

# TRUST TOPICS

## Trust Glossary

**This *Trust Topics* defines the most common types of trusts used in estate planning and highlights their key features.**

Trusts offer a variety of options to manage, protect and preserve assets.

Trusts offer numerous benefits to individuals for management and preservation of assets during their lifetimes and after their deaths. However, the many types of trusts, and the frequent use of acronyms to identify trusts, may discourage clients from exploring appropriate options.

All share a common bond in that a trust, in its most basic sense, is an arrangement whereby an individual (the “grantor”) transfers assets to a newly created legal entity managed by a “trustee.” The trustee can be a bank, a trust company or an individual—a trusted friend or family member or even the grantor in some circumstances.

This arrangement is governed by a document (the “trust agreement”) created by a grantor during the grantor’s lifetime. Depending on the nature, purpose and duration of this arrangement, the trust may be revocable (changeable) or irrevocable (not changeable). A trust can also be created through an individual’s (the “testator”) will (the “testamentary trust”) to take effect after the testator’s death.

### GLOSSARY

#### Credit Shelter Trust

Also known as a bypass trust or a unified credit trust, this trust is typically created under a will or revocable trust agreement and funded after death with an amount equal to a testator’s or grantor’s unused “applicable exclusion amount,” the maximum amount insulated from federal estate taxes at an individual’s death. Due to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, the applicable exclusion amount rose from \$675,000 in 2001 to \$1,000,000 in 2002 and 2003; to \$1,500,000 in 2004 and 2005; to \$2,000,000 in 2006, 2007 and 2008; and to \$3,500,000 in 2009.

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A credit shelter trust generally reduces, and may even eliminate, federal estate taxes ultimately due on the estates of a married couple. Although the terms of this trust can vary, most credit shelter trusts benefit a surviving spouse for life; other individuals, such as the children, may also benefit. At the surviving spouse's subsequent death, the trust's assets can pass outright or in trust to the children or other designated individuals free of federal estate taxes.

### **Crummey Trust**

A Crummey trust is an irrevocable trust established for the benefit of one or more individuals and is typically created as a vehicle for receiving and retaining annual tax-free gifts in trust. Normally, a gift in trust is not a gift of a present interest and does not qualify for the annual \$12,000 gift tax exclusion because the beneficiary does not have immediate use of the property. To avoid this restriction, a Crummey trust gives the beneficiary a current right to withdraw the property contributed to the trust, not to exceed \$12,000, called "Crummey withdrawal power," during a limited period of time (typically 30 or 60 days). If, after receiving formal notice, the beneficiary fails to withdraw the property during the specified period (the usual occurrence), the gifted property becomes part of the trust

assets and is administered with the other property in accordance with the provisions of the trust agreement.

Most irrevocable life insurance trusts are Crummey trusts. This planning technique is also an alternative to a 2503(c) minor's trust when making gifts to minors.

### **Dynasty Trust**

Also known as a perpetual trust, this irrevocable trust is typically created by a grantor during the grantor's lifetime for the benefit of the grantor's children, grandchildren and more remote descendants. This trust is generally funded with an amount up to the grantor's maximum available generation-skipping transfer ("GST") tax exemption (\$2,000,000 in 2007 and 2008 and \$3,500,000 in 2009).

A dynasty trust is normally created to last for a term that will not violate a particular state's "rule against perpetuities" (the maximum trust term permitted under state law), which is equivalent to a period of 21 years beyond the lives of designated individuals living at the time the trust is created.

A number of states, including Alaska, Delaware, Illinois, New Jersey and South Dakota, have abolished laws relating to the rule against perpetuities, making it attractive to establish a dynasty trust in those jurisdictions.

If properly drafted and properly administered, a dynasty trust can last hundreds of years, providing a vehicle to pass assets from one generation to the next, free of estate tax, gift tax and GST tax.

### **Generation-Skipping Transfer Tax Exempt Trust ("GST Exempt Trust")**

A GST exempt trust is an irrevocable trust, such as a dynasty trust, to which all or a portion of a grantor's unused GST tax exemption has been allocated. The exemption represents the amount of assets a grantor can insulate from GST tax. Subject to several exceptions, the GST tax is imposed whenever there is a transfer to a "skip" person—an individual who is two or more generations below the grantor, such as a grandchild or great-grandchild. A skip person can also be a non-family member if that individual is more than 37½ years younger than the grantor.

The GST tax is in addition to any estate or gift tax owed on a transfer. In 2007 and 2008, each individual is allowed a lifetime GST tax exemption of \$2,000,000. The lifetime GST tax exemption increases to \$3,500,000 in 2009. A GST exempt trust is generally created to use an individual's GST tax exemption, thereby insulating those trust assets from GST taxes and allowing them to pass to future generations, free of any GST tax.

Generation-skipping transfers that exceed an individual's GST tax exemption are taxed at the highest federal estate and gift tax rates, which are currently 45% and will remain at that rate through the end of 2009.

### **Generation-Skipping Transfer Tax Non-Exempt Trust ("GST Non-Exempt Trust")**

A GST non-exempt trust is an irrevocable trust to which no portion of a grantor's unused generation-skipping transfer tax exemption has been allocated.

### **Grantor Retained Annuity Trust ("GRAT")**

A GRAT is an irrevocable trust into which the grantor transfers assets and retains the right to receive, at least annually, payment of a fixed dollar amount (the "annuity") for a specified term of years (the "GRAT term"). At the end of the GRAT term, the trust's remaining assets, including appreciation, pass to designated beneficiaries, generally members of the grantor's family (the "remainderpersons").

A transfer to a GRAT constitutes a taxable gift if the value of the grantor's retained right to receive the annuity is less than the value of the transferred property. If the grantor dies during the GRAT term, some part or all of the remaining trust assets will be includable in the grantor's estate for estate tax

purposes. However, if the grantor survives the GRAT term, the assets remaining at the end of the GRAT term pass to the remainderpersons free of any further gift tax.

### **Inter Vivos Trust**

An inter vivos trust is created during a grantor's lifetime. Depending upon the grantor's wishes, this trust can be revocable or irrevocable. It is distinguished from a testamentary trust, which is created under a will and becomes effective and irrevocable after an individual's death.

### **Irrevocable Trust**

An irrevocable trust cannot be revoked or amended by a grantor during the grantor's lifetime or at the grantor's death. It is distinguished from a revocable trust, which can be revoked or changed during the grantor's lifetime.

### **Irrevocable Life Insurance Trust ("ILIT")**

An ILIT is an irrevocable trust created by an individual ("grantor-insured") to remove life insurance proceeds from the grantor-insured's estate for estate tax purposes. This technique uses the trust as the owner and beneficiary of the life insurance policies. This trust can be funded either by transferring an existing policy to the trust or by having the trust purchase a new policy on the grantor-insured's life. If existing insurance is

transferred to the trust, the grantor must live for three years for the proceeds to be removed from the estate for estate tax purposes.

### **Qualified Domestic Trust ("QDOT")**

A QDOT is created for the benefit of a surviving spouse who is not a U.S. citizen. The trust can qualify for the federal estate tax marital deduction.

In general, property passing from a decedent to a surviving spouse who is not a citizen of the United States does not qualify for the marital deduction unless the property is distributed to a QDOT. Similar to a QTIP trust (described below) the QDOT must provide that the surviving spouse is entitled to receive all income from the trust, payable at least annually. The QDOT is subject to a number of stringent requirements, however. For example, the trust must have at least one U.S. trustee who is a U.S. citizen or domestic corporation. Similarly, if trust principal is distributed to the non-citizen spouse, the U.S. trustee is required to withhold funds equal to the estate tax attributable to the principal distributed.

Although exceptions are made for principal distributions due to hardship, the estate tax is determined at the highest rate applicable to the deceased spouse's estate.

### **Qualified Personal Residence Trust (“QPRT”)**

A QPRT is an irrevocable trust into which a grantor transfers a personal residence and reserves the right to occupy the residence, without payment of rent, for a specified term of years (the “QPRT term”). When the QPRT term ends, the residence passes to designated beneficiaries, usually the grantor’s children or other family members, either outright or in further trust. The grantor may continue to reside in the residence when the QPRT term ends, but the grantor must pay fair market value rent to avoid the inclusion of the residence in the grantor’s estate for estate tax purposes.

The major advantage of this technique, if the grantor survives the QPRT term, is the grantor’s ability to transfer a personal residence to family members at the future date (when the QPRT term ends) using the present value of the residence for gift tax purposes reduced by the actuarial value of the grantor’s retained right to occupy the residence during the QPRT term. If the residence appreciates in value during the QPRT term, that appreciation will pass to family members free of estate and gift tax. If the grantor dies during the QPRT term, the entire value of the residence will be includable in the grantor’s estate for estate tax purposes.

If specific statutory requirements are met, a vacation home can also qualify for this planning technique.

### **Qualified Terminable Interest Property Trust (“QTIP Trust”)**

A QTIP trust is created for the benefit of a surviving spouse. The trust qualifies for the federal estate tax marital deduction so that no estate tax is payable on the assets passing to the trust. A QTIP trust must pay the surviving spouse all income from the assets at least annually, and no other person can have a present interest in the assets during the surviving spouse’s lifetime. In addition, to the extent that the trust’s assets qualify for the marital deduction, those assets are includable in the surviving spouse’s estate for federal estate tax purposes at the spouse’s subsequent death.

### **Revocable Trust**

Also known as a living trust, this is a trust created by a grantor to manage the grantor’s assets during the grantor’s lifetime. The grantor retains the right to change or alter the terms of the trust, including the right to completely revoke the trust. The trust becomes irrevocable and unamendable at the grantor’s death.

One of the often-cited benefits of a fully-funded revocable trust is the avoidance of probate and its attendant delay in the management of estate

assets. The primary benefit, however, is that the trust provides a pre-arranged mechanism to assure the continued management and preservation of assets if an individual becomes disabled. The trust’s provisions then simplify asset management at death. The trust can also set forth all of the dispositive provisions of the grantor’s estate plan.

Generally speaking, a revocable trust does not save the grantor income taxes during the grantor’s lifetime, nor will it save estate taxes at the grantor’s death.

### **Supplemental Needs Trust (“SNT”)**

Also known as a special needs trust, this trust is created for the benefit of a disabled person to supplement but not supplant or diminish governmental benefits such as Supplemental Security Income (SSI) or Medicaid, to which the disabled person may be entitled. An SNT is typically created by a parent or grandparent for the benefit of a disabled child or grandchild to provide additional funds for the disabled individual in areas not covered by governmental benefits, without jeopardizing or reducing those benefits. An SNT may also consist of proceeds of a personal injury award.

### **Testamentary Trust**

A testamentary trust is created under a will. It becomes effective and irrevocable after an individual dies and the testator’s will is admitted to probate.

### **2503(c) Minor's Trust**

A 2503(c) minor's trust is an irrevocable trust established for the benefit of a minor child to receive and retain annual tax-free gifts in trust until the child reaches age 21. Normally, a gift in trust is not a gift of a present interest and does not qualify for the annual \$12,000 gift tax exclusion because the beneficiary does not have immediate use of the assets.

Internal Revenue Code § 2503(c) creates an exception to this rule, however, and specifically authorizes gifts in trust for a minor child's benefit that will qualify for the annual gift tax exclusion, if three conditions are met. The trust instrument must provide that: 1) the principal and income from the trust may be expended for the child's benefit at all times; 2) all undistributed principal and income must be distributed to the child when the child reaches age 21; and 3) if the child dies before reaching age 21, the principal and income will be included in the child's estate.

If properly structured, the trust can continue for the child's benefit after the child reaches age 21, if the child does not withdraw the property from the trust at that time.

## **CHARITABLE TRUSTS**

### **Charitable Lead Annuity Trust ("CLAT")**

A CLAT is required to distribute a specific dollar amount to a qualified charity. The annuity amount must be paid out periodically, at least annually, for a specified number of years or for the life or lives of individuals. At the end of the trust's term, the remainder interest must be distributed to one or more non-charitable beneficiaries. A CLAT can be created during a donor's lifetime or at death.

### **Charitable Lead Unitrust ("CLUT")**

A CLUT is required to distribute a sum equal to a fixed percent of the net fair market value of the trust's assets as valued annually to a qualified charity. The unitrust amount must be paid out periodically, at least annually, for a specified number of years or for the life or lives of individuals; at the end of the trust's term, the remainder interest must be distributed to one or more non-charitable beneficiaries. A CLUT can be created during a donor's lifetime or at death.

### **Charitable Remainder Annuity Trust ("CRAT")**

A CRAT is required to distribute a fixed sum of at least 5% of the initial value of the trust's assets to a non-charitable beneficiary. The annuity amount must be paid out periodically, at least annually, for a specified number of years or for the life or lives of individuals; at the end of the trust's term, the remainder interest must be distributed to a qualified charity. No additions to the trust's principal may be made after the trust is established. A CRAT can be created during a donor's lifetime or at death.

### **Charitable Remainder Unitrust ("CRUT")**

A CRUT is required to distribute a fixed sum of at least 5% of the net fair market value of the trust's assets as valued annually to a non-charitable beneficiary. The unitrust amount must be paid out periodically, at least annually; at the end of the trust's term, the remainder interest must be distributed to a qualified charity. Additions to the trust's principal may be made after the trust is established. A CRUT can be created during a donor's lifetime or at death.

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