT, 15.5

Trustee

Appointment, 15.33

Limits on trustee's powers to satisfy annuity obligation, 15.8

Powers, 15.34

Valuation issues. See **Valuation**

Grantor Retained Income Trust (GRIT)

See also **Retained Interests**

Generally, 1.2

Advantages, 14.2-14.3

Basis, 14.8, 14.10

Description, 14.29

Fractional interests, 14.7

Spousal interests, 14.9

Valuation. See **Valuation**

Assets, Generally, 14.6, 14.18

Common law GRIT defined, 17.7

Defined, 6.2, 17.7

Determining when to use GRIT, 14.12, 14.14

Distributions

Limitation, 14.22

Settlor fails to survive term, 14.24

Settlor survives term, 14.23

Termination of trust, 14.25

Drafting considerations, 14.4, 14.15

Governing statute and QPRT regulations, 17.2

Lack of statutory requirements, 14.5

Objectives, 14.1

Provisions

Declaration of transfer to trustee, 14.16

Distribution (see Distributions, above)

Governing law, 14.28

Irrevocability of trust, 14.19

Name of trust, 14.17

Property of trust, 14.18, 14.29

Term of trust (see Term of trust, below)

Trustee (see Trustee, below)

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Qualified personal residence trust. See **Qualified Personal Residence Trust (QPRT)**

Tax treatment

Estate tax, 14.12, 14.15

Income tax, 14.8

Obtaining new basis, strategy, 14.10

Real property tax, 14.11

Spousal interest, 14.9

Term of trust, tax consequences, 14.4

Term of trust

Generally, 14.20

Operation during, 14.21

Selection, 14.4

Trustee

Appointment, 14.26

Powers, 14.27

Grantor Retained Life Estate. See Life Estates

Grantor Retained Unitrust (GRUT)

See also **Retained Interests**

Generally, 1.2, 16.4

Amount of unitrust, 16.23

Assets, 16.5

Benefits, 16.2

Defined, 6.2

Determining when to use GRUT, 16.4, 16.14

Distributions

General requirements, 16.6

Commutation period, 16.28

Correcting distributions, 16.24

During trust term, 16.21-16.26

Expiration of trust term, 16.29

Income distribution, 16.8, 16.26-16.27

Introductory clause, 16.21

Limitation on distributions, 16.27

Payment for each taxable year, 16.22

Payment for each year of trust, 16.22

Short taxable year, 16.25

Termination of trust, 16.30

Drafting considerations

Generally, 16.15

Required governing instrument provisions, 16.6

Fractional interests, 16.7

Loans to GRUT

Settlor, loan by, 16.8

Trustee prohibited from making, 16.5

Objectives and design, 16.1

Property of trust

Generally, 16.18

Description, 16.35

Irrevocability, 16.19

Provisions

Amount (see Amount of unitrust, above)

Declaration of transfer to trustee, 16.16

Distribution (see Distributions, above)

Governing law, 16.33

Name of trust, 16.17

Property of trust (see Property of trust, above)

Statement of settlor's intent, 16.34

Term of trust (see Term of trust, below)

Trustees (see Trustees, below)

Tax considerations

Estate tax, 16.12

Income tax issues, 16.8

Real property tax, 16.11

Repurchase/exchange strategy for obtaining new basis, 16.10

Spousal interests, 16.9

Term of trust

Basic clause, 16.20

Expiration, 16.15, 16.29

Length of term, 16.6

Selecting term, 16.3

Trustees

Generally, 16.31

Loan to GRUT, trustee prohibited from making, 16.5

Powers, 16.32

Valuation issues. See **Valuation**

Grantor Trusts

See also **Nongrantor Trust**

Achieving grantor trust powers

Generally, 5.9

Power to add beneficiaries, 5.10

Charitable beneficiaries, effect of independent trustee's power to add, 5.9

Charitable lead annuity trust (CLAT), avoiding grantor trust status, 18A.27

Decedent's estate, inclusion of grantor trust in, 3.1

Dynasty trusts. See **Dynasty Generation-Skipping Trust**

Gifts to trust, action needed for completion, 2.15

GRAT. See **Grantor Retained Annuity Trust (GRAT)**

GRIT. See **Grantor Retained Income Trust (GRIT)**

GRUT. See **Grantor Retained Unitrust (GRUT)**

Income tax issues. See **Income Tax**

QDOT as grantor trust, 2.81A

QPRT's grantor trust status. See **Qualified Personal Residence Trust (QPRT)**

S corporation shareholder, 19.96-19.97

Settlor's leaseback of encumbered property transferred to trust, 19.61

GST. See Generation-Skipping Transfer (GST) Tax

Guardianship and Conservatorship

Appointment for controlling minor's property, 12.13

Crummey withdrawal power

Exercise on minor's behalf, 2.36, 12.80-12.81

Notification, 12.83

Duties and powers, 12.21

Minors. See **Minors**

Trustee's distribution power, 10.105

Hague Conference on Private International Law, 20.1

Handicapped Persons. See Disabled Persons

Herr Trust. See Minors' Trust, IRC §2503(b)

Husband and Wife. See Spouses

Hybrid Trusts

Estate and gift tax considerations, 9.40

Income tax considerations, 9.39

Illness

Basis for removing trustee, 10.31

Cotrustee's, 10.13

GST exemption, allocation to separate trust for sick child, 5.29

Improvements and Repairs

Charitable remainder trust property, 18.33

Rental income expenditures, 19.17, 19.18, 19.59

Special assessments, 19.15

Income and Principal

See also **Distributions**

Accumulation power. See **Accumulation Power**

Adjustments between principal and income, rules and state laws affecting trustee's power over

Distributions, 3.10, 3.12, 3.18A

QDOT, 2.80

QTIP, 2.39A, 2.79

Allocation. See **Allocation**

Anticipatory assignment of income doctrine, effect on settlor's transfer of appreciated property to charitable remainder trust, 18.20

Below-market rate or interest-free loans, 2.10, 10.81

Beneficiary-trustee power over, 10.6, 10.25, 10.26

Business operations. See **Operation of Business**

Capital gain, donee paying donor's gift tax liability, 2.32

Charitable deduction. See **Charitable Gifts and Deduction**

Conversion of income interests to unitrust interests, 10.116A

Corporate distributions, allocation between income and principal, 19.25

Cotrustees' power. See **Cotrustees**

Decedent's gross estate

Income, generally, 2.47

Retained income interest (see Retained income interest in transferred property, below)

Distributions. See **Distributions**

Encumbered property. See **Encumbered Property**

Foreclosed property, 19.72, 19.73

Gift of income, advantages and disadvantages, 2.45-2.46

Gift tax, paying from trust income, 2.31

GRAT, 15.11

GRIT, 14.4, 14.6

GRUT, 16.7, 16.26

Herr trusts, 12.68-12.71

Income tax. See **Income Tax**

Invasion of principal, 9.21-9.21A, 9.25, 9.45

Investment strategies, effect of defining distribution rights in terms of right to income or principal, 10.110

Marital deduction. See **Marital Deduction**

Minors' trust

Income and principal, IRC §2503(c). See **Minors' Trust, IRC §2503(c)**

Income only interests, IRC §2503(b). See **Minors' Trust, IRC §2503(b)**

Natural resources, trustee's power to invade principal, 19.112

Nonindependent trustee, tax consequences, 10.11

Option money, 19.13, 19.14

Pooled income fund. See **Pooled Income Fund (PIF)**

QPRT income. See **Qualified Personal Residence Trust (QPRT)**

QSST, 19.99-19.100

Qualified personal residence trust (QPRT), provision requiring distribution of income to settlor, 17.80, 17.91

Rent. See **Rent**

Retained income interest in transferred property

Available to creditors, 2.51

Rental income, 2.50

Supporting grantor's dependents, 2.53

Using for grantor's benefit, 2.52

Separate trust. See **Separate Trusts for Minor Beneficiaries**

Settlor-trustee power, 10.4

Single trust with discretion to distribute principal. See **Single Trust With Discretion To Distribute Principal**

Spendthrift clause's effect on, 10.123

Sprinkling trust or power. See **Sprinkling Trust or Power**

Step-transaction, 19.57

Supplemental Security Income (SSI), effect of applicant's income on amount of, 13.10

Support and maintenance payments, 5.26

Surviving spouse's rights in QTIP trust, 2.79

Testamentary power of appointment over income, 9.38C

Trustee's use of. See **Trustees**

Uniform Principal and Income Act. See **Uniform Principal and Income Act (UPAIA)**

Valuing term certain income interests, 6.22, 6.24

Income in Respect of Decedent (IRD)

Gross estate of decedent, includable income, 2.47

Income Tax

General drafting considerations, 1.2, 3.1, 7.6

Accumulation trust, 9.31-9.32, 9.35-9.36, 9.38

Allocation, 10.111

Basis. See **Basis**

Beneficiary-trustee consideration, 9.53

Beneficiary-trustee distributions by special trustee, 10.25

Business enterprise income and loss allocations. See **Operation of Business**

Capital gains and losses. See **Gains and Losses**

Charitable gift annuity, 18.120

Charitable remainder trust

Generally, 3.45-3.46, 18.20

Charitable lead trusts, grantor and nongrantor, 3.49-3.51

Noncharitable beneficiaries, 3.47

Recipients, 3.48, 18.31-18.32, 18.35

Trust and trustees, 18.33-18.35, 18.40, 18.66

Closely held businesses. See **Closely Held Businesses**

Complex trusts, 3.14-3.18D

Crummey trust or withdrawal power, 12.99-12.100

Custodial property, 12.35

Debt forgiveness, 10.81

Deductions

Charitable lead annuity trust. See **Charitable Lead Annuity Trust (CLAT)**

Charitable. See **Charitable Gifts and Deduction**

Estate tax attributable to decedent's income, availability of deduction for, 2.23C

Marital. See **Marital Deduction**

Settlor's leaseback of transferred property, 19.59-19.60, 19.65

Trust investment adviser fees as miscellaneous itemized deductions, 3.5

Defective grantor trusts

Beneficiary defective trust, 3.44D

Grantor irrevocable life insurance trust (GILIT), 3.44E

Installment sale to, 3.44B

IRC §674(c) provisions, 3.40

IRC §675(4)(C) provisions, 3.41-3.41A

IRC §677(a)(3) provisions, 3.42

IRC §678 provisions, 3.43

Sale to grantor trust versus GRAT, 3.44C

Special concerns and considerations, 3.44

Depreciation. See **Depreciation**

Dynasty trust, income tax treatment of, 13A.10

Education expenses paid from trust income, 5.21

Electing small business trust, 3.64-3.67, 15.11

Encumbered property transfers, 19.53-19.55, 19.57, 19.61-19.62

Foreign trusts. See **Foreign Trusts**

Grantor as trust owner

Administrative powers, 3.27

Controlling enjoyment of trust, 3.26

Election to treat revocable trust as part of decedent's estate for income tax purposes, 3.44A

Power to revest title to trust property, 3.28

Power to use income for own benefit, 3.29

Reversionary interest, 3.25

Grantor trust

Generally, 3.22-3.24, 3.39

Defective grantor trusts (see Defective grantor trusts, above)

Grantor as trust owner (see Grantor as trust owner, above)

Grantor retaining powers yet not trust owner (see Grantor with retained powers not trust owner, below)

Person other than grantor treated as owner, 3.38

Reporting requirements, 3.39D

Trust owned entirely by one person who is not trustee, 3.39B

Trust owned entirely by one person who is trustee, 3.39A

Trust owned entirely by two or more persons, 3.39C

Grantor with retained powers not trust owner

Generally, 3.30

Independent trustee's powers, 3.36

Power to accumulate income under certain circumstances, 3.33

Power to apply income and principal to support dependents, 3.31

Power to distribute corpus under certain circumstances, 3.32

Power to distribute or accumulate income for minor beneficiary, 3.34

Power to use income to discharge grantor's support obligations, 3.37

Trustee's power to distribute income and principal limited by ascertainable standard, 3.35

GRAT distributions, 15.11

GRIT distributions, 14.8

GRUT distributions, 16.5, 16.8

Hybrid trust, 9.39

Increase in settlor's income taxes, effect of provision requiring trust to pay, 5.9

IRC §674 exceptions

Generally, 9.38

Power affecting beneficial enjoyment only after occurrence of event, 9.38B

Power to allocate among charitable beneficiaries, 9.38D

Power to allocate between corpus and income, 9.38F

Power to apply income to satisfy support obligation, 9.38A

Power to withhold income during disability of beneficiary, 9.38E

Testamentary power of appointment, 9.38C

Kiddie tax

Generally, 1.7, 3.19, 12.5

Avoidance, 3.20

Leaseback payments. See **Rent**

Life insurance, 11.12-11.13

Minors

Generally, 12.12

Guardianship property, 12.19

Incentive trust, 12.113

Joint tenancy, 12.17

Kiddie tax, 12.5

Medical and education expenses, 12.14

Minors' trust under IRC §2503(b), 12.74

Minors' trust under IRC §2503(c), 12.56-12.57, 12.63

Multistate trusts. See **Multistate Trusts**

Nongrantor trust. See **Nongrantor Trust**

Payable on death (POD) or Totten trust account income, 12.15

Permanent trust tax planning purpose, 5.2, 5.9

Pooled income fund, 18.107

Power of appointment, 9.57

QSSTs

General rules, 3.57, 3.62

Basic requirements, 3.58

Creative use of S corporations and trusts, 3.63

Distributing all income requirement, 3.59

Election of QSST, 3.61, 19.99, 19.102A

One-beneficiary requirement, 3.60

QTIP inter vivos trust, 2.39A, 2.79

Qualified personal residence trust (QPRT), income tax advantage of, 17.10

Relationship between federal and state tax rules, 3.2

Remainder interest distribution, 9.46

Rental income, 19.11

Retirement plans, 19.117

S corporation stock

Generally, 3.24, 3.52, 3.66, 15.11

Grantor trusts, 3.53-3.56

QSSTs (see QSSTs, above)

Source of income, determining if nonresident's income taxable by California, 20.92

Separate trust for each minor beneficiary, 9.28-9.29

Settlor-trustee retained powers, 9.14, 10.5

Simple trust, 3.11-3.13

Single trust with discretion to distribute principal, 9.24

Special needs trust, income taxation of, 13.26

Spendthrift trust, 9.67

Spouse with administrative power, 10.6

Sprinkling trust, 9.9, 9.14, 9.19

Stock distributions

Publicly traded, 19.25, 19.26

QSST, 19.101, 19.102

Support and maintenance trusts

Generally, 5.17, 5.26-5.27

Separate versus multiple trusts, 5.29-5.31

Throwback rules, 3.74, 9.32, 10.95, 10.96

Trust assets generating income, 2.55

Trustee's tax considerations

Distributions, 10.106, 10.107-10.108

Tax-sensitive trustee, avoiding tax consequences, 10.99, 10.100

Underproductive property, 19.47, 19.48

Unitrust, 9.45

Incompetent Persons

See also **Disabled Persons**

Donor's subsequent incompetence, effect on retained powers, 2.17

Trustee

Cotrustees, 10.13, 10.16

Removal of incapacitated trustee, 10.29, 10.31

Independent Trustees

See also **Trustees**

Generally, 10.7, 10.12

Charitable remainder trust, 18.17

Confer general power of appointment, 4.39

Family pot trust, sample long term form, App A

Income and principal, trustee's discretion to make adjustments between, 19.11

Limitations on exercising discretion, 10.10

Minors' trust, sample form, App B

Related or subordinate party, 3.36, 9.10, 9.14, 10.7, 10.12

Sprinkling trust, 9.14, 9.15

Unlimited power without ascertainable standard, 2.19

Individual Retirement Accounts (IRAs)

Coverdell education savings accounts, 12.37B

Valuation discount to reflect beneficiary's future income tax liability prohibited, 2.23C

Inferences. See Presumptions and Inferences

Inflation

Annuity trust adjustment for, 9.42

Gift to noncitizen spouse, effect of inflation on amount of exclusion, 2.39, 18.21

Unitrust adjustment, 9.43

Insider Transactions. See Self-Dealing

Installment Payments

Dynasty trusts, installment promissory note. See **Dynasty Generation-Skipping Trust**

Estate tax. See **Estate Tax**

Settlor's leaseback of property sold to trust, 19.63

Installment Sales

Defective grantor trust, installment sale to, 3.44B

Insurance

Investment funds overseen by trustee, rules regarding insurance requirements for, 10.60

Life. See **Life Insurance**

Title insurance policy, loan prerequisite, 10.80

Trustee's power to insure assets and against liability, 10.86, 10.87

Intellectual Property

Generally, 19.114

Allocating expenses and income, 19.19, 19.110

Copyright

Assignment and licensing, 19.115

Term, renewal, and termination, 19.116

Funding trust with, 19.109

Reserve account for expenses and income, 19.111

Intent

Donor's transfer intent, relevancy of, 2.8

Settlor's intent

Contrary allocations, UPAIA considerations, 10.110

GRAT provision, 15.36

GRUT provision, 16.34

Investment powers of cotrustee, 10.21

Trustee's service consistent with, 10.9

Validity of multistate trusts, 20.12

Trustee's breach of trust, 10.38

Interest on Money

Below-market rate or interest free loans, tax consequences, 2.10, 10.81

Closely held business, interest on estate tax owed, 2.89

Deferred estate taxes owed, 2.88-2.90

Encumbered property interest payments. See **Encumbered Property**

IRS valuation tables. See **Valuation**

Settlor's loan to GRAT, 15.11

Internal Revenue Service Valuation Tables. See Valuation

Interpretation of Cases and Statutes. See Construction and Interpretation

Intestate Succession

Drafting trusts, provision on applicability of California's intestate succession law, 10.134

Inventory

Definition of inventory value, 19.37

Investments

Agency relationship (see Delegation function, below)

Annuity. See **Annuity**

Bonds and undertakings. See **Bonds and Undertakings**

Charitable remainder trust restrictions, 18.5, 18.82, 18.83

Closely held or family businesses. See **Closely Held Businesses**

Commingling. See **Commingling**

Common trust funds, 10.44

Delegated function

Compensation of agent, 19.9

Liability for agent's acts, exonerating trustee, 19.10

Prudent investor requirement, 10.59

Trustee's authority to delegate, 10.76, 10.77-10.78, 19.6, 19.7

Duty of trustee

Generally, 10.59

Diversify assets, 10.65, 10.66

Keep trust property separate, 10.42

Preserve trust property, 10.27, 19.50

Productive, trustee's duty to make trust property, 19.34

Prudent investor rule (see Prudent investor rule, below)

Employment of agents. See **Agency**

Foreclosure. See **Foreclosure**

Insiders or self-dealings. See **Self-Dealing**

Insurance for invested funds, rules regarding, 10.59-10.60

Life insurance. See **Life Insurance**

Miscellaneous itemized deduction, trust investment adviser fees as, 3.5

Mortgages and trust deeds. See **Mortgages and Trust Deeds**

Multistate trusts, conflict of laws principles, 20.32

Pooled income fund property, 18.111-18.112

Power of settlor to direct investments. See **Settlor**

Power of trustee

Generally, 10.59, 19.23, 19.67, 19.80

Abandonment of tangible personal property, 19.32, 19.33

Bonds and undertakings, 19.27

Broad investment powers under prudent investor rule, 10.60

Cotrustees' investment power. See **Cotrustees**

Decedent's gross estate, excludable powers, 2.59

Employ agents or investment counsel. See **Management of Trust Property**

Life insurance, 11.19

Limited investment powers, 10.61

Mortgages and trust deeds. See **Mortgages and Trust Deeds**

Prudent investor rule (see Prudent investor rule, below)

Puts, calls, margin accounts, and other specialized investments, 10.60, 19.30, 19.31

Retain property (see Retain property and operate business, trustee's power to, below)

Special trustee, 10.22

Prudent investor rule

Generally, 10.59, 10.76

Broad investment powers, 10.60

Lack of diversity in investments as violation of, 18A.5

Restricted investment powers, 10.61

Puts, calls, margin accounts, and other specialized investments, 19.30, 19.31

Retain property and operate business, trustee's power to

Generally, 10.63

Settlor's clear intent or court order, requirement for, 10.62

Unproductive or underproductive property, 10.64

Stock. See **Securities**

Substituting trust assets, equivalence to investment power, 2.61

Tangible personal property, 19.32, 19.33

Underproductive or non-income producing property. See **Underproductive Property**

IRAs. See Individual Retirement Accounts (IRAs)

IRD. See Income in Respect of Decedent (IRD)

Joint Tenancy or Interest

Advantages and disadvantages, 12.18

Charitable remainder trust, joint and survivor recipients

Annuity payment, 18.49-18.51

Unitrust payment, 18.54, 18.56

Estate tax, determining portion of joint tenancy asset included in decedent's estate, 2.67-2.68

Gift donor's powers or interests, 2.13, 2.18

Legal and tax aspects, 12.17

Life insurance, joint lives coverage, 11.39, 11.47

Jurisdiction

Administration of trust, 10.104, 20.19-20.23

Litigation special needs trust, court's continuing jurisdiction over, 13.32

Multistate trusts. See **Multistate Trusts**

Kiddie Tax. See Income Tax

Land Use Planning

Trustee's power, 19.4, 19.5

Lapsed Powers

Appointment

Beneficiary's right to terminate minors' trust under IRC §2503(c), 12.57

Gift and estate tax, 2.11, 2.65

GST tax aspect, 4.10

Lapsed power as release, 12.89

Special valuation rules, 2.25, 2.30

Crummey withdrawal right

Generally, 2.15, 12.86, 12.109

Analyzing excess lapse issues, 12.87, 12.89, 12.96

Avoiding excess lapses, 12.90, 12.96-12.97

Hanging power, 12.91, 12.98

Life insurance lapse rates, 11.26

Lead Trust. See Charitable Lead Trust (CLT)

Leased Property

Expenses of rental property, 19.17, 19.18

Funding trust with leaseholds, generally, 19.109

Leasebacks

Generally, 19.58, 19.62

Encumbered property, 19.61-19.62

Rent payments. See **Rent**

Qualified personal residence trust. See **Qualified Personal Residence Trust (QPRT)**

Retained leasehold interest, Estate property, 2.50

Special valuation rules, 2.25, 2.29

Trustee's power to lease property, 10.69, 10.70, 19.58, 19.112

Levine Ruling, 12.70-12.71

Licensing

Copyright, 19.115

Liens. See Encumbered Property

Life Estates

Depreciation of residence or farm, 2.42

Residence use or occupancy, 2.50

Retained life estate

Generally, 2.49

Annuities, 2.55, 2.66

Assets available to creditors, 2.51

Direct or implied right to use or occupy real property, 2.50

Discretionary control over trust income, 2.62

Reciprocal trusts, 2.54

Right to have income used to support dependents, 2.53

Trustee's power to use income and corpus for decedent's benefit, 2.52

Trust holding life tenant interest in S Corporation, effect of, 3.59

Valuation. See **Valuation**

Life Expectancy Tables. See Valuation

Life Insurance

Company ratings and portfolio analysis, 11.22

Consideration in exchange for policy transfer, 11.12

Estate tax treatment, generally, 2.47, 2.63, 2.67

Expenses. See **Expenses and Expenditures**

Illustration questionnaires

Generally, 11.43, 11.49

Blended insurance, 11.46

Second-to-die insurance, 11.47

Term insurance, 11.44

Variable insurance, 11.48

Whole life insurance, 11.45

Premiums

Claims' effect on premiums, 11.25

Gift tax consequences, 11.2

Gross estate, includable item, 2.47

Methods of payment, tax consequences, 11.13

Term insurance (see Term insurance, below)

Whole life insurance (see Whole life insurance, below)

Reformation of trust to avoid inclusion in estate, 11.3

Sale of life insurance policy between trusts, effect of, 11.12

Selecting appropriate insurance product

Generally, 11.21, 11.23, 11.29, 11.43

Company expenses, 11.28

Company rating and portfolio analysis, 11.22

Investment experience of insurer, 11.25

Lapse rate or persistency experience, 11.27

Mortality or claims experience of insurer, 11.25

Obtaining information, 11.49

Risk factors, generally, 11.24

Term insurance (see Term insurance, below)

Whole life insurance (see Whole life insurance, below)

Substituting decedent's own assets for insurance policies, 2.61

Substituting versus backdating applications, 11.9, 11.9B

Terminally ill person as measuring life for transfer, 6.36

Terminology defined or construed. See **Construction and Interpretation; Definitions**

Term insurance

Generally, 11.30

Annual renewable term policy, 11.31

Blended whole life/term policy, 11.38, 11.46

Decreasing term policy, 11.33

Illustration questionnaires, 11.44

Level term policy, 11.32

Modified term policy, 11.34

Return of premium (ROP) term insurance, 11.30

Transfers within 3 years of death, 2.64

Trust. See **Life Insurance Trust**

Valuation, 11.10

Whole life insurance

Generally, 11.35

Blended whole life/term policy, 11.38, 11.46

Current assumption (interest-sensitive) policy, 11.37

Joint lives (second or first to die) policy, 11.39, 11.47

Limited-pay policy, 11.36

Questions if less expensive than competing policies, 11.45

Universal policy, 11.40

Variable policy, 11.41, 11.48

Variable/universal policy, 11.42

Life Insurance Trust

Generally, 1.2, 11.1

Community property, partitioning, 11.4

Crummey withdrawal demands, satisfying, 11.14

Funding

Avoiding estate tax inclusion of new policy, 11.9-11.9B

Community property, 5.12

Contingent marital deduction gift, 11.8

Existing life insurance policy, estate tax consequences, 11.3

Gift tax exclusions on transfers, 11.11

Gift tax value of transfers, 11.10

GST tax problems (see GST tax problems, below)

Including pre-owned policy in insured's estate (IRC §2035), 11.7

Selecting appropriate policy. See **Insurance**

Grantor irrevocable life insurance trust (GILIT), 3.44E

GST tax problems

Generally, 11.3, 11.11, 11.15

ETIP periods, 11.16

Exemption allocation formula, 11.18

Exemption allocation planning, 11.17

Incidents of ownership defined, 11.6

Objectives, 11.2

Premium payment methods, tax consequences, 11.13

Reciprocal trust doctrine, avoiding, 11.5

Removing policy from trust, 11.12

Sample life insurance trust for

Children, App D

Spouse and issue, App E

Special considerations, 11.3

Trustee

Power to invest in life insurance, 11.19

Power to remove and replace trustee, 11.20

Selecting and changing, 11.6

Substituting insurance applications, 11.9, 11.9B

Types of insurance products. See **Life Insurance**

Limitation of Actions. See Statutes of Limitations

Limited Liability Company (LLC)

Valuation of interest, 2.23

Limited Partnerships

See also **Partnerships**

Annual exclusion, present-interest requirement for, 2.35

Assets transferred to family limited partnership

Donor's estate, criteria for demanding inclusion of assets in, 2.48

Fractional-share defined value, sale of limited partnership interest in family limited partnership to another trust in exchange for promissory note as violation of public policy, 3.44B

Qualified personal residence trust (QPRT) as alternative to family limited partnership, 17.63

Valuation of interest, effect of limited marketability and minority interest discounts on, 2.23D

Closely held partnership converted to, 19.80

Valuation of interest, 2.23B-2.23D

Liquidation

Charitable remainder trust funding asset, 18.13

Corporate distribution of property in liquidation of corporation, allocation to principal, 19.25

Lapsed rights and restrictions, 2.30

Leaseback property sold to trust, 19.62-19.63

Limiting donee's right to liquidate family partnership interest, 19.78

Operation of business. See **Operation of Business**

QSST liquidating distributions, 19.101, 19.102

Stock redemption or dividends to pay estate tax, 2.91

Sufficiency of liquid assets satisfying *Crummey* demands, 11.14

Litigation

Delaying distribution until resolution of claims or liability, 10.108, 10.109

Notice. See **Notice and Notification**

Petitions. See **Petitions**

Power of trustee to prosecute or defend claims, 10.84, 10.85

Special needs trust for proceeds. See **Litigation Special Needs Trust (LSNT)**

Litigation Special Needs Trust (LSNT)

See also **Special Needs Trust (SNT)**

Generally, 13.4, 13.28

Accountings, court requiring, 13.33

Claims by government agencies, deferral of, 13.34

Continuing court supervision of LSNT, 13.36

Defined, 13.4

Establishing LSNT, requirements for

Generally, 13.28

Amount reasonably necessary to meet special needs of minor or person with disability, money paid to trust not exceeding, 13.31

Court approval for establishing LSNT, 13.32

Disabled adults, creation of LSNT for, 13.35

Order establishing LSNT, court providing for protection of beneficiary in, 13.32

Substantial impairment, requirement of, 13.29

Unmet special needs of disabled beneficiary, 13.30

Estate and gift tax consequences of funding and termination of LSNTs, 13.37

Medi-Cal regulations, exemption of LSNT in determining individual's resources for Medi-Cal eligibility purposes, 13.24

Petitions

Establishment of LSNT, petition for, 13.32

Termination of trust, petition for, 13.33

Termination of trust

Deferral of claims by government agencies until termination of trust, 13.34

Estate and gift tax consequences of, 13.37

Petition for, 13.33

Livestock. See Farms and Ranches

Loans

Below-market rate or interest-free loans, tax consequences, 2.10, 10.81

Beneficiary loaning distributed funds back to trust or estate, 3.18B

Encumbered property transferred to trust. See **Encumbered Property**

Grantor retained unitrust. See **Grantor Retained Unitrust (GRUT)**

Power of trustee

Borrow money, 10.79, 10.80

Lend to probate estate, 10.88, 10.89

Lend to trust, 10.82, 10.83

Make loans, generally, 10.81, 19.67

Promissory notes

Action needed for gift of, 2.15

GRAT, trustee prohibited from issuing note to satisfy annuity obligation, 15.8

Installment sale to defective grantor trust in exchange for promissory note, 3.44B

Qualified personal residence trust (QPRT), restrictions on borrowing against residence in, 17.20

Related or subordinate party borrowing income or principal, 3.27, 10.81, 12.56

Settlor borrowing from trust, 5.10

Settlor loaning funds to GRAT, 15.8, 15.8-15.9

Settlor loaning funds to GRUT, 16.8

Trust deed. See **Mortgages and Trust Deeds**

Trust income used to repay gift tax payment loan, 2.31

Management of Trust Property

See also **Administration of Trust**

Generally, 19.1, 19.80

Closely held or family businesses, 19.78, 19.80, 19.82

Employment of agents. See **Agency**

Insurance, 10.86, 10.87

Multistate trusts. See **Multistate Trusts**

Operation of business enterprise. See **Operation of Business**

Out-of-state assets, 10.57

Powers excluded from decedent's gross estate, 2.59, 19.11

Real property

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Rental property expenses, 19.17, 19.18

Reconciling beneficiary needs with management concerns, 1.5

Settlor's desires and directions, 10.3, 19.85

Settlor's power to delegate management, 10.59, 10.76

Trustee's powers. See **Powers of Trustee**

Marital Deduction

See also **Qualified Terminable Interest Property (QTIP) Trust**

Generally, 2.39, 9.62

Charitable remainder trust, 2.41, 18.21

Decedent's estate assets

Generally, 2.75

Discount and premium valuation problems, 2.71

Terminable interest rule exceptions, 2.76-2.79

Undistributed accrued income, 10.113

GRAT, 15.15A

GRIT, 14.9

GRUT, 16.9

Life insurance trust contingent marital deduction gift, 11.8

Multistate trusts, 20.80

Noncitizen surviving spouses, 2.39, 2.80-2.83

Overriding restrictive investment clause, 10.61

Pooled income fund, 18.107

Power to allocate benefits, 10.93, 10.94

QTIP inter vivos trust, 2.39A, 2.39B-2.39C, 2.39D, App I

QTIP trust qualification, 10.114

Qualified domestic trust (QDOT). See **Qualified Domestic Trust (QDOT)**

Qualified subchapter S trust and marital deduction trust compared, 19.98

Spouse with administrative power, 10.6

Tax-sensitive trustee, 10.11

Trustee's discretion, 19.19

Underproductive property. See **Underproductive Property**

Wasting asset, 19.109

Marital Dissolution

Binding effect of decree determining child of marriage, 10.133

Settlement agreement dissolving marriage, consideration element, 2.33, 2.68

Marketability

Fair market valuation

Charitable gift tax deduction, 2.40

Corporate or partnership interests, 2.26

Life estates, term of years, and remainder interests, 2.22

Retained life estate, 2.49

Time for valuing transfer, 2.20

Willing buyer and seller standard, 2.21, 2.23

Lack of marketability discount, 2.23B, 2.24, 13A.7

Premium valuation. See **Premiums**

Medi-Cal and Medicaid

See also **Medicare; Supplemental Security Income (SSI)**

Generally, 13.6, 13.13

Eligibility for Medi-Cal benefits

Generally, 13.14

Transfer and recovery rules, effect of, 13.15

Special needs trust (SNT)

Deductibility of Medi-Cal reimbursement claim as claim against estate, 13.37

Federal Medicaid law, 13.21

Trust regulations (see Trust regulations, below)

Trust regulations

Generally, 13.22

First party SNTs, 13.24

Third party special needs trusts, 13.23

Medical Expenses

Direct payments under IRC §2503(e), 12.14

Gift and estate tax exclusion, 2.38

GST tax considerations, 4.14, 4.38

Medi-Cal. See **Medi-Cal and Medicaid**

Special needs trust issues. See **Litigation Special Needs Trust (LSNT); Special Needs Trust (SNT)**

Medicare

See also **Medi-Cal and Medicaid**

Social Security distinguished, 13.16

Menace. See Undue Influence

Mineral Interests. See Natural Resources

Minority-Interest Discount

Dynasty trust, using minority interest discount to enhance value of, 13A.7

Estate tax, 2.70-2.71, 2.79

Gift tax, 2.23B, 2.23E, 2.24

Minors

Common planning devices for gifts, 12.1

Custodianship. See **Custodianship**

Disabled child defined, 13.16

Distributions to minors, prevention of

Generally, 9.8, 9.47

CUTMA custodian as alternative distributee, 9.49A

Drafting distribution clause, 9.4

Education expenses. See **Education Expenses**

Emancipated minors' rights, 12.13

Grandchildren

Crummey powers, 12.94

Generation-skipping transfers. See **Generation-Skipping Transfer (GST) Tax**

Per capita distribution, 10.132

Sample multiple vested interest trusts for skip persons (sensitive trustee permitted), App C

Sprinkling trust, grandchildren benefiting from, 9.8

Support of, 5.20

Guardianship

Advantages, 12.20

Child's ability to manage assets, 12.9

Crummey withdrawal power as present interest gift, 2.36, 12.80-12.81

Disadvantages, 12.21-12.22

Legal and tax aspects, 12.19

Holding power of appointment, 4.39, 10.139

Issue and children definitions. See **Drafting Trusts**

Joint tenancy property

Advantages and disadvantages, 12.18

Legal and tax aspects, 12.17

Nontax aspects of gifts to minors, generally

Generally, 12.7

Donor's loss of control over assets, 12.11

Impact on child's incentive, 12.10

Legal disability of minor, 12.8

Manage assets, child's ability, 12.9

Outright gifts

Advantages and disadvantages, 12.13

Legal and tax aspects, 12.12

Payable on death (POD) and Totten trust accounts, legal and tax aspects, 12.15

Preventing outright distributions to minors, 9.47-1

Support and maintenance. See **Support and Maintenance**

Tax aspects of gifts to minors, generally

Generally, 12.2, 12.12

Custodianship issues. See **Custodianship**

Estate tax. See **Estate Tax**

Gift tax, 12.3, 12.57

GST tax, 12.6

Income tax, 12.5

Trusts

Crummey. See **Minors' *Crummey* Trust or Withdrawal Power**

Hybrid trust benefits, 9.39-9.40

Incentive trust (non-§2503 trust). See **Minors' Incentive Trust**

Income interest only. See **Minors' Trust, IRC §2503(b)**

IRC §2503(b). See **Minors' Trust, IRC §2503(b)**

IRC §2503(c). See **Minors' Trust, IRC §2503(c)**

Life insurance trust for children, App D

Life insurance trust for spouse and issue, App E

Payable on death (POD) and Totten trust accounts, 12.16

Separate trusts. See **Separate Trusts for Minor Beneficiaries**

Single trust with discretion to distribute principal, 9.22

Special needs trust for disabled child. See **Litigation Special Needs Trust (LSNT); Special Needs Trust (SNT)**

Sprinkling. See **Sprinkling Trust or Power**

Trustee's distribution power, 10.105

Minors' *Crummey* Trust or Withdrawal Power

Generally, 12.80

Amount of withdrawal right

Generally, 12.87

Excess lapses, 12.89-12.90, 12.96

Multiple trust problems, 12.91

Spouse's *Crummey* power, 12.88

Annual exclusion requirements

Generally, 12.3

Minor beneficiaries, 12.81

Rights of withdrawal (see Rights of withdrawal, below)

Guardian's power as present interest, 2.36, 12.81

Naked *Crummey* powers

Cristofani ruling, 12.94-12.95

IRS disapproval, 12.93

Notification. See **Notice and Notification**

Rights of withdrawal

Generally, 12.82

Amount (see Amount of withdrawal right, above)

Hanging *Crummey* power, 12.98

Lapsed. See **Lapsed Powers**

Limitation (5 or 5), 12.89-12.91, 12.96, 12.97, 12.98, 12.102, 12.109

Liquid assets satisfying withdrawal power, 12.92

Naked *Crummey* powers (see Naked *Crummey* powers, above)

Notification importance, persons, and form, 12.83-12.84, 12.85

Period of withdrawal right, 12.86

Sample multiple vested interest trusts for skip persons (sensitive trustee permitted), App C

Tax consequences

Estate tax, 12.105-12.106

Gift tax, 12.3, 12.101-12.104, 12.109

GST tax, 12.107-12.108

Income tax, 12.99-12.100

Sprinkling trusts, 12.110

Minors' Incentive Trust

Generally, 12.111

Distribution

Child exercises withdrawal right or dies, 12.120

Conditions, 12.117

Medical emergency, 12.118

Noncompliance with incentive provisions at specified ages, 12.121

Withdrawal right at specified ages and upon compliance with incentive, 12.119

Estate tax aspect, 12.115

Gift tax aspect, 12.114

GST tax aspect, 12.116

Income tax aspects, 12.113

Nontax incentive planning, 12.112

Minors' Trust, IRC §2503(b)

Advantages and disadvantages, 12.66

Annual exclusion qualification aspect

Generally, 12.64, 12.71

Deferred, 12.71

Crummey trust compared, 12.80

Distribution

Balance if beneficiary dies before age 21, 12.78

Discretionary early distribution of principal, 12.79

Post-age-21 income, 12.77

Pre-age-21 income at age 21, 12.76

Herr trust

Generally, 12.68

Description and tax aspects, 12.69

Distribution of pre-age-21 income at age 21, 12.76

Estate tax, 12.73

Qualification of post-age-21 interest, 12.70

Levine holding, 12.70-12.71

Tax aspects

Estate tax, 12.73

Gift tax, 12.72

GST tax, 12.75

Herr trust, 12.69-12.70

Income tax, 12.74

Tax benefits versus nontax objectives, 12.65

Valuing income and remainder interests, 12.66

Variants

Combination §2503(b) trust and Uniform Transfers to Minors Act, 12.71

Herr trust, accumulation of pre-age-21 income for single beneficiary, 12.68-12.71

Standard trust, current income interest with post-age-21 principal distribution, 12.67, 12.69

Minors' Trust, IRC §2503(c)

Generally, 12.38

Advantages and disadvantages, 12.57, 12.63

Annual exclusion gifts, 2.37

Crummey trust compared, 12.80

Distribution of income and principal to living child

Child's power to terminate trust after attaining specified age, 12.61

Discretionary payment before child attains age 18 or 21, 12.59

Division of trust estate, 12.58

Outright at age 18 or 21, 12.60

Distribution of property

Age 21 distribution, 12.43

Minor's death (see Distribution on minor's death, below)

Trustee's powers (see Distribution power of trustee, below)

Distribution on minor's death

Generally, 12.44, 12.62

Beneficiary's power of appointment, distribution according to, 12.46, 12.62A

Distribution to child's estate, 12.45, 12.62

Limited power of appointment, 12.48

Taker in default, 12.47, 12.62A

Distribution power of trustee

Generally, 12.39

Discretionary sprinkling power, 12.42

Other resources of minor, 12.40

Using property for legal support, 12.41, 12.54

Herr trust variant, 12.68

Qualification requirements

Distribution of property (see Distribution of property, above)

Trustee's distribution power as not substantially restricted (see Distribution power of trustee, above)

Sample trust, App B

Tax aspects

Estate tax, beneficiary's death, 12.50

Estate tax, settlor's death, 12.51-12.54

Gift tax, 12.49

GST tax, 12.55

Income tax, 12.56-12.57, 12.63

Trusts continuing after age 21, 12.57

Termination, 12.43

Modifications. See Amendments and Modifications

Mortality

See also **Actuarial Tables**

Insurer's mortality or claims experience statistics, 11.25, 11.28

IRS valuation tables, mortality component, 6.8-6.10, 6.36

Whole life insurance premium factor, 11.35

Mortgages and Trust Deeds

Acceleration of, 19.50

Charitable remainder trust interest, 18.14

Dynasty trust, deed of trust with assignment of rents, 13A.20

Foreclosure. See **Foreclosure**

Powers of trustee

Allocation of proceeds on disposition of property acquired by foreclose, 19.73

Foreclose on property having security owned by trust, 19.70, 19.71

Investment, generally, 19.67

Subordinate debt or security, 19.68, 19.69

Qualified personal residence trust. See **Qualified Personal Residence Trust (QPRT)**

MQTs. See Medi-Cal and Medicaid

Multiple Trusts or Skips

Annuity trust or unitrust income tax consideration, 9.45

Crummey withdrawal right 5 or 5 exclusion, 12.91

GRATS, 15.10

GRITs, 14.7

GRUTs, 16.7

GST tax problems, 4.1, 4.13, 4.15, 4.20, 4.34

Jurisdiction for resolving issues, 20.26

Multistate trusts. See **Multistate Trusts**

Pipe dream trust, support and maintenance, 5.29-5.31

Power of trustee

Consolidate trust administration, 10.101, 10.103

Divide trust property, 10.101, 10.102

Sample multiple vested interest trusts for skip persons (sensitive trustee permitted), App C

Shares created under trust as separate trusts, 10.43

Multistate Trusts

Generally, 20.1, 20.35

Administration of trust

Generally, 20.8, 20.19

Change in situs, 10.104, 20.23

Charitable trust administration problems, 20.70

Personal property, 20.21

Real and personal property, 20.22

Real property, 20.20

Savings clause for unforeseen tax consequences, 20.25

Self-dealing, 20.33

Trust governed by law of place of administration, 20.24

Arbitration, 20.31

Assignment and attachment of beneficiary's interest, 20.60

Charitable trusts

Administrative problems, 20.69

Hypothetical case application, 20.71

Marital rights, 20.69

Nature of problems, 20.66

Rule against perpetuities, 20.68

State law's effect, 20.67

Conflict and choice of laws

All real and personal property in one state, 20.39

Characterization analysis, 20.8

Community property, 20.52

Continuous change in theories, 20.3

Enforceability and desirability of clause, 10.125, 10.126, 20.38

Governing law, trust clauses. See **Governing Law**

Interest-analysis theory, 20.4

Nature of problem, 20.2

Powers of appointment, 20.61

Real property in several states and personal property, 20.40

Specifying law to govern validity, construction, and administration, 10.126

Trustee validating transactions, 20.5

Using out-of-state counsel, 20.7

Construction and interpretation of trust

Generally, 20.8, 20.15

Personal property, 20.17

Real and personal property, 20.18

Real property, 20.16

Credit issues. See **Debts**

Death taxes (see Estate tax, below)

Defining technical terms, 20.37

Disclaimer of beneficiary's interest, 20.60

Drafting checklist, 20.101

Estate tax

Generally, 20.73

Beneficiary's interest, 20.87

Characterization of property, 20.49, 20.77

Character of decedent's interest in trust property, 20.81

Computing state death tax credit or deduction for federal estate tax, 2.84, 20.79

Exemption and arbitration statutes, 20.76

Hypothetical case application, 20.82-20.83, 20.86-20.87

Intangible personal property, 20.75

Minimizing, 20.83

Multiple domiciles, 20.78, 20.82

Payment and apportionment, 20.84-20.85

Pick-up tax, 20.80

Real property and tangible personal property, 20.74

Family rights' violations

Children's rights, 20.58

Hypothetical case application, 20.59

Surviving spouse's rights, 20.57

Gift tax

Hypothetical case application, 20.91

Intangibles, 20.89

Planning for, 20.90

Real property and tangibles, 20.88

Hypothetical case (Jones trust)

Administration of trust analysis, 20.22-20.23

Charitable trusts analysis, 20.71

Defining technical terms, 20.37

Facts presentation, 20.6

Family rights violations analysis, 20.59

Gift tax analysis, 20.91

Income tax analysis, 20.94

Pour-over bequests analysis, 20.46

Power of appointment analysis, 20.65

Property tax analysis, 20.99

Real and personal property situs planning, 20.41

Revocability analysis, 20.36

State death taxes analysis, 20.82-20.83, 20.86-20.87

Transferring property to trust in another jurisdiction analysis, 20.56

Trustee's compensation analysis, 20.34

Trustee selection analysis, 20.43

Validity of trust analysis, 20.9-20.10, 20.14

Income tax

Community property transfers, 20.51

Hypothetical case application, 20.94

Planning for, 20.95

Tax credit statutes, 20.93

Trusts and beneficiaries, 20.92

Investments, 20.32

Jurisdiction

Generally, 20.26

Choice-of-forum clauses, 20.31

Conflicting rights and claims to trust property, 20.27

Federal court refusing jurisdiction despite diversity existence, 20.29

Non-situs state courts' entitlement to act, 20.28

Transferring property to trust in another jurisdiction (see Transferring property to trust in another jurisdiction, below)

Validity of choice-of-forum clauses, 20.30

Marital rights

Charitable trusts, 20.69

Surviving spouse's rights violation, 20.57

Transferring property to trust in another state, 20.50

Out-of-state counsel involvement, 20.7

Personal property (see Real and personal property, below)

Pour-over bequests to living trusts, validity, 20.45-20.46

Power of appointment

Generally, 20.61

Choice of law governing exercise of power, 20.64

Drafting considerations, 20.62

Exercise of power, 20.63

Hypothetical case application, 20.65

Property tax

Basic principles, 20.96

Beneficiary's domicile taxing intangibles, 20.98

Hypothetical case application, 20.99

Planning for, 20.100

Settlors' domicile taxing intangibles, 20.97

Real and personal property

All real and personal property in one state, 20.39

Appointing trustee for real property, 20.44

Construction and interpretation of trust (see Construction and interpretation of trust, above)

Death or estate taxes (see Estate tax, above)

Gift taxes (see Gift tax, above)

Income taxes (see Income tax, above)

Property taxes (see Property tax, above)

Real property in several states and personal property, 20.40

Validity of trust (see Validity of trust, below)

Revocability, 20.36

Taxation

Generally, 20.2, 20.72

Death or estate taxes (see Estate tax, above)

Gift taxes (see Gift tax, above)

Income tax (see Income tax, above)

Property taxes (see Property tax, above)

Transferring property to trust in another jurisdiction

Generally, 20.47-20.48

Agreement and trust between spouses, effect of, 20.53

Change of settlor's residence, effect of, 20.55

Choice of law for community property, 20.52

Death tax purposes, character of property for, 20.49

Hypothetical case application, 20.56

Income tax effects of community property transfers, 20.51

Marital rights, 20.50

Procedure, 20.54

Trustee

Appointing trustee for real property, 20.44

Compensation, 20.34

Exoneration of liability, 20.33

Validating transactions, 20.5

Who may act as trustee, 20.42

Validity of trust

Generally, 20.8-20.9

Determining character of property as real or personal, 20.14

Equitable conversion of real property, 20.11

Personal property, 20.12

Pour-over bequests to living trusts, 20.45

Real and personal property, 20.13

Real property, 20.10

Name of Trust

Declaring trust name, 8.5

GRAT, name of, 15.20

GRIT, name of, 14.17

GRUT, name of, 16.17

Natural Resources

Allocation

Expenses and income, 19.110

Receipts from royalties, allocation of, 19.19

UPAIA considerations, 10.110

Establishing reserve for, 19.110, 19.111, 19.112

Funding trust with, 19.109

Trustee's powers

Allocating receipts, 19.113

Lease or own property, 10.69, 10.70, 19.112

Negligence

Trustee's breach of trust, exoneration of, 10.38

No-Contest Clause

Charitable remainder trust, 18.100

Sample and explanation, 10.136

Nongrantor Trust

See also **Grantor Trusts**

Alternative minimum tax, 3.9

Charitable lead annuity trust. See **Charitable Lead Annuity Trust (CLAT)**

Complex trusts, 3.14-3.18D

Determining distributable net income (DNI), 3.10

Determining taxable income, 3.5

Disallowance of certain capital losses, 3.8

Kiddie tax, 1.7, 3.19-3.20

Rate of tax, 3.7

Selecting taxable year, 3.6

Simple trust, 3.11-3.13

Termination, tax consequences, 3.21

Treated as association taxable as corporation, 3.4

Treated as separate taxpayer and/or pass-through entity, 3.3

Nonproductive Property. See Underproductive Property

Notes

Promissory notes

Dynasty trust. See **Dynasty Generation-Skipping Trust**

Fractional-share defined value, sale of limited partnership interest in family limited partnership to another trust in exchange for promissory note as violation of public policy, 3.44B

Loans. See **Loans**

Self-canceling installment note (SCIN), rebutting presumption of gift in case of sale of property to son in exchange for, 2.8

Notice and Notification

Allocation of GST tax exemption, 4.23

Births, deaths, and other events affecting interests, 10.119, 10.120

Crummey withdrawal right

Generally, 12.80

Basic form, 12.85

Importance of written notice, 12.83

Persons receiving notice, 12.84

Custodian resignation, 12.27

Guardian's exercise of *Crummey* withdrawal power on minor's behalf, 2.36

Proposed action, notice of, 10.109A-10.109B, 10.109C

Spousal consent to split-gifts, 2.43

Oil and Gas Interests. See Natural Resources

Operation of Business

Allocation of net receipts and proceeds of liquidation

Generally, 19.92

Definition of business conducted by trustee, 19.93

Losses, 19.94

Proceeds of liquidation, 19.95

Charitable remainder trust

Funding, 18.14

Taxation, 18.33-18.36

Closely held and family partnership interests. See **Closely Held Businesses**

Liquidation (see Allocation of net receipts and proceeds of liquidation, above)

Management issues

Compensation of trustee, 19.87, 19.88-19.89

Delegation of powers, drafting around statutory limitations on, 10.76

Directions on management of business enterprise, 10.3, 19.85

Exonerating trustee from liability, 19.86

Reimbursing trustee for expenses, 19.90, 19.91

Trustee's power to operate business, necessity for clear language outlining or court order authorizing, 10.62-10.63

Self-dealing by trustee. See **Self-Dealing**

Settlor's leaseback of transferred property, 19.60

Trustee's power to acquire liability insurance, 10.86, 10.87

Options

Allocating option money, 19.13, 19.14

Life insurance trust, restricted design options, 11.3

Power of trustee to grant options, 10.67, 10.68

Settlor's repurchase of property sold to trust, 19.66

Valuing property that includes options, 2.25, 2.29, 19.76

Other States or Countries. See Foreign Trusts; Multistate Trusts

Partition

Community property funding, Life insurance trust, 11.4

Trustee's power, 19.4

Partnerships

See also **Limited Partnerships**

Generally, 19.79

Closely held or family interests. See **Closely Held Businesses**

Control defined, 19.75

Taxation under IRC §704(e), 19.77-19.79

Valuing transferred interests

Freeze technique, 2.25

Funding GRAT with partnership interest, 15.3

Lapsing rights and restrictions, 2.30

Requirements and procedure, 2.26

Payable on Death (POD) Account

Advantages and disadvantages, 12.16

Legal and tax aspects, 12.15

Penalty

Foreign trusts, penalties for US persons failing to comply with reporting requirements for transfers to, 3.69, 3.69H

Insider trading, 19.107

Private foundation, prohibited transactions, 18.40

Retirement plans, 19.117

Permanent Trust

Annuity trust. See **Annuity and Annuity Trust**

Balancing personal and tax objectives, 5.3

Distinguishing permanent trust from other trusts, 1.2, 5.1

Funding, 5.11

Hybrid trusts. See **Hybrid Trusts**

Nontax purposes, generally, 5.2

Pipe dream trust. See **Pipe Dream Trust**

Separate trusts. See **Separate Trusts for Minor Beneficiaries**

Single trust with discretion to distribute principal. See **Single Trust With Discretion To Distribute Principal**

Spendthrift trust. See **Spendthrift Trust**

Sprinkling trust. See **Sprinkling Trust or Power**

Tax purposes

Generally, 5.2-5.3

Achieving grantor trust powers, 5.9-5.10

Dividing community property, 5.12

Gifting strategy, 5.12A

Planning generation-skipping transfer tax, 5.6-5.7

Preventing inclusion of trust property in beneficiaries' taxable estate, 5.5

Reducing settlors' estate tax, 5.4, 5.9

Reducing settlors' income tax, 5.8

Unitrust. See **Unitrust**

Perpetuities

Rule against perpetuities

Generally, 9.58

Dynasty trust, effect of rule on, 13A.5

Multistate trusts, 20.68

Rule of Shelley's case, 20.8

Savings clause trust including power of appointment, 9.59

Personal Property

Bonds and undertakings, 19.27

Charitable remainder trust property, 18.14

Choice of law clause desirability, 10.125

Domicile, 20.12

Equitable conversion of real property, 20.11, 20.20

Multistate trusts. See **Multistate Trusts**

Puts, call, margin accounts, and other specialized investments, 19.30, 19.31

Sale, generally. See **Sale of Property**

Stock. See **Securities**

Tangible personal property

Authorizing abandonment, 19.33

Difficulty of holding in trust, 19.32

Underproductive property. See **Underproductive Property**

Personal Residence

Charitable remainder interest

Gift tax consequences, 2.42

With retained estate, 18.123

Defined and construed, 2.42

Trust. See **Personal Residence Trust (PRT); Qualified Personal Residence Trust (QPRT)**

Personal Residence Trust (PRT)

See also **Qualified Personal Residence Trust (QPRT)**

Grantor retaining interest, 2.28

Repurchase of home from PRT or QPRT, 14.10, 19.66

Survival prerequisite, 6.26

Petitions

Consolidate or divide multiple trusts, 10.101

Cotrustees' incapacity, authorizing other cotrustee as sole trustee, 10.16

Litigation SNT. See **Litigation Special Needs Trust (LSNT)**

Removal of trustee, 10.29

Resignation of trustee, 10.27

Supervised custodianship, 12.32

Termination of trust, 9.6-9.7

Pipe Dream Trust

Generally, 5.13-5.14

Estate and gift tax principles, 5.15-5.16

Flexibility versus control, 5.28

Income tax principles, 5.17

Road to reality, 5.18

Single versus multiple trusts, 5.29-5.31

Support and legal obligations

Education expenses, 5.21

Minors, 5.20

Parents and adult children, 5.22

Trustee's discharge power, 5.23, 5.27

POD. See Payable on Death (POD) Account

Pooled Income Fund (PIF)

Generally, 18.106, 18.108

Beneficiaries' income based on rate of return, 18.115

Charitable remainder trust comparison, 18.2, 18.107

Commingling of property, 18.111

Contributing remainder interest to charity, 18.109

Estate tax deduction allowance, 2.74

Gift tax deduction allowance, 2.42

IRS Table S application, 6.15

Life income interest

Creating, 18.110

Terminating, 18.116

Maintenance by charity, 18.113

Prohibiting exempt securities, 18.112

Sample document, 18.117

Trustee, donor or beneficiary as, 18.114

Power of Attorney

Gifts, including provision authorizing power to make, 2.34

Powers of Appointment

Generally, 2.65, 10.57-10.58

Allocating receipts and disbursements power distinguished, 10.111

Ascertainable standard, limitation, 2.12

Beneficiary-trustee

Generally, 10.6, 10.99

Apply principal without limitation, 9.62

Power to distribute if power of appointment not exercised, 10.139

Power to remove trustee and appoint successor, 10.32

Special trustee to make discretionary payments, 10.25

Distributions discharging support obligations, 5.23

Donee-trustee holding, 2.11-2.12, 2.19

General power of appointment, 2.11, 9.55, 9.57, 12.44, 12.47

GST taxable distributions, general powers of appointment, 4.10

Investing

Life insurance, 11.19

Settlor or nonadverse party, 10.21

Jointly held, 2.13, 2.18

Lapsed powers. See **Lapsed Powers**

Limited power of appointment

Limited broad power, 9.55

Minors' trust under IRC §2503(c), 12.48

Narrow limited power, 9.55

Reciprocal-trust doctrine application, 2.54

Minor holding general power of appointment, 4.39, 10.139, 12.44, 12.46

Minors' trust under IRC §2503(c), 12.44, 12.46-12.48

Multistate trusts. see **Multistate Trusts**

Perpetuities saving clause trust including, 9.59

Purpose, 9.54

Release of general power of appointment, 2.11, 2.65, 4.10

Reserved powers, transfer of property under, 2.48

Special trustee, 10.19, 19.22

Spendthrift trust, 9.65

Spouse's general power of appointment, 10.6

Successor trustees. See **Trustees**

Tax considerations

Estate and gift tax, 2.65, 9.56

Gains and losses from sale of property, 19.11

GST tax, 9.60

Income tax, 9.57

Testamentary. See **Testamentary Transfers or Trust**

Powers of Trustee

Generally, 2.61-2.62, 10.57-10.58

Accumulate income. See **Accumulation Power**

Allocation. See **Allocation**

Alter, revoke, or terminate trust, 2.59-2.60

Appointment. See **Powers of Appointment**

Beneficiary-trustee, 10.6

Borrow, 10.79, 10.80

Buy from probate estate, 10.88, 10.89

Buy from trust, 10.82, 10.83

Cash. See **Cash**

Charitable remainder trustee, beneficiary designation, 18.66, 18.67-18.68

Closely held business interests. See **Closely Held Businesses**

Complete versus incomplete gifts to trust, effect on, 2.15

Consolidate or divide trusts, 10.101, 10.102-10.103

Control beneficial enjoyment, 2.17, 2.61-2.62, 19.12

Decedent's estate. See **Estate Tax**

Depreciation of reserve or allowance, 19.19

Designate successor trustee, 10.36

Discharge support obligations, 5.23, 5.27

Disclaimer of powers, 10.91, 10.92

Distributions. See **Distributions**

Employment of agents. See **Management of Trust Property**

Encumbered property, 10.67, 10.68, 19.56

Environmental cleanup and related concerns, 19.20, 19.21

Foreclosure. See **Foreclosure**

GRAT, 15.34

GRIT, 14.27

GRUT, 16.32

Independent trustee. See **Independent Trustees**

Insurance, assets and liability, 10.86, 10.87

Investments. See **Investments**

Jointly held power with donor, 2.18

Lease trust property, 10.69, 10.70, 19.58, 19.112

Life insurance trust. See **Life Insurance Trust**

Limitations on trustee's discretion, 10.10-10.11

Litigating claims, 10.84, 10.85

Loans. See **Loans**

Marital deduction power of appointment trust, 19.19

Minors' trust under IRC §2503(c)(1), 12.39-12.42, 12.54, 12.56

Mortgage and trust deed. See **Mortgages and Trust Deeds**

Moving situs of administration of trust, 10.104

Multiple trusts. See **Multiple Trusts or Skips**

Natural resources, 19.112, 19.113

Permanent trust, 5.2

Purchase bonds at discount, 19.29

Purchase bonds at premium, 19.28

QSST trustee, 19.100

Qualified personal residence trust (QPRT), provision for trustee's powers, 17.105

Real property powers. See **Real Property**

Related or subordinate party, 3.35-3.36

Release, 10.84, 10.85, 10.91, 10.92

Retained power over disposition of transferred property, 2.16

Retain property, 10.62, 10.63-10.64

Securities management. See **Securities**

Sell, exchange, manage, encumber, and grant options, 10.67, 10.68, 10.82, 10.83

Settlor-trustee, 2.17, 10.3-10.5

Special trustees. See **Special Trustees**

Sprinkling. See **Sprinkling Trust or Power**

Support of grantor's dependents, 2.53

Tax-related powers

Disclaim, release, or restrict administrative powers, 10.91, 10.92

Distributions, consider tax consequences, 10.95, 10.96

Elections and other decisions, adjust for tax consequences, 10.93, 10.94

Estate tax payment, 10.97

GST tax payment, 10.98

Prohibited powers, 10.100

Tax-sensitive trustee limitations, 10.99, 10.112C

Terminate trust

Distributions on exercising termination power. See **Distributions**

Small trust, 9.7

Underproductive or unproductive property. See **Underproductive Property**

Premiums

See also **Discounts**

Bonds and undertakings. See **Bonds and Undertakings**

Control and marketability premium valuation

Bonds, 19.27

Charitable or marital gifts, 2.71

Gifts, generally, 2.23

Life insurance policy, 2.47

Stock, 2.70-2.71

Life insurance premiums. See **Life Insurance**

Preservation

Duty to preserve trust assets, 19.50

Presumptions and Inferences

Domestic partnership, presumptions regarding child of, 10.133A-10.133B

Failure to exercise naked *Crummey* power, 12.93

Insurer's mortality tables' assumption of death before 100, 11.35

Intrafamily transfers, presumption of gifts, 2.8

Joint tenancy title, 12.17

Residence, retained use or occupancy right, 2.50

Settlement agreement dissolving marriage, consideration element, 2.33, 2.68

Trustee exercising allocation discretion contrary to UPAIA, 10.110

Prior Transfer Property (PTP) Credit, 2.82, 2.86

Private Foundation

Accelerated charitable trust, transfer of highly appreciated assets to private foundation through use of, 18.9B

Charitable lead annuity trust. See **Charitable Lead Annuity Trust (CLAT)**

Charitable remainder

Restrictions, 18.79-18.80, 18.81

Settlor's income tax deduction aspect, 18.20, 18.66-18.67

Pooled income fund. See **Pooled Income Fund (PIF)**

Sanctions for prohibited transactions, 18.40

Professional Advisors

Attorneys. See **Attorneys**

Exoneration of professional trustee's conduct, 10.38

Independent trustee. See **Independent Trustees**

Investment, 10.21, 10.56

Promise To Marry

Consideration for property transfer, gift tax consequences, 2.33

Promissory Note. See Notes

Proof. See Burden of Proof

Property Tax and Assessments

Allocation, 19.15-19.16

GRAT property, 15.14

GRIT property, 14.11

GRUT property, 16.11

Leaseback property, deduction entitlement, 19.59

Multistate trusts. See **Multistate Trusts**

Qualified personal residence trust (QPRT), property tax consequences for, 17.47

Proration. See Allocation

Prudent Investor Rule. See Investments

Public Benefits

Litigation special needs trust. See **Litigation Special Needs Trust (LSNT)**

Medi-Cal and Medicaid. See **Medi-Cal and Medicaid**

Special needs trust. See **Special Needs Trust (SNT)**

SSI. See **Supplemental Security Income (SSI)**

Public Policy

Choice-of-law clause, California's public policy against, 20.38

Fractional-share defined value, sale of limited partnership interest in family limited partnership to another trust in exchange for promissory note as violation of public policy, 3.44B

Savings clause void as against public policy, 20.39

QDOT. See Qualified Domestic Trust (QDOT)

QPRT. See Qualified Personal Residence Trust (QPRT)

QSST. See S Corporations

QTIP. See Qualified Terminable Interest Property (QTIP) Trust

Qualified Domestic Relations Order (QDRO)

Distribution of retirement benefits under, 19.117

Qualified Domestic Trust (QDOT)

Generally, 2.75, 2.80

Designation of successor trustees, 2.81G

Inter vivos QDOT

Generally, 2.81A, App J

Alternative spousal access trust, 2.81H

Construction of trust, 2.81B

Designated filer, 2.81E

Distribution of principal and income, 2.81F

Security requirements, compliance with, 2.81C

Termination of trust, 2.81A

United States citizen as trustee, 2.81D

Inter vivos QDOT and forms, 2.81A-2.81B, App J

Prior transfer property (PTP) credit, effect of, 2.82, 2.86

Purposes, 1.2

Requirements for, 2.81

Trustees

Adjustments between principal and income, rules affecting trustee's power over, 2.80

Inter vivos QDOT (see Inter vivos QDOT, above)

Waiver of trustee's citizenship requirements, 2.81

Usage, generally, 2.75, 2.80

Qualified Personal Residence Trust (QPRT)

See also **Personal Residence Trust (PRT)**

Generally, 17.1

Acronyms, using with clients, 17.3

Advantages of QPRTs

Generally, 17.6

Creditor advantages (see Creditor advantages of QPRT, below)

Tax advantages (see Tax advantages of QPRTs, below)

Alternatives to QPRT

Generally, 17.59

Family limited partnerships, disadvantages of, 17.63

Grantor retained annuity trust (GRAT), 17.64

Intentionally defective QPRT, 17.67

Joint purchase of new residence, 17.65

Outright gift of residence to children or trust, 17.60

Part gift, part sale of residence, 17.62

Sale-leaseback of residence between parent and child, 17.61

Summary of alternatives to QPRT, table, 17.68

Zeroed-out QPRT, 17.66

Annual gift tax exclusion

Calculating value of QPRT gift, 17.54

Contributions to pay mortgage not qualifying for, 17.18

Transfers to QPRTs not qualifying for annual gift tax exclusion, 17.34

Candidates for QPRTs, 17.22

Cash

Excess cash, distribution of, 17.81

Separate account for cash additions, 17.78

Client memorandum, 17.110

Conversion of QPRT into GRAT

Additions, prohibition against, 17.100

Annuity, amount of, 17.97

Annuity, payment of, 17.94

Beginning date for annuity, deferral of payment, 17.95

Commutation (prepayment) of settlor's interest prohibited, 17.102

Distribution on expiration of trust term, 17.103

Distribution to other beneficiaries prohibited, 17.101

Each year of trust, payment for, 17.96

Gift tax issues involving, 17.32

Introductory provision, 17.93

Necessity of grantor trust status for GRAT, 17.44

Short taxable year, 17.98

Value of trust estate, 17.99

Creditor advantages of QPRT

Generally, 17.11

Bankruptcy trustee, time limit for attacking fraudulent transfer of residence to QPRT, 17.14

Diminishing value of retained interest in QPRT, 17.12

Selection of term for QPRT, protecting equity from future creditors as factor in, 17.53

Statute of limitations for filing action based on fraudulent transfer, 17.13

Defined and construed, 2.28, 6.2, 17.1, 17.30

Diagrams for husband and wife, 17.112

Disadvantages of QPRT

Generally, 17.15

Financial disadvantages (see Financial disadvantages of QPRTs, below)

Tax disadvantages, 17.16

Distributions

Conversion of QPRT to annuity trust, distributions on (see Conversion of QPRT into GRAT, above)

Excess cash, distribution of, 17.81

Income, distribution to settlor, 17.80

Limit on trust distributions, 17.82

Termination of QPRT (see Distributions on termination of QPRT, below)

Distributions on termination of QPRT

Accrued income, 17.91

Conversion of QPRT to annuity trust, distribution on expiration of trust term, 17.103

Introductory provision, 17.89

Remaining trust estate, 17.91

Settlor survives, distribution on termination if, 17.109

Trust operations account, 17.90

Drafting QPRT

Generally, 17.69

Additions to trust estate, limits on, 17.73

Conversion to annuity trust (see Conversion of QPRT into GRAT, above)

Description of transferred property, 17.108

Distributions (see Distributions, above)

Distributions on termination (see Distributions on termination of QPRT, above)

Governing law, 17.106

Irrevocability of trust, 17.74

Letter transmitting draft QPRT to client, 17.111

Name of trust, 17.71

Operation during trust term (see Operation during trust term, below)

Statement of intent, 17.107

Term of trust, 17.75

Trustees (see Trustees, below)

Trust estate, 17.72

Duration of QPRT (see Length of term for QPRT, selection of, below)

Dynasty trust's advantages over, 13A.2

Estate taxes

Advantages of QPRT, 17.9

Disadvantages of QPRT, 17.16

Grantor's failure to survive term of trust, inclusion of residence in grantor's estate, 17.38

Grantor surviving term of trust (see Grantor surviving term of trust, estate tax consequences of, below)

Length of term for QPRT, estate tax motivation in selecting, 17.51

Reversionary interest valuation, 2.57

Tax apportionment clause, effect of, 17.39

Example of QPRT, 17.4

Expenses of QPRTs

Initial expenses in setting up QPRT, 17.23

Ongoing expenses, 17.24

Payment of expenses, 17.83

Financial disadvantages of QPRTs

Generally, 17.17

Borrowing against residence, restrictions on, 17.20

Financial statements, effect of transferring property to QPRT on, 17.19

Mortgaged property, disadvantages in transferring to QPRT, 17.18

Rent (see Rent, grantor's payment to trust after QPRT term ends, below)

Fraud (see Creditor advantages of QPRT, above)

Generation-skipping transfers

Generally, 17.45

Remainder beneficiary trust, parent allocating GST exemption to, 17.57

Gift of residence as alternative to QPRT (see Alternatives to QPRT, above)

Gift taxes

Advantages of QPRT, 17.8

Annual exclusion (see Annual gift tax exclusion, above)

Calculating value of QPRT gift, 17.54

Conversion of QPRT into GRAT, gift tax issues involving, 17.32

Grantor retaining interest, 2.28

Multiple QPRTs for same residence, gift tax treatment of, 17.55

Partial interest transfers, 2.14

Transfer of completed residence as gift, 17.33

Zeroed-out QPRT, no gift tax cost for, 17.66

Grantor surviving term of trust, estate tax consequences of

Extend term of trust, effect of grantor giving independent third person power to, 17.37

Residence excluded from grantor's taxable estate, 17.35

Reverse or return QPRT allowing grantor to retain use of residence after end of term, 17.36

Selecting length of term for QPRT, effect on grantor's chances of failing to survive term, 17.50

GRAT issues

Alternative to QPRT, GRAT as, 17.64

Conversion of QPRT into GRAT, 17.32

GRUT's repurchase of home from QPRT, 16.10

Income tax issues relating to QPRT

Generally, 17.40

Advantages of QPRT, 17.10

Conversion of QPRT into GRAT, necessity of grantor trust status for GRAT, 17.44

Grantor trust status for QPRT, necessity of, 17.41

Repurchase of residence by grantor resulting in recognition of gain by seller, 17.42

Strategies for grantor trust status, 17.43

Leases

End of QPRT term, leasing residence after, 17.35

Sale-leaseback of residence between parent and child as alternative to QPRT, 17.61

Length of term for QPRT, selection of

Generally, 17.50

Estate tax motivation in selecting length of term for QPRT, 17.51

Extend term of trust, effect of grantor giving independent third person power to, 17.37

Multiple QPRTs with different terms for same residence, 17.55

Protection of equity from future creditors, selection of shorter term for, 17.53

Rent, client's concerns of paying after end of QPRT term, 17.52

Sample form provision, 17.75

Mortgages

Disadvantages of transferring mortgaged property to QPRT, 17.18

Refinancing mortgage for residence in trust, higher interest rate for, 17.24

Operation during trust term

Cash additions, separate account for, 17.78

Cessation of QPRT status, 17.87

Cessation of use of residence as personal residence, 17.86

Damage to or destruction of personal residence, 17.85

Distributions (see Distributions, above)

Exclusive use of residence, 17.79

Expenses of trust, payment of, 17.83

Introductory provision, 17.76

Limitations on trust property, 17.77

Sale of residence, 17.84

Transfer to settlor prohibited, 17.88

Personal residence requirement

Generally, 17.26

Appurtenant structures, personal residence including, 17.27

Community property residence, partitioning into equal shares and holding as tenants in common, 17.29

Exclusive use of residence satisfying, 17.79

Multiple QPRTs for single residence, permissibility of, 17.28, 17.55

Repurchase strategy, 19.66

Undivided fractional share interest in personal residence, funding QPRT with, 17.28

Regulations for QPRT

Generally, 17.25

Grantor retained annuity trust (GRAT), conversion of QPRT into, 17.32

Personal residence requirement (see Personal residence requirement, above)

Required governing instrument provisions, 17.30

Summary of governing instrument regulations, 17.31

Rent, grantor's payment to trust after QPRT term ends

Generally, 17.21

Selecting length of QPRT term, client's concerns over paying rent after end of trust as factor in, 17.52

Reverse QPRT

Generally, 17.36

Example of, 17.58

Sale of residence

Alternatives to QPRT (see Alternatives to QPRT, above)

Sample provision for, 17.84

Sample QPRT, App P

State tax considerations

Generally, 17.46

Documentary transfer tax, exemption for transfer of residence to QPRT, 17.48

Real property tax consequences for QPRT, 17.47

Structuring QPRT

Generally, 17.49

Calculating value of QPRT gift, 17.54

Length of term for QPRT (see Length of term for QPRT, selection of, above)

Maximum of 3 residences for married couple, 17.56

Multiple QPRTs for same residence, 17.28, 17.55

Remainder beneficiary, advantages of naming trust as, 17.57

Tax advantages of QPRTs

Generally, 17.7

Estate tax advantage of QPRT, 17.9

Gift tax advantage of QPRT, 17.8

Income tax advantage, 17.10

Tax issues

Disadvantages of QPRT, 17.16

Estate taxes (see Estate taxes, above)

Generation-skipping transfers (see Generation-skipping transfers, above)

Gift taxes (see Gift taxes, above)

Income tax (see Income tax issues relating to QPRT, above)

Regulations for QPRT (see Regulations for QPRT, above)

Repurchasing residence, effect of, 14.10, 19.66

State taxes (see State tax considerations, above)

Termination of QPRT

Distributions on termination (see Distributions on termination of QPRT, above)

Property tax reassessment, termination of QPRT resulting in, 17.47

Trustees

Borrowing against residence in QPRT, 17.20

Declaration of transfer to trustee, 17.70

Office of trustee, 17.104

Powers of trustee, 17.105

Underutilization of QPRTs, 17.5

Qualified Subchapter S Trust (QSST). See S Corporations

Qualified Terminable Interest Property (QTIP) Trust

See also **Marital Deduction**

Charitable remainder trust distinguished, 18.21

Decedent's estate, 2.79

Funding of inter vivos QTIP trust and California law, effect on possible tax benefits, 2.39A, 2.79

GST tax's effect on QTIP election, 4.4, 4.31

Inter vivos QTIP trust and forms, 2.39A, 2.39B-2.39C, 2.39D, App I

Marital deduction entitlement, 2.41, 2.79, 10.113

Noncitizen spousal gifts, tax consequences, 2.39

Overriding restrictive investment clause, 10.61

Prior transfer property credit, availability of, 2.86

Purposes, 2.1

Spouse with administrative power, 10.6, 10.64

Spouse with charitable remainder, 18.122

Questionnaires. See Charts, Checklists, Questionnaires, and Tables

Ranches. See Farms and Ranches

Real Property

Allocation. See **Allocation**

Choice of law clause desirability, 10.125

Conservation easement, excluding from value of gross estate, 2.72

Creation and validity of trusts containing, 19.2

Equitable conversion, 20.11, 20.20

Gains and losses

Purchase option money, 19.13, 19.14

Sale, exchange, or transfer of property, 19.11, 19.12

GRIT asset, 14.6

Leased. See **Leased Property**

Management issues. See **Management of Trust Property**

Minors' ability to acquire, 12.12

Mortgages and trust deeds. See **Mortgages and Trust Deeds**

Multistate trusts. See **Multistate Trusts**

Powers of trustee

Allocating gains and losses (see Gains and losses, above)

Beneficiary rent-free occupancy, 19.36

Carry insurance against contractual and tort liability, 10.85

Compromise and release claims and debts, 10.84

Distribute real property in kind, 10.108

Employ managers and brokers. See **Management of Trust Property**

Encumber property, 10.66-10.77

Environmental cleanup and related concerns, 19.20, 19.21

Land use planning, 19.4, 19.5, 19.6

Mortgages and trust deeds. See **Mortgages and Trust Deeds**

Sell, exchange, manage, encumber, and grant options, 10.67, 10.68, 10.82, 10.83

Special trustee, 19.22

Spendthrift provisions, 10.128

Subdivide, develop, and sell property, 19.4, 19.5

Rental property expenses, 19.17, 19.18

Rent. See **Rent**

Sale. See **Brokers; Sale of Property**

Special trustee, 19.22, 19.60

Tax and assessment. See **Property Tax and Assessments**

Receiver

Resignation of trustee causing receivership, 10.27

Reciprocal Trust Doctrine

Generally, 2.37A, 2.54, 5.12, 11.5

Custodial property, 12.33

Minors' trust under IRC §2503(c), 12.53

Records and Reports

Foreign trusts, reporting requirement for. See **Foreign Trusts**

Obligations of joint tenants to account to other tenant for changes, limitations on, 12.17-12.18

Redemptions

Advantages of gifts, 2.45

Disadvantages of gifts, 2.46

Estate tax value of majority block of stock, effect of redemption agreement on, 2.71

Paying estate tax by stock redemptions, 2.91

Reformation of Trust

Charitable remainder trust. See **Charitable Remainder Trust (CRT)**

Grantor retained annuity trust (GRAT), ineffectiveness of amendment to conform to *Walton,* 15.6

Life insurance trust, effect of reformation on ownership of, 11.6

Reimbursement

Business enterprise expenses trustee pays, 19.90, 19.91

GRAT provision, 15.11

GRUT provisions, 16.8

Guardian's expenses, 12.19

IRS requirement, trust reimbursement clause, 14.8

Special needs trust. See **Special Needs Trust (SNT)**

Related or Subordinate Party

Borrowing income or principal, 3.27, 10.81, 12.56

Choosing as trustee

Generally, 9.40, 10.2, 10.5

Independent or special trustee, 3.36, 9.10, 9.14, 10.7, 10.12

Defective grantor trust, 3.40

Defined, 3.36

Family partnership rules distinguished, 19.77

Powers of trustee, 3.35-3.36

Removal and substitution of trustee, 2.62, 9.12, 9.14, 9.52, 10.29, 11.6

Release

Crummey withdrawal right, 12.84, 12.89

General power of appointment, 2.11, 2.65, 4.10

Marital right relinquishment, estate tax, 2.68

Power of trustee, 10.84, 10.85, 10.91

Remainder Interests

See also **Retained Interests; Reversionary Interests**

Charitable. See **Charitable Gifts and Deduction**

Decedent's interest

Deferral of estate tax, 2.82

Includable in gross estate, 2.47

Distribution of remainder, 9.49

Extension of time to pay estate tax, 2.90

Gift tax on annuity remainder interest, 2.55

GRAT interests. See **Grantor Retained Annuity Trust (GRAT)**

GRIT interests. See **Grantor Retained Income Trust (GRIT)**

GRUT interests. See **Grantor Retained Unitrust (GRUT)**

Minors' IRC §2503(b) trust property, 12.65, 12.67

Pooled income fund. See **Pooled Income Fund (PIF)**

Transfers retaining, 2.16

Underproductive property, 19.35

Valuation. See **Valuation**

Removal of Trustee. See Trustees

Rent

Active ownership of business and passive rental of property, importance of distinguishing, 2.89

Allocation of rental income, 19.11, 19.110

Beneficiary occupying residence rent free, 19.36

Dynasty trust, deed of trust with assignment of rents, 13A.20

Foreign trusts assets, 3.69

Leaseback of gratuitously transferred property, tax treatment of payments

Generally, 19.58

Deductibility by settlor, 19.60

Income to grantor trust, 19.61

Income to nongrantor trust, 19.59

Leaseback of property sold to trust, tax treatment of payments

Generally, 19.62

Installment sale tax treatment, 19.63

Nonrecognition of capital loss, 19.65-19.66

Realization of capital gain, 19.64, 19.66

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Reserve account, 19.111

Right to receive rental income, 2.50

Repairs. See Improvements and Repairs

Reports. See Records and Reports

Reserved Interests. See Retained Interests; Reversionary Interests

Residence

Beneficiary occupying rent free, 19.36

Charitable deduction, 2.74

Charitable remainder interest, 2.42

Depreciation. See **Depreciation**

Farms and ranches. See **Farms and Ranches**

Gift-splitting spousal election, residency requirement, 2.43

Nexus for imposing state income tax, 3.2

Reserved use or occupancy, direct or implied, 2.50

Trust

Generally. See **Personal Residence Trust (PRT)**

Qualified. See **Qualified Personal Residence Trust (QPRT)**

Underproductive property aspect, 19.35

Resignation

Custodian, procedure, 12.27

Trustee. See **Trustees**

Retained Interests

See also **Remainder Interests; Reversionary Interests**

Charitable gift tax deduction entitlement, 2.40

Decedent's estate issues. See **Estate Tax**

5 or 5 amount, excess lapse of retained interests, 12.89

Life estates. See **Life Estates**

Power over disposition of transferred property, 2.16

Power to vote stock, 2.56

Subsequent incompetence of donor, 2.17

Trust

Generally. See **Grantor Retained Income Trust (GRIT)**

Annuity. See **Grantor Retained Annuity Trust (GRAT)**

Powers retained, recognized gain aspect, 19.55

Qualified trust interests, 2.27-2.28

Reciprocal trust doctrine, 2.54, 11.5

Residence. See **Qualified Personal Residence Trust (QPRT)**

Unitrust. See **Grantor Retained Unitrust (GRUT)**

Voting rights, 2.56, 19.103, 19.104

Retirement Plans

Charitable remainder trust property, 18.14

Source of trust funding, 19.109, 19.117

Return. See Generation-Skipping Transfer (GST) Tax

Reverse QPRT. See Qualified Personal Residence Trust (QPRT)

Reversionary Interests

See also **Remainder Interests; Retained Interests**

Gift and estate tax, 2.16, 2.57, 9.46, 9.61

GRAT, tax consequences, 15.11

GRIT, tax consequences, 14.8

GRUT, tax consequences, 16.8

Minors' trust under IRC §2503(c), 12.47

Valuation. See **Valuation**

Revocation of Trust

Settlor's power to revoke CRT, 18.96, 18.97

Settlor's subsequent incompetence, 2.17

Termination of trust. See **Termination**

Right of First Refusal

Special valuation rules, 2.25, 2.29, 19.76

Rule Against Perpetuities. See Perpetuities

Rule in *Shelley's* Case, 20.8

Safe Harbor

Crummey withdrawal power, 4.1, 4.10, 12.95

Insured holding incidents of ownership in fiduciary capacity, 11.6

Securities sold in violation of registration requirements, 19.108

Salaries and Compensation

See also **Fees**

Adviser to trustee, 10.77

Agent of trustee, 10.77, 19.6, 19.9

Custodian, 12.25

Guardian, 12.19

Trustees. See **Trustees**

Sale of Property

Advantages and disadvantages of sale to trust, 19.62

Authorizing agent assistance, 19.4, 19.5, 19.6

Brokers. See **Brokers and Dealers**

Charitable remainder trust property, 18.13

Deemed sale, contribution of appreciated assets to trust as, 18.31

Equitable conversion, 20.11

Foreclosure. See **Foreclosure**

Gains or losses, 19.11, 19.12, 19.62-19.66

Leaseback of property sold to trust. See **Rent**

Life insurance policy, effect of sale between trusts of, 11.12

Part gift-part sale transaction, 2.32-2.33, 19.55, 19.62

Payment of indebtedness on transferred property, 19.50

Power of trustee, 10.67, 10.68, 10.82, 10.83, 10.88, 10.89

Purchase option money, 19.13, 19.14, 19.66

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Securities, 19.108

Settlor's veto power, 10.53

Underproductive property sale, 19.37, 19.38-19.39

Savings Clause

Administration of trust savings clause for unforeseen tax consequences, 20.25

Charitable lead annuity trust (CLAT), charitable deduction savings clause for, 18A.24, 18A.25

Charitable remainder trust, 18.42, 18.43

Perpetuities, power of appointment, 9.59

Validity of savings clauses, 20.39

S Corporations

Generally, 19.96

Allocation, UPAIA considerations, 10.110

Charitable remainder trust property, 3.40, 18.14

Grantor trust as shareholder, 19.97

GRAT shareholder, 3.24, 15.11

GRIT consideration, 14.8

GRUT shareholder, 16.8

Marital deduction and related trusts as shareholder, 19.98

Number of S corporation shareholders, 3.66

Qualified subchapter S trust (QSST)

GRIT issues, 14.8

Income tax issues. See **Income Tax**

Life tenant interest in S corporation stock, effect of trustee only holding, 3.59

Liquidating distributions, 19.101, 19.102

Marital deduction trust distinguished, 19.98

Qualifying trust as QSST, 19.100

Requirements, 3.61, 19.99

Successive income beneficiary refusing to consent to election, effect of, 3.61

Trusts as eligible stockholders, types of, 3.57

Tax implications

Authorizing trustee to make distributions paying capital gains tax, 19.102

ESBT. See **Electing Small Business Trust (ESBT)**

Gain and loss, generally, 19.101

Income tax. See **Income Tax**

Securities

Generally, 19.105

Allocating stock dividends, 10.114, 19.25, 19.26

Charitable remainder trust property, 18.14, 18.17, 18.82

Employee stock ownership plan (ESOP), effect of power to control beneficial enjoyment of corpus or income irrevocably payable to, 9.38D

Estate and gift tax transfers, 2.48, 2.56, 2.71

Estate tax payment method, 2.91

Insider trading, 19.106-19.107

Minors holding, 12.12, 12.23

Ownership, determining, 19.107

Pooled income fund, 18.107

Power of trustee

Hold in nominee's, broker's, or street name, 10.74, 10.75

Management, 10.71, 10.72, 19.24

Register shares for sale, 10.73

Prudent investment limitation, 10.60

Publicly traded stock distributions and rights, 19.24-19.25, 19.26

Qualified subchapter S trust (QSST). See **S Corporations**

Redemption. See **Redemptions**

Restricted or control securities defined, 19.108

Rule 10b-5, 19.106

Rule 144, 18.17, 19.108

S corporation. See **S Corporations**

Section 16, 19.107

Valuation of stock

Decedent's estate, rules affecting valuation of, 2.72

Discounts and premiums, 2.23-2.24, 2.70-2.71

Special valuation rules, 2.25-2.26, 19.76

Voting issues. See **Voting**

Selection of Trustee. See Trustees

Self-Canceling Installment Note (SCIN)

Rebutting presumption of gift in case of sale of property to son in exchange for, 2.8

Self-Dealing

See also **Conflicts of Interest**

Generally, 10.44

Authorization, 10.45

Excise tax on acts of self-dealing between disqualified person and private foundation, 18.36A

Exoneration of trustee's self-dealing, 19.82, 19.107

Multistate trusts, 20.33

Power of trustee, 10.82, 10.83

Private or charitable foundation rules and exceptions, 18.79-18.80, 18.81

Securities, insider trading, 19.106-19.107

Separate Property

See also **Community Property**

Community property, dividing into separate property and reciprocal trusts, 5.12, 18.12

Herr trust contributions, 12.69

Multistate trusts transfers. See **Multistate Trusts**

Reciprocal trusts and separate property, dividing community property into, 5.12, 18.12

Single shares, separate shares distribution, 9.21A

Support and maintenance trusts, separate versus multiple trusts, 5.29-5.31

Trustee's duty to keep trust property separate, 10.42

Separate Trusts for Minor Beneficiaries

Accumulation of income during child's minority, 9.27, 9.30

Basic form, 9.26

Description and advantages, 9.25

Distribution

After child reaches age 21, 9.28

Income and principal during child's minority, 9.27

Minors' trust benefits under IRC §2503(c), 12.49, 12.58

Sample multiple vested interest trusts for skip persons (sensitive trustee permitted), App C

Shares created under trust as separate trusts, 10.43

Tax consequences

Generally, 9.28

Estate and gift tax, 9.29

Generation-skipping transfer tax, 9.30A

Income tax, 9.30

Settlement

Delaying distribution until resolution of claims or liability, 10.108, 10.109

Dissolving marriage, consideration element of settlement agreement, 2.33, 2.68

Multistate trust compromise agreement, 20.17

Power of trustee to compromise claims, 10.84, 10.85

Special needs trust. See **Litigation Special Needs Trust (LSNT)**

Settlor

Charitable remainder trust

Beneficiary, gift tax, 18.21

Revoking beneficiary interest, 18.96-18.97

Trustee, settlor as, 18.18

Commutation of interest. See **Commutation of Trust Interest**

Death

Estate of settlor. See **Estate Tax**

Trust termination distributions. See **Distributions**

Declaration of trust, 8.3

Defined, 11.4

Designating successor trustees, 10.32, 10.33-10.35

Encumbrance on transferred property

Interest payment obligation, 19.50

Leaseback, 19.61-19.62

Personal liability, 19.53-19.54

Exonerating trustee from liability. See **Trustees**

Intent. See **Intent**

Investments (see Power to control trust investments, below)

Leaseback of transferred property. See **Leased Property; Rent**

Members of family defined for GRIT purposes, 14.2

Pipe dream trust. See **Pipe Dream Trust**

Power to add beneficiaries, 5.10

Power to control enjoyment of trust, 5.15, 5.28, 9.38B, 18.21, 18.96

Power to control trust investments

Generally, 10.21, 10.52

Consultant, nonbinding recommendations by, 10.56A

Delegate investment and management functions, 10.59

Directing investments, 10.54

Directing management of business, 10.3, 19.85

Independent investment counsel, binding decisions by, 10.56

Personal to settlor, 10.55

Retained power to make allocations, 10.111

Retained voting rights, 19.103, 19.104

Veto power, 10.53

Power to remove trustee and appoint successor, 9.12, 9.15, 10.34

Power to terminate small trust, 9.6-9.7

Resignation as trustee, 9.15

Retained powers, recognized gain aspect, 19.55

Reversionary interests. See **Reversionary Interests**

Spendthrift. See **Spendthrift Trust**

Spouse of settlor as beneficiary-trustee, 10.6

Sprinkling trust or powers. See **Sprinkling Trust or Power**

Survival aspect

GRAT distributions, 15.4

GRIT distributions, 14.4, 14.8, 14.23-14.24

Trustee, settlor as, 9.42-9.43, 10.3-10.5, 10.8, 10.11, 10.91, 10.99, 10.100, 18.18

Shares and Shareholders. See Securities

Signatures

Agreement of trust format, 8.8

Declaration of trust format, 8.9

Formality, 7.3

Spouse's consent to transfer, 8.10

Simple Trust

Defined and construed, 3.11

Estimated tax payments, 3.13

Taxation of trust and beneficiaries, 3.12

Single Trust With Discretion To Distribute Principal

Description, 9.20

Distribution of all income required but principal permitted

Separate shares, 9.21A

Single trust, 9.21

Tax consequences

Estate tax, 9.22

Generation-skipping transfer tax, 9.24A

Gift tax, 9.23

Income tax, 9.24

Small Trust

Termination and distribution, 9.6, 9.7

SNT. See Special Needs Trust (SNT)

Social Security

Medicare distinguished, 13.16

Software. See Computers and Computer Software

Special Needs Trust (SNT)

See also **Litigation Special Needs Trust (LSNT)**

Chart, summary of SNTs, 13.27

Death of beneficiary

First party SNT, termination on death of beneficiary, 13.53

Third party SNT, termination on death of beneficiary, 13.48

Distribution provisions for third party SNT, 13.42

Basic form, distribution for special needs, 13.43

Trust advisory committee, 13.44

First party SNT

Generally, 13.5

Chart summarizing, 13.27

Death of beneficiary, termination of first party SNT on, 13.53

Distribution provisions for, 13.52

Income taxation of, 13.26

Introductory clauses for first party SNT, 13.51

Litigation special needs trust. See **Litigation Special Needs Trust (LSNT)**

Medi-Cal trust regulations, effect of, 13.24

SSI benefits. See **Supplemental Security Income (SSI)**

Income taxation of SNTs, 13.26

Petitions. See **Litigation Special Needs Trust (LSNT)**

Public benefits

Medi-Cal recipients. See **Medi-Cal and Medicaid**

Reimbursement from trust for public benefits received, restrictions on state or county seeking, 13.25

Requirement to seek, 13.45

SSI recipients. See **Supplemental Security Income (SSI)**

Trust estate to supplement public benefits, 13.46

Purpose, 1.2, 13.1

Reimbursement

Medi-Cal reimbursement claim, deductibility as claim against estate, 13.37

Restrictions on state or county seeking reimbursement from SNT for public benefits received, 13.25

Third party SNT's exemption from reimbursement claims, 13.38

SSI benefits. See **Supplemental Security Income (SSI)**

Termination provisions for third party SNT

Generally, 13.47

Backstop termination clause for third party SNT, 13.49

Death of beneficiary, termination of third party SNT on, 13.48

Payment of expenses of third party SNT, 13.50

Third party SNT

Generally, 13.3

Chart summarizing, 13.27

Distribution provisions (see Distribution provision for third party SNT, above)

Income taxation of, 13.26

Introductory clauses for, 13.38

Irrevocability, limited power of amendment for third party SNT, 13.40

Medi-Cal trust regulations, effect of, 13.23

Purpose of, 13.41

Restrictive rules under federal law, inapplicability to third party SNTs, 13.21

Sample third party SNT, App M

SSI eligibility, effect of third party SNT on, 13.17

Termination provisions (see Termination provisions for third party SNT, above)

Title of third party SNT, 13.39

Trust protector clause, 13.54

Types

Generally, 13.2

First party SNT (see First party SNT, above)

Litigation special needs trust. See **Litigation Special Needs Trust (LSNT)**

Third party SNT (see Third party SNT, above)

Special Trustees

See also **Trustees**

Generally, 10.8, 10.12

Accumulation trust, 9.36, 9.37

Appointment

Generally, 10.19

Powers of trustee, effect of special trustee's powers on, 10.20

Successor special trustee, 19.22

Support and maintenance, 9.52

Trustee's appointment of special trustee to make payments to beneficiary trustee, 10.26A

Business enterprise management, 19.85

Compensation, 10.20

Distributions to beneficiary-trustee, 10.25, 10.26

Investment power, 10.22

Minors' trust under IRC §2503(c), 12.51, 12.56

Power to add beneficiaries of named class, 5.10, 9.11A

Real property, 19.22, 19.60

Related or subordinate party, 3.36, 9.10, 9.14, 10.7, 10.12

Sprinkling power, 9.10, 9.11-9.11A

Vesting certain powers in special trustee, 10.100

Spendthrift Trusts

Disclaimers, 9.68

Minors' trust under IRC §2503(c), 12.49

Necessity of spendthrift trust, 9.64

Piercing spendthrift trusts, examples of beneficiary's obligations requiring, 10.123

Purpose of spendthrift clause, 10.123

Sample spendthrift clauses, short and long form, 10.124

Sample trust, 9.65

Satisfying grantor's creditor claims, estate tax consequences, 2.51

Tax considerations

Estate and gift tax, 9.66

Income tax, 9.67

Spouses

Administrative powers of spouse beneficiary-trustee, 10.6

Annual-exclusion gifts, 2.39, 18.96

Charitable remainder trust, 2.41, 18.12, 18.21, 18.96-18.97

Community property. See **Community Property**

Consent to transfer, 2.43, 8.10

Consideration for transferred property

Estate tax consequences, 2.68

Gift tax consequences, 2.33

Credit shelter funded by wasting asset, 19.109

Custodial property, 12.33

Defined, 10.135-10.135A

Elections. See **Elections**

Emancipated minor, 12.13

"5-or-5" withdrawal power, 4.29

GRAT interests, 15.12

GRIT interests, 14.9

GRUT interests, 16.9

Jointly held property or interests, gift and estate taxes, 2.18, 2.67-2.68

Life insurance trust

Community property funding, 11.4

Reciprocal trust doctrine application, 11.5

Transfers within 3 years of death, 11.7

Marital deduction. See **Marital Deduction**

Member of family, spouse as, 6.25

Multistate trusts' transfers. See **Multistate Trusts**

Noncitizen spouse, gift to, 18.21

Preventing outright distributions to deceased beneficiary's spouse, 9.47

QDOT requirements, 2.75, 2.80-2.81

QTIP trust for spouse

Administrative power, 10.6, 10.64

Charitable remainder, 18.122

Reciprocal trust doctrine, 5.12, 11.5, 12.36

Sample life insurance trust for spouse and issue, App E

Split-gift

Generally, 2.43

Estate tax, 12.51

GST tax, 4.4

Lapse of withdrawal right, 12.87

Sprinkling trust distribution to deceased child's spouse, 9.9, 9.17

Surviving spouse. See **Surviving Spouse**

Underproductive property in marital deduction trust. See **Underproductive Property**

Sprinkling Trust or Power

Generally, 9.8, 9.9

Charitable remainder trust, 18.18, 18.94, 18.95

Crummey trusts, 12.110

Guidelines for sprinkling power, 9.9-9.10, 9.63

Hybrid trust distinguished, 9.39

Income only and with ascertainable standard

Basic form, 9.17

Description, 9.16

Estate, gift, and GST tax, 9.18

Income tax, 9.19

Minors' trust under IRC §2503(c), 12.42

Special trustee power, 9.10, 9.11-9.11A

Tax consequences

Estate tax, 9.10, 9.12, 9.18

Gift tax, 9.13, 9.18

GST tax, 9.8-9.9, 9.14A, 9.18

Income tax, 9.14, 9.19

SSI Benefits. See Supplemental Security Income (SSI)

Standards

Ascertainable standard, limitation for distributions. See **Distributions**

Trustee's standard of care, generally, 10.38, 10.110

Valuation standards. See **Valuation**

Statute of Frauds, 19.2

Statutes of Limitations

See also **Time**

Disclosure of taxable gift transfers to IRS, time for revaluation, 2.46A

Litigation special needs trust, time limit for state agencies to file claim after beneficiary's death or termination of, 13.34

Qualified personal residence trust, statute of limitations for fraudulent transfers involving, 17.13

Stock. See Securities

Structuring Trust Instrument. See Drafting Trusts

Subchapter S Trusts (QSST). See S Corporations

Subdivisions

Additions to subdivided or partially or wholly distributed trust, 10.122

Separate property. See **Separate Property**

Trustee's powers, 19.4, 19.5

Subordinate Party. See Related or Subordinate Party

Substitution

Converting trust property acquired through foreclosure, 19.73

Investment power, substituting trust assets, 2.61

Removal of trustee. See **Trustees**

Successor Custodian. See Custodianship

Successor Trustee. See Trustees

Supplemental Security Income (SSI)

See also **Medi-Cal and Medicaid**

Generally, 13.6

Amount and eligibility for benefits

Generally, 13.7

Disabled and aged poor, SSI eligibility requirements for, 13.8

Income, effect on amount of benefits, 13.10

In-kind support and maintenance, reduction of SSI benefits for, 13.11

Resources available to applicant, effect on SSI eligibility, 13.9

Special needs trust (see Special needs trust (SNT), below)

Transfer rules disqualifying individuals for making gifts of assets to qualify for SSI benefits, 13.12, 13.18

Eligibility for SSI (see Amount and eligibility for benefits, above)

First party special needs trusts (SNTs)

Generally, 13.18

Irrevocability clause, avoiding Social Security Administration's attack on, 13.20

Irrevocability clause, requirement first party SNT contain, 13.19

Special needs trust (SNT)

First party SNTs (see First party special needs trusts (SNTs), above)

Third party SNT, effect on SSI eligibility, 13.17

Support and Maintenance

See also **Minors; Spouses**

Beneficiary-trustee limitation, 9.52, 10.6

Custodial property. See **Custodianship**

Education. See **Education Expenses**

Estate tax principles, 2.53, 5.24

Flexibility versus control, 5.28

Gift tax principles, 5.25

Guardian's obligation, 12.19

Medi-Cal and Medicaid. See **Medi-Cal and Medicaid**

Pipe dream trust. See **Pipe Dream Trust**

Scope of support obligation

Generally, 5.19, 9.12, 9.38A, 12.12

Education. see **Education Expenses**

Minors, 5.20, 9.27

Minors' trust under IRC §2503(c)(1), 12.40-12.41, 12.52, 12.54

Parents and adult children, 5.22

Single versus multiple trusts, 5.29-5.31

Special needs trusts

Generally and third party. See **Special Needs Trust (SNT)**

Litigation. See **Litigation Special Needs Trust (LSNT)**

Spendthrift clause's effect on, 10.123

SSI benefits, in-kind support and maintenance resulting in reduction of, 13.11

SSI. See **Supplemental Security Income (SSI)**

Trustee's powers to discharge obligations

Generally, 5.23, 9.12

Independent trustee's discretionary power to discharge support obligation, 5.27

Surety and Suretyship. See Bonds and Undertakings

Surviving Spouse

Acquisition of citizenship, 2.83

Administrative powers, tax consequences, 10.6

Alternate valuation date, spouse electing, 2.72

Annuity payments, spouse's right to receive if settlor fails to survive annuity term, 15.12

Death, trust termination distributions. See **Distributions**

Estate trust, 2.76, 5.4

General power of appointment trust, 2.78

Loss of step-up basis for community property, 2.46

Marital deduction issues. See **Marital Deduction**

Multistate trusts, violations of surviving spouse's rights, 20.57

Power to require trustee make property productive, 10.64

Prior transfer property (PTP) credit, 2.82, 2.86

Qualified domestic trust (QDOT) established by, 2.81

Qualified terminable interest property (QTIP) trust, 2.79

Retirement plan benefits, 19.117

Survivorship requirement, 2.77

Survivorship

Beneficiary prerequisite, 2.66, 2.77, 9.2, 9.46

Charitable remainder annuity trust payment, 18.51

Form, 9.48

Spouse's survivorship. See **Surviving Spouse**

Tables. See Charts, Checklists, Questionnaires, and Tables

Tax

Allocation of income and principal. See **Allocation**

Assessments. See **Property Tax and Assessments**

Charitable deduction. See **Charitable Gifts and Deduction**

Charitable lead annuity trust. See **Charitable Lead Annuity Trust (CLAT)**

Circular 230, effect of, 1.7A

Credit. See **Tax Credit**

Custodianship. See **Custodianship**

Depreciation. See **Depreciation**

Encumbered property transfers. See **Encumbered Property**

Estate tax. See **Estate Tax**

Gains and losses. See **Gains and Losses**

Generation-skipping transfers. See **Generation-Skipping Transfer (GST) Tax**

Gift tax. See **Gifts and Gift Tax**

Income tax. See **Income Tax**

Marital deduction. See **Marital Deduction**

Powers of trustee relating to taxes. See **Powers of Trustee**

Property tax. See **Property Tax and Assessments**

Qualified domestic trust. See **Qualified Domestic Trust (QDOT)**

Settlor's leaseback of transferred property. See **Rent**

Tax liens. See **Encumbered Property**

Tax-sensitive trustee. See **Trustees**

Valuation issues. See **Valuation**

Tax Credit

Estate tax. See **Estate Tax**

Gift tax

Generally, 2.67, 2.85

Unified credit (see Unified credit, below)

Multistate trusts interests, computing state death tax credit or deduction for federal estate tax return, 2.84, 20.79

Prior transfer property (PTP), 2.82, 2.86

Unified credit

Generally, 2.5

Gifts, 12.114

Gifts to minor, 12.3, 12.44, 12.66

Wasting asset funding spouse's credit shelter, 19.109

Tax Return. See Generation-Skipping Transfer (GST) Tax

Tenancy in Common

Qualified personal residence trust (QPRT), partitioning community property residence into separate interests held as tenants in common, 17.29

Termination

Copyright, 19.115-19.116

Custodianship, 12.30

Pooled income fund interest, 18.116

Settlor's subsequent incompetence, 2.17

Trust

Accounting requirement, 10.117, 10.118

Charitable remainder trust, 18.36A, 18.64

Commutation. See **Commutation of Trust Interest**

Distributions. See **Distributions**

GRAT, 15.27, 15.31-15.32

GRIT, distributions on trust termination, 14.25

Litigation SNT. See **Litigation Special Needs Trust (LSNT)**

Minors' trust under IRC §2503(c), 12.43, 12.57, 12.61

Nongrantor trust, income tax consequences, 3.21

QDOT, termination of inter vivos, 2.81A

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Revocation. See **Revocation of Trust**

Small trust, 9.6-9.7

Third party special needs trust. See **Special Needs Trust (SNT)**

Term Life Insurance. See Life Insurance

Term of Trust

Commutation. See **Commutation of Trust Interest**

GRAT. See **Grantor Retained Annuity Trust (GRAT)**

GRIT. See **Grantor Retained Income Trust (GRIT)**

GRUT. See **Grantor Retained Unitrust (GRUT)**

Leasebacks within or extending, 19.58

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Termination of trust. See **Termination**

Testamentary Transfers or Trusts

See also **Estate Tax**

Charitable remainder trust

Deferred payments, 18.45, 18.92

Contributions to CRT, 18.75, 18.77

Requirements, 18.91

Power to revoke recipient's interest, 18.96, 18.97

Definition and scope, 2.48

Power of appointment

Generally, 9.38C, 9.57

Minors' trust under IRC §2503(c), 12.44, 12.46

Revoking CRT beneficiary interest, 18.97

Third Parties

Donor's retained interest powers exercisable with third party having adverse interest, 2.18

Jointly holding powers with donor, 2.18

Nonadverse party holding investment power, 10.21

Power to use trust income or corpus for grantor's benefit, 2.52

Settlor's leaseback of transferred property, payment to third party, 19.60

Special needs trust. See **Special Needs Trust (SNT)**

Special trustee, third party as, 10.8

Spendthrift restrictions, 2.51, 10.128

Trustee exculpatory clause, inapplicability to trustee's liability to third persons, 10.38

Timber Interests. See Natural Resources

Time

See also **Statutes of Limitations**

Capital gain income resulting from donee paying donor's gift tax liability, 2.32

Charitable remainder trust

Payments, 18.16, 18.45

Reformation deadlines, 18.103-18.104

Converting trust property acquired through foreclosure, 19.73

Copyright term, 19.116

Crummey trust withdrawal power

Expiration of power, 12.80

Period, 12.86

Qualifying as present interest, 2.36

Deductions for charity given by nongrantor trusts, timing rules affecting, 3.5

Duration of trust. See **Term of Trust**

Estate tax

Alternate valuation date, 2.72

Payment, 2.46, 2.87-2.91

Estate tax inclusion period (ETIP), 4.29

Foreign trusts

Annual reporting requirement when United States grantor, 3.69A

Control test, 12-month grace period after inadvertent change in trust residence, 3.68E

Gift tax payments, 2.46

GRAT

Real property tax exclusion, 15.14

Short taxable year, 15.27

GRUT

Real property tax exclusion, 16.11

Short taxable year, 16.25

GST exemption allocations, timely and late, 4.24-4.27, 4.29

Lapsed powers. See **Lapsed Powers**

Life insurance. See **Life Insurance**

QPRT term. See **Qualified Personal Residence Trust (QPRT)**

Reversionary interest valuation, 2.57

Settlor's leaseback of property sold to trust as tax-free exchange, 19.64

Survivorship, Devises to surviving spouse, 2.66

Transfers within 3 years of death. See **Transfers Within 3 Years of Death**

Valuation of decedent's retained life estate, 2.49

Totten Trust Account

Advantages and disadvantages, 12.16

Legal and tax aspects, 12.15

Transfers Within 3 Years of Death

General power of appointment, release or lapse, 2.65

Life insurance trust, 11.7, 11.9-11.9A, 11.19

Minors, transfers to, 12.4

Tax consequences

Generally, 2.4, 2.45-2.46, 2.65, 2.72

Estate tax inclusion period (ETIP), 4.29

Voting rights, relinquishment or cessation as estate property, 2.56

Trust Deeds. See Mortgages and Trust Deeds

Trustees

Advisors to trustee. See **Professional Advisors**

Agent-trustee relationship. See **Agency**

Attorney as trustee, 10.9

Beneficiary-trustee. See **Beneficiary-Trustee**

Bond, 10.48, 10.49, 19.27

Charitable beneficiaries, effect of independent trustee having power to add, 5.29

Charitable lead annuity trust (CLAT), selection of trustee for, 18A.18

Charitable remainder trust. See **Charitable Remainder Trust (CRT)**

Commingling interests. See **Commingling**

Compensation

Generally, 8.6, 10.50, 10.51

Charitable remainder trust, 18.18

Cotrustee, reasonable compensation of, 10.51B

Excessive compensation, effect of, 10.29

Managing business enterprise, 19.87, 19.88-19.89

Multistate trusts, 20.34

Percentage of net value of principal plus reasonable compensation (individual trustee), 10.51A

Performing attorney services, 19.87

Special trustee, 10.20

Conflict of laws, validation principle, 20.5

Corporate. See **Corporate Trustees**

Cotrustees. See **Cotrustees**

Duty

Accounting, 10.117, 10.118

Act fairly regarding beneficiaries, 10.44, 10.82

Diversify assets, 10.65, 10.66

Investment-related, 10.56, 10.59

Keep trust property separate, 10.42

Loyalty, 10.44

Make trust property productive, 10.62

Operate business, 10.62-10.63

Preserve trust property, 10.27, 10.84, 19.50

Segregate or divide trust property, 10.101, 10.102

Environmental cleanup liability, 19.20, 19.21

Exonerating trustee from liability

Generally, 10.38

Agent's acts, 19.10, 19.86

All or independent trustees, 10.39

Cotrustee's acts, 10.40

Management of business interest, 19.86

Multistate trusts, 20.33

Notifying trustee about births, deaths, and other events affecting interests, 10.119, 10.120

Self-dealing or insider actions, 19.82, 19.107

Successor trustee's predecessor's acts, 10.41

GRAT, appointment and powers, 15.33-15.34

GRIT, appointment and powers, 14.26-14.27

GRUT, appointment and powers, 16.31-16.32

GST tax payment responsibility, 4.11

Incapacitated. See **Incompetent Persons**

Independent trustee. See **Independent Trustees**

Insider transactions. See **Self-Dealing**

Investment power. See **Investments**

Life insurance trust. See **Life Insurance Trust**

Management of trust property. See **Management of Trust Property**

Multistate trusts. See **Multistate Trusts**

Operating business enterprise. See **Operation of Business**

Partner of transferred partnership asset, 19.79

Pooled income fund, 18.114

Powers of trustee. See **Powers of Trustee**

QPRT. See **Qualified Personal Residence Trust (QPRT)**

QSST, 19.100

Qualified domestic trust (QDOT). See **Qualified Domestic Trust (QDOT)**

Reimbursement for business enterprise expenses, 19.90, 19.91

Related or subordinate party. See **Related or Subordinate Party**

Removal of trustee

Generally, 10.29

Drafting attorney as trustee, 10.9

Estate tax consequences, 2.62

Incapacity or illness grounds, 10.31

Life insurance trust, 11.6, 11.20

Related or subordinate party, 2.62, 9.12, 9.14, 9.52, 10.29, 11.6

Replacement by beneficiary or third party, 10.6, 10.30

Settlor's power, 9.12

Successor trustee (see Successor trustee designation, below)

Resignation of trustee

Authorization, 10.28

Methods, 10.27

Settlor, 9.15

Successor trustee (see Successor trustee designation, below)

Securities

Shareholder as trustee, 19.82

Underwriter or broker as trustee, 19.108

Selection of trustee

Generally, 10.1-10.2

Beneficiary-trustee, 10.6

Cotrustees and special trustees, 10.8

Drafting attorney, 10.9

Independent trustee, 10.7

Settlor or nonadverse party as trustee, 9.14, 10.3-10.5, 19.8

Successor trustee (see Successor trustee designation, below)

Self-dealing. See **Self-Dealing**

Settlor as trustee, 9.14, 10.3-10.5, 19.8

Special trustee. See **Special Trustees**

Standard of care, 10.38, 10.110

Statute of frauds requirements, 19.2

Successor trustee designation

Generally, 10.32, 10.33

Beneficiary's power to designate successor, 10.37

Corporate trustee as successor, 10.7, 10.29

Corporate trustee unwilling or unable to serve, settlor designation when, 19.36

Disclaimer of powers, 10.91

Investments, consulting with nominated successor trustee, 10.21

Minors' trust under IRC §2503(c), 12.53

Remaining cotrustee and then settlor designates successor, 10.34

Resignation of prior trustee, 10.27, 10.28

Settlor's power, 9.12, 9.15, 10.34

Sprinkling trust's substitution of independent trustee, 9.15

Trustee's power to appoint successor, 9.15, 10.36

Tax-sensitive trustee

Bond premium amortization, 19.27, 19.28

Bond premium discount, 19.29

Defined, 10.38

Exculpatory clause, 10.38

Limited administrative powers, generally, 10.11, 10.91

Power to allocate income and principal, 10.99, 10.100, 10.112C

Sample multiple vested interest trusts for skip persons (sensitive trustee permitted), App C

Tax elections and adjustments, 10.93-10.94

Usage of trust income or corpus

Ascertainable standard limitation. See **Distributions**

Enjoyment or benefit of grantor, 2.52

Satisfying grantor's creditors, 2.51

Supporting grantor's dependents, 2.53

Tuition. See Education Expenses

Underproductive Property

Allocation. See **Allocation**

Appropriateness of trust possessing, 10.62

Charitable remainder or lead

trust, 18.13, 19.49

GRAT funding, 15.8

GRITs, 14.6

GRUT property funding, 16.5

Making property productive

Spouse's power, 19.46

Trustee's duty, 19.34, 19.46

Marital deduction trust

Generally, 19.44

Conversion to productive property, spouse's power to compel, 19.46

Full beneficial enjoyment accorded spouse, 19.45

No special adjustments for underproductive property, 19.39

Ordinary expenses

Allocation, 19.40, 19.41

Definition, 19.42

Power of trustee to acquire or retain property

Appropriateness as trust asset, 10.61-10.62, 10.64, 19.35, 19.47

Exercisable only in fiduciary capacity, 19.48

Tax implications, 19.47

Sale proceeds, allocation, 19.38

Tax considerations

Generally, 19.43

Charitable interests, 19.49

Estate and income tax implications, 19.47, 19.48

Marital deduction trust (see Marital deduction trust, above)

Valuation limitation, 6.36

Undue Influence

Client's choice of trustee, attorney's confirmation that outside influence didn't prompt, 10.31A

Removal of trustee, grounds, 10.9

Unified Credit. See Tax Credit

Uniform Principal and Income Act (UPAIA)

Generally, 10.110-10.111

Adjustments between principal and income

QSST beneficiary, trustee's adjustment between income and principal to offset income tax on capital gain imposed on, 3.59

Trustee's authority to make under UPAIA, 19.37A

Allocation of expenses between income and principal under, 10.115

Clause requiring UPAIA to govern, 10.112A

Uniform Prudent Investor Act (UPIA)

Generally, 10.59, 10.76

Broad investment powers, 10.60

Restricted investment powers, 10.61

Uniform Transfers to Minors Act (CUTMA). See Custodianship

Unitrust

Basic form, 9.43

Charitable remainder unitrust (CRUT). See **Charitable Remainder Trust (CRT)**

Conversion of income interests to unitrust interests, 10.116A

Grantor retained. See **Grantor Retained Unitrust (GRUT)**

Historical perspective, 9.41

Inter vivos unitrust QTIP trust, 2.39C

Qualified interest criteria, 2.27-2.28

Tax considerations

Estate and gift tax, 9.44

Income tax, 9.45

Transfers of partial interest, gift tax consequences, 2.14

Unproductive Property. See Underproductive Property

UPAIA. See Uniform Principal and Income Act (UPAIA)

UPIA. See Uniform Prudent Investor Act (UPIA)

Validity. See Void or Voidable Transactions

Valuation

See also **Basis**

Generally, 2.14, 6.1-6.3

Alternate valuation date, 2.72, 2.75

Alternate valuation methods, 2.22

Annual-exclusion gifts, 2.35

Annuity

Generally, 2.55

Fair market value, present value as, 6.13-6.13A

High yield annuity limitation, 6.36-6.37

IRS Table B (term certain) application, 6.22-6.23, 6.26

IRS Table K (adjustment factors), 6.28-6.29

IRS Table S (single life) application, 6.16-6.17, 6.19-6.20

Special valuation rules, 2.25

Applying same rules for gift and estate tax purposes, 2.5-2.6, 2.69

Appreciated property. See **Appreciated Property**

Bonds. See **Bonds and Undertakings**

Charitable gifts

Charitable deduction, 2.40, 6.27

IRS Table B application, 6.27

IRS Table S application, 6.20

Remainder interests (see Charitable remainder interests, below)

Charitable remainder interests

Generally, 2.28, 18.6A, 18.47

Adjustment factors, 6.29, 18.70, 18.71

Computing payment amount, valuation for, 18.17-18.18

Gift and estate tax consequences, 6.3, 18.23, 18.25

IRS valuation tables, 18.24-18.25

Minimum value of remainder, 18.7

Not in trust, 2.42

Reformed interests, 18.105

Single life, remainder following, 6.20

Specific assets, value consideration for transfer of, 18.14

Unitrust, generally, 18.26-18.29

Unitrust interest in income-only unitrust, valuation of, 18.58

Unitrust remainder interest following two measuring lives, 6.34-6.35

Unitrust remainder interest postponed for years with adjusted payout rate, 6.32-6.33

Unitrust single life remainder interest with adjusted payout rates, 6.30-6.31

Unitrust valuation if other than first day of trust's taxable year, 18.60, 18.61

Community property interests, 2.70, 15.12

Comparable sales information, 2.23

Corporations. See **Corporations**

Cost of living adjustment, 2.72

Disclosure to IRS of taxable gift transfers to prevent revaluation, 2.46A

Discounts. See **Discounts**

Dynasty trust. See **Dynasty Generation-Skipping Trust**

Encumbered property transfers, 19.55-19.57

GRAT

Generally, 15.1

Annuity amount expressed as percentage of trust's initial value, 15.9

Assets, 15.8

Benefits of valuation, 15.2

Calculation procedure, 15.16

Creation of GRAT minimizing value of gift, 15.6

Discounts, 15.10

Spousal property, 15.12

Transferred interest, 2.27-2.28, 6.17

GRIT

Generally, 14.1, 14.6

Advantages and benefits, 14.2-14.3

Calculation procedure, 14.1, 14.13

Fractional interests, 14.7

Remainder factor for term certain, 6.25

Techniques for reducing tax liability, 2.28

GRUT

Generally, 16.1, 16.8

Assets, 16.4

Benefits of valuation, 16.2

Calculation procedure, 16.13

Fractional interests, 16.7

Transferred interest, 2.27-2.28

GST exemption allocations, 4.18, 4.23-4.25, 4.29-4.30

Inventory value defined, 19.37

IRS valuation tables

Adjustment factors for annuities (Table K), 6.28-6.29

After April 30, 1989 and before May 1, 1999 transfers' procedures, 6.13

After April 30, 1999 and before May 1, 2009 transfers' procedures, 6.13A

After November 30, 1983 and before May 1, 1989 transfers' procedures, 6.12

Charitable remainder trust, 18.24-18.25

Components (interest rate and mortality), 6.8-6.10, 6.36

Computation of present value of annuity, income, and remainder interests for term certain, 6.22

Computation of present value of single life annuity, income, and remainder interest, 6.16

Computer software programs, selection and use, 6.38-6.40

CRUT following single life interest with adjusted payout rates (Tables U(1) and F), 6.30-6.31

CRUT interest, postponed for years with adjusted payout rate (Tables D and F), 6.32-6.33

CRUT interest with two measuring lives (Tables U(2) and F), 6.34-6.35

Example of valuing life estate, 6.11

Life remainders (see Life estate interests, below)

Limitations on valuing high yield annuities, underproductive property, inadequately preserved property, and transfers during terminal illness, 6.36-6.37

List of certain interests using tables, 6.14

List of IRS publications containing valuation tables, 6.6

List of IRS valuation tables, 6.5

Minors' trust, IRC §2503(b) income and remainder interests, 12.65

Requesting IRS computation, 6.7

Sample selection of IRS tables, 6.41

Term certain (see Term certain remainder factors (Table B), below)

Use of, 6.4

Joint tenancy property, 12.17

Life estate interests

Generally, 2.22

Fair market value, present value as, 6.13-6.13A

IRS Table B application (see Term certain remainder factors (IRS Table B), below)

IRS Table S application (see Single life remainder factors (IRS Table S), below)

Life insurance held by decedent, 2.47, 2.63

Pooled income fund interest, 18.116

Retained life interest, 2.49

Life expectancy table (see IRS valuation tables, above)

Life insurance company, ratings and portfolio analysis, 11.22

Life insurance transferred to trust, 11.10, 11.18

Marketability issues. See **Marketability**

Minors' IRC §2503(b) trust property, income and remainder interests, 12.65

Partnership interest. See **Partnerships**

Premiums. See **Premiums**

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Reducing value by amount of gift tax donee pays, 2.32

Remainder interests

Generally, 2.22

Charitable (see Charitable remainder interests, above)

Fair market value, present value as, 6.13-6.13A

GRIT (see GRIT, above)

Pooled income fund, 18.107-18.108, 18.116

Single life (see Single life remainder factors (IRS Table S), below)

Term certain (see Term certain remainder factors (IRS Table B), below)

Retained interest

Establishing nontaxable value of, 2.16

Gift and estate tax consequences, 6.3

GRIT (see GRIT, above)

Life estate, 2.49

Reversionary interest

Generally, 2.57

Fair market value, present value as, 6.13-6.13A

Single life (IRS Table S), 6.19

Term certain (IRS Table B), 6.25

Single life remainder factors (IRS Table S)

Annuities, 6.17

Charitable gifts, 6.20

Example computation, 6.16

Life interests, 6.18

Overview, 6.15

Remainders or reversionary interests, 6.19

Software for valuing interests, 2.22, 2.32, 18.30

Special valuation techniques for reducing tax liability

Advantage of gift, 2.45

Buy-sell and other restrictive agreements limitation, 2.25, 2.29, 19.76

Closely held business interest. See **Closely Held Businesses**

Corporation or partnership interest, 2.26, 19.75

Decedent's estate assets, 2.72

Disadvantages of gift, 2.46

Lapsed rights and restrictions, 2.30

Mortality component (terminal illness), 6.36

Options and leases, 2.29

Overview, 2.25

Qualified trust interests and exceptions, 2.27-2.28

Transfers within 3 years of death, 2.64, 2.72

Standard for valuing gifts

Generally, 2.3-2.4, 17.2

Willing buyer and seller standard, 2.21, 2.23-2.24, 2.70

Stock. See **Securities**

Tax-exclusive versus tax-inclusive valuation of property, 1.6, 2.4

Term certain remainder factors (IRS Table B)

Annuities, 6.23

Charitable contributions, 6.27

Contingent remainder interests, 6.26

Example computation, 6.22

Income, 6.24

Overview, 2.22, 6.21

Remainders or reversionary interests, 6.25

Time for valuing transfer, 2.20

Transfer-for-value rule, 11.12

Underproductive property or assets, 6.36

Valuation freeze, 1.6, 2.3

Zero-value rate for intra-family transactions, 2.30-2.31, 6.3, 6.25

Void or Voidable Transactions

Multistate trusts' validity. See **Multistate Trusts**

Savings clauses, 20.38

Selling securities in violation of registration requirements, 19.108

Settlor's leaseback of transferred property, 19.60

Voting

Cotrustees, 10.13

Lapsed right, 2.30

Minority or swing vote interests, 2.23B, 2.24

Retained voting rights

Controlled corporation stock, 10.52, 19.103, 19.104

Tax consequences, 2.56

Settlor's power to control voting of trust shares, 10.52

Special trustees holding voting power, 19.85

Waiver

Charitable remainder trust (CRT), spousal waiver requirement for, 18.6B

Qualified domestic trust (QDOT), waiver of trustee's citizenship requirements, 2.81

Trustee's accounting obligation, 10.117

Wasting Asset Transfers

Allocation of expenses and income

Generally, 19.109

Establishment of reserve account, 19.111

Real property, 19.19

Rules, 19.110

Funding trust with depleted assets, 19.109

Reserve account, 19.110, 19.111

Wife and Husband. See Spouses

Wills

Terminable interests for surviving spouse, using assets to acquire, 2.75

Testamentary transfers or trust. See **Testamentary Transfers or Trust**

Words and Phrases. See Construction and Interpretation; Definitions

Worthier Title, Doctrine of, 20.8

Writings

Declaration of trust, generally, 8.1

Leaseback transaction, 19.60

Multistate trust choice of law, 20.10

Notice of proposed action, 10.109B

Notification of *Crummey* withdrawal right, 12.83

Statute of frauds requirements, 19.2

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