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## **IRREVOCABLE TRUSTS**

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An irrevocable trust is a trust that cannot be changed or amended after it is signed and notarized. Irrevocable trusts are created to protect assets from frivolous lawsuits, unwanted creditors, and federal estate and gift taxes. Creditors are prohibited from accessing assets in an irrevocable trust that was set up in good faith (not created just after receiving summons from a court of law or similar situations).

There are many types of irrevocable trusts; however, we will focus on the most common ones: the Irrevocable Life Insurance Trust (ILIT), the Qualified Personal Residence Trust (QPRT), the Charitable Remainder Trust (CLT), and the Wealth Replacement Trust (WRT).

### **1. Irrevocable Life Insurance Trust (ILIT):**

An Irrevocable Life Insurance Trust is created to own and be the beneficiary of life insurance policies on the life of the grantors. If the policies are owned by the trust, proceeds will be free of federal estate taxes.

A frequent use of ILIT is to hold second-to-die insurance that will help defray the cost of estate taxes that are due on the death of the second spouse. This is especially necessary in cases where the estate cannot be reduced to avoid taxes and the estate is not liquid, as estate taxes are due in cash within nine months of the death of the surviving spouse. The ILIT produces liquid funds to satisfy the estate taxes.

### **2. Qualified Personal Residence Trust (QPRT):**

A Qualified Personal Residence Trust is an irrevocable trust in which the grantor gives a personal residence to family members while retaining the right to live in the home. By placing the residence in a QPRT, the value of the home is reduced for federal gift tax purposes and is eliminated from the estate of the grantor for federal estate tax purposes, while the grantor still retains the right to live in the home during the trust period.

The discounted value for gift tax purposes is dependent on the term of the trust, the age of the grantor and the date of the trust being formed. In order to have the residence out of the grantor's estate for estate tax purposes, the grantor must survive the term of the trust.

A QPRT allows the residence to be sold state without destroying the trust. It also allows funds to be held for improvements on the property.

If the residence is no longer used as a personal residence, the trust is converted to a Grantor Retained Annuity Trust (GRAT) so as not to lose the reduction in the gift tax that has been accomplished. This occurs when the residence is not replaced within two years after a sale or other methods of disposition.

The trust is used for removing a residence that will appreciate over the term of the trust so that the appreciation is removed from the estate of the grantor. The disadvantage of the QPRT is that the residence passes to the beneficiaries at the same basis that the grantor had. This means that substantial capital gains may be due when the residence is sold. However, this is not important if the property does not have much appreciation. If the residence would add a large dollar amount to the estate if included, it is better to pay the capital gain tax of 15% than the much larger federal estate tax that

starts at 37% and rises rapidly. (Tip: The \$250,000/\$500,000 exclusion of gain from the sale of the residence can also be availed of by the trust.)

### 3. Charitable Remainder Trust (CRT):

A Charitable Remainder Trust is an irrevocable trust created for the purpose of holding assets given to the trust by a donor. A CRT is a split interest trust where donated assets are shared between non-charitable beneficiaries for life of a term of years, after which the trust assets are paid to qualified beneficiaries.

The best assets for use in a CRT are highly appreciated assets in which the donor has a low basis. The trust can sell the assets at fair market value, without the capital gains tax that the donor would have had to pay; thus, the assets will produce more income when placed in the trust by escaping capital gains tax.

A gift to a CRT has the following benefits:

- A. A current charitable income tax deduction for the present value of the remainder interest that is the portion of the assets that go to charity.
- B. The assets are transferred to the CRT and may be subsequently sold without the imposition of federal income tax on any gain realized.
- C. The non-charitable beneficiaries may receive more income after the transfer than the asset was earning before the transfer.
- D. The donor retains control over the designation of the ultimate charity to receive the assets.
- E. If the donor is the trustee, he may control the investment of the CRT's assets.
- F. The assets are out of the donor's estate for federal estate tax purposes.
- G. The assets are out of the reach of creditors.

### 4. Wealth Replacement Trust (WRT):

A Wealth Replacement Trust is an irrevocable trust that is created for the purpose of owning a policy insuring the life or lives of the donor of a CRT. The donor usually uses the income tax savings from the contributions to the CRT and the increased income produced by the CRT to pay the costs of life insurance required to fund the WRT. The death benefit is usually set at the value of the assets transferred to the CRT.

By the use of the CRT combined with the WRT, the following results are obtained:

- A. Donor receives a substantial income tax deduction.
- B. Income stream to non-charitable beneficiaries is increased.
- C. Beneficiaries of WRT receive death benefit of WRT free of income, gift, and estate tax.
- D. The charity receives the assets of the CRT.
- E. The assets of the CRT are excluded from donor's estate for estate tax purposes.

### 5. Charitable Lead Trust (CLT):

A Charitable Lead Trust is an irrevocable split interest trust that is the mirror image of the CRT. Income is paid to the charitable beneficiaries for a term of years or for the donor's life, after which the remaining assets of the trust pass to the non-charitable beneficiaries, which are often the donor's heirs.

The benefits of a CLT, after charitable giving, is that it removes assets from the donor's estate and passes it to the maker's heirs at a future date. The value to the donor is that the assets are valued for gift tax purposes as the value of the remainder interest to be transferred in the future. This is always much less than the fair market value of the assets at date of transfer.