

CHAPTER EE

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trust, n. 1. The right, enforceable solely in equity, to the beneficial enjoyment of property to which another person holds legal title; a property interest held by one person (the *trustee*) at the request of another (the *settlor*) for the benefit of a third party (the *beneficiary*). For a trust to be valid, it must involve specific property, reflect the settlor’s intent, and be created for a lawful purpose. (BLACK’S LAW DICTIONARY 1513 (7TH ed. 1999))

INTRODUCTION TO THE USE OF TRUSTS IN ESTATE PLANNING

I. HISTORY OF TRUSTS.

- A. Trusts have an ancient and distinguished history in English common law that goes back to the Middle Ages. A trust is a right over property, either real or personal property, held by one party (the Trustee) for the benefit of the another (the Beneficiary). This concept was originally borrowed by Roman civil law, which recognized a “use” as a legally-enforceable confidence imposed upon another person, ordinarily for the disposition and management of land.

- B. Under England’s medieval feudal system, the King was entitled to collect certain taxes upon the death of a noble when the noble’s lands passed to his heir. Some clever nobles placed their lands in “uses,” thereby avoiding the royal taxes. Therefore, the use of trust arrangements to avoid inheritance taxes is almost a thousand years old. The Statute of Uses was enacted during the reign of Henry VIII in 1536 and is an early example of “loophole-closing.” By this law the King abolished the favorable tax treatment previously allowed for “uses” in avoiding the medieval land taxes. In the 20th Century, American and British attorneys use trusts to accomplish the desired disposition of property, sometimes for tax reasons and also to achieve the owner’s dispositive plans.

- C. In civil law jurisdictions, i.e. most European countries, which base their legal systems upon Roman law and the Code Napoleon, owners of real and personal property generally do not have the unrestricted right to dispose of their property at death, or to create trusts for that purpose. This continental property law can be seen in the law of Louisiana, which provides a decedent’s surviving spouse with a “usufruct,” and also confers certain rights of forced heirship on the decedent’s children.

II. WHAT IS A TRUST?

- A. **trust, n. 1.** The right, enforceable solely in equity, to the beneficial enjoyment of property to which another person holds legal title; a property interest held by one person (the *trustee*) at the request of another (the *settlor*) for the benefit of a third party (the *beneficiary*). For a trust to be valid, it must involve specific property, reflect the settlor's intent, and be created for a lawful purpose. (Black's Law Dictionary 1513 (7th ed. 1999)).
- B. A trust is a "fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it." Restatement (Second) of Trusts, section 2.
- C. Essential Elements of a Trust:
1. Trustee
 2. Beneficiary
 3. Trust Property (res)

III. HOW TRUSTS ARE CREATED.

- A. Trusts are created in several ways:
1. By Will. These trusts are known as testamentary trusts and constitute a part of the testator's Last Will and Testament. Testamentary trusts are "dormant" until the Will is probated following the testator's death. Therefore, a testamentary trust is not fully established until the date of the testator's death. Probate of the Will is a required step to make a testamentary trust operational.

2. By Agreement (or Deed) of Trust. A person (the Settlor or Grantor) who desires to create a trust that will become operational during their lifetime ordinarily does so by executing a Trust Agreement or a Deed of Trust. Such trusts are often called “inter-vivos trusts” because they are made between living persons, as opposed to the testamentary trust, which is created in the Will of a decedent.
3. By Court Action. Courts of equity have powers to impose a resulting or constructive trusts. Judges ordinarily apply this legal doctrine in order to remedy an act of fraud or misappropriation of property.

IV. COMMON FEATURES OF ALL TRUSTS.

A. All trusts will ordinarily contain all of the following elements:

1. Governing Document. The written instructions specifying the terms of the trust are contained in the Will, Trust Agreement or Court Order (in the case of a constructive trust).
2. Trust Assets. The property subject to the terms of the trust is often referred to as being the “trust principal,” “trust estate,” “corpus,” or “res.” All of these terms mean essentially the same thing and refer to the property that is the subject of the trust.
3. The Settlor. The person who, having the requisite capacity, creates the trust. Also known as grantor, donor, or trustor.
4. The Beneficiary. All trusts have one or more beneficiaries, who are the persons who are named or otherwise designated to enjoy the income and principal of the trust property. The Beneficiary is considered to be the equitable owner of the trust property.
5. Trustee(s). All trusts will have one or more Trustees, who are the legal owners of the trust property. As the legal owners the Trustees are vested with powers to manage, invest and dispose of the trust property, subject to the terms of the governing document. A trust will ordinarily continue after the death or resignation of its Trustee and another substitute or successor Trustee will be appointed to carry on the duties of the Trustee.

6. Time Period of Trust. Most trusts will have a definite beginning and ending point, ordinarily beginning at the death of the testator/settlor who created the trust and ending upon the beneficiary of the trust reaching a specified age of financial maturity. The Rule Against Perpetuities is a common law legal doctrine that limits the term of trusts to the lifetimes of beneficiaries or certain other described persons who were living when the trust was established, plus an additional period of twenty-one (21) years. The rule ordinarily limits the term of all private trusts, i.e. trusts created for the benefit of individuals. However, charitable and governmental trusts are exempt from the limits of the Rule Against Perpetuities. Delaware and some other states have repealed the common law doctrine known as the Rule Against Perpetuities, so that private trusts established in those jurisdictions may continue indefinitely.

V. COMMON TRUST PROVISIONS.

- A. Identification of Settlor, Trustee and Initial Corpus. The trust instrument should identify the settlor, the trustee and the initial corpus. The trustee and the settlor should all sign the trust agreement. If it is desirable not to disclose the initial corpus in the trust instrument, a nominal corpus should be identified in the instrument. This listing of assets is ordinarily done on a schedule or exhibit attached to the trust instrument.
- B. Identify Beneficiaries. The trust agreement or Will should identify the beneficiaries of the trust by name or description. If there are contingent beneficiaries, the conditions under which they are to receive income or principal must be set forth in detail.
- C. Powers of Trustees. (See also Section VII). The trust instrument or Will should specify the powers of the trustees (initial and successors). When drafting these fiduciary powers, the attorney should be aware of any applicable statutes and whether they need to be specifically referenced in the trust instrument in order to be applicable. The process is sometimes shortened by referring to a statute which sets forth trustee's powers (e.g., the "Colorado Fiduciaries Powers Act," C.R.S. § 15-1-801, et seq. and also § 64.1-57 of the Code of Virginia).
- D. Spendthrift Provisions. If a purpose of the trust is to safeguard trust assets from creditors, appropriate spendthrift language should be included. "Spendthrift" provisions ordinarily prohibit a beneficiary from assigning or otherwise anticipating his inheritance.

- E. Perpetuities Savings Clause. If there is even a remote possibility that the Rule Against Perpetuities may be violated, a savings clause should be considered, including provision for who takes the property when the provision is applicable.
- F. Bond. The trust instrument should specify whether the trustee is exempted from having to post bond or other security. Distinctions may be needed in the case of successor or substitute trustees.
- G. Successor Trustees. Provision should be made for the appointment of a successor trustee in the event that the initial trustee(s) cease(s) to perform for any reason. Successors may be appointed according to a list set forth in the agreement or according to instructions set forth in the agreement, or by a court.
- H. Trustee Fee. Provision should be made for a reasonable fee for the trustee, or agreement should be made with a trustee who is willing to serve without fee.
- I. Underage Beneficiaries. The trust instrument should provide continuing trust protection and management for any beneficiary who is under age 18 until a specified age of financial maturity, often age 21 or higher.

VI. DESIGNATING TRUSTEES.

- A. In General. The following factors may be helpful when the attorney assists the settlor in selecting a trustee. Generally, it is beneficial if the trustee has an understanding of the needs of the settlor and his family and possibly of the settlor's business. Individual trustees should be expected to survive the settlor. Corporate trustees should be qualified to do business in all jurisdictions where the settlor has property. The nature of the settlor's assets and businesses may sometimes require multiple trustees. In addition, when selecting trustees, consideration should be given to the following questions:
 - 1. Does the individual or institution have the experience and specialized knowledge necessary to handle investments and administrative requirements, including knowledge about fiduciary income tax returns?
 - 2. Can the individual or institution repay any damages if default or breach occurs?

3. What possible tax considerations attend the selection of the individual? There may be adverse income or estate tax consequences where a beneficiary is a trustee or co-trustee.

B. Corporate Trustee.

1. Advantages. Corporate trustees generally have expertise in asset management, record keeping, accounting and preparation of reports and tax returns. Also, corporate trustees have perpetual existence and when dealing with the trust and its beneficiaries can act impartially.
2. Fees. Corporate trustees require payment of fees for their expertise. It is prudent to inquire about the fee structure of a particular institution prior to naming it. Fees typically are based on a percentage of the value of assets being managed and tend to approximate 1% per annum of the principal value of the trust. In some states compensation of trustees and other fiduciaries is specified by statute.

C. Individual Trustee.

1. Advantages. The individual trustee may have a better understanding of the personal needs and values of the settlor and his family and, therefore, may be able to provide a personal touch when dealing with beneficiaries and discretionary distributions to them. Also, an individual trustee may be willing to serve without fees for his services.
2. Possible Disadvantages. An individual trustee who is unsophisticated with respect to trust management may cause trust assets to be dissipated through poor investment choices. The trust may incur tax liabilities if proper tax returns are not filed. Also, there can be estate or income tax problems where the trustee is also a beneficiary of the trust.

- D. Co-Trustees. Appointment of an individual trustee and a corporate trustee as co-trustees is a good approach because it combines the advantage of a personal touch with the expertise of professional asset management, but may also result in additional expense if both trustees are entitled to a fee. Serving as a trustee can be a heavy responsibility. For that reason it is often advisable to use a “fiduciary team” composed of two individuals or perhaps a corporate co-trustee to serve with a member of the family as the individual co-trustee.

VII. TRUSTEE’S POWERS AND ADMINISTRATIVE PROVISIONS.

- A. Trustee's Powers. The Will or trust agreement should include broad administrative powers to assure the most efficient and economical administration of the trust assets.
 - 1. Statutory Powers. Statutory powers vary from state to state and may vary with subsequent legislation. Always check local law to determine whether specific reference to a fiduciary powers statute is required. For example, the Colorado Fiduciaries' Powers Act (C.R.S. § 15-1-801, et. seq.) confers certain powers on all fiduciaries unless the Will or trust clearly limits such powers. If in doubt, it is ordinarily best to include specifically a power that may be needed.
 - 2. Some Useful Powers to Give to the Trustee.
 - a. Exercise tax elections.
 - b. Apply property for the benefit of a beneficiary.
 - c. Real property management.
 - d. Settle claims.
 - e. Allocate receipts between income and principal.
 - f. Retain original property, regardless of its type or investment suitability.

- g. Broad investment authority.
 - h. Sale and lease.
 - i. Use of nominee form for registration of securities.
 - j. Lend and borrow.
 - k. Employ agents and attorneys.
 - l. Delegate powers to other trustees.
 - m. Consent to corporate changes.
 - n. Rights and voting proxies.
 - o. Continuation of business.
 - p. Partnership interests.
 - q. Manage oil and gas interests.
 - r. Distribute assets in kind.
 - s. Purchase assets from the estate of the settlor.
 - t. Abandon property.
 - u. Consolidate multiple trusts.
 - v. Terminate the trust if its administration is uneconomical.
3. Consider a Limitation on the Powers of any Interested Trustee.

- a. Since In re Wall Estate, 101 T.C. 300 (1993), the Internal Revenue Service has given up trying to assert that the power to remove a trustee can cause the holder of that removal power to be subject to estate tax as the owner of the trust corpus. Nevertheless, caution remains advisable in naming a beneficiary as a trustee or co-trustee.
- b. The following protective provision (taken from a Will produced using DL) may reduce the risk of causing a removal power to cause the assets of the trust to become subject to estate or gift tax with respect to the holder of the power.

Notwithstanding anything to the contrary contained in this will, during such time as any current or possible future beneficiary of any trust created hereunder may be acting as a Trustee hereunder, such person shall be disqualified from exercising any power to make any discretionary distributions of income or principal to himself or herself or to satisfy any of his or her legal obligations, or to make discretionary allocations of receipts or disbursements as between income and principal. Such powers shall be exercisable, if at all, only by the other Trustee acting at the time with such beneficiary. No Trustee who is a current or possible future beneficiary of any trust hereunder shall participate in the exercise of any powers of my Trustees which would cause such beneficiary to be treated as the owner of trust property for tax purposes.

B. Administrative Provisions.

1. Incorporation by Reference. The trust should provide for the incorporation of the appropriate fiduciaries' powers act, or other state law applicable, to be effective with respect to administration of the trust estate.
2. Release of Power. All administrative powers and powers to designate fiduciaries should be releasable in whole or in part, temporarily or irrevocably, by written instrument delivered to the trustee or filed in the records of the trust.
3. Reports. The trustee should be required to render reports, at least annually, to the beneficiaries, showing the assets held as principal of the trust and all receipts, disbursements and distributions. The records of the trustee with respect to the trust should be open to inspection by the beneficiaries.

4. Advisory Standards. Advisory standards can be listed to guide the trustee in exercising his discretionary powers. These standards can include the purposes of the trust, investment criteria and other provisions the settlor would like to include concerning the treatment of beneficiaries, management of trust assets and distributions of income and principal.
5. Power to Terminate Early. It is advisable to give the trustee the power to terminate the trust early if it is no longer economically viable to continue the trust.

VIII. SIMPLE WILLS WITHOUT TRUSTS.

Some individuals and married couples may have situations that are sufficiently simple to avoid the use of any trust provisions. Under current federal estate tax law this would include an individual or married couple with a combined gross estate of \$2,000,000 or less (assuming death occurs in 2006 through 2008). Estates under this level need not use trust provisions if all of the persons named in the will to inherit property are over age 18 and do not have “special needs.” Special needs would include disabled or incapacitated persons who may require long-term medical or custodial care due to mental or physical disability.

IX. NON-TAX USES OF TRUSTS IN WILLS.

A. Testamentary Trusts.

1. A testamentary trust is one created by a Will, as part of the Will.
2. It becomes both effective and irrevocable at the time of death.
3. It is funded with all or a part of the decedent’s assets.

B. Primary Uses of Testamentary Trusts.

1. Contingent Trusts for Minors or Other Beneficiaries.

- a. Allows the testator to name a trustee to manage assets for minor children in the event of a common accident or death of the surviving spouse.
- b. Normally used to manage assets at least until the minor reaches the age of majority (ordinarily age 18), often to age 21 or older.
- c. Avoids the possible need for a court-supervised guardianship or conservatorship of property if the children - beneficiaries are minors and no trust was provided in the Will.
- d. DL Wills allows the creation of multiple trusts through both the creation of pre-residuary trusts and residuary trusts for multiple children or blended families.
- e. Determination of Shares. There are basically two methods used to determine the shares provided for minor children or other beneficiaries, as follows:
 - (1) Separate Shares Upon Testator's Death. In most cases, the testator's Will directs that the inheritance for his children will be divided into equal shares, as of the date of the testator's death. The DL software provides a screen where this decision is made by the drafting attorney.
 - (2) Disadvantage of Separate Shares Upon Testator's Death. Creation of separate shares upon the testator's death can have an adverse impact upon the testator's younger children, if the younger children are also specified to receive shares equal to those of their older siblings. An older child who has already graduated from college will be able to use and enjoy virtually all of his inheritance. In contrast, support and education expenses of younger beneficiaries will consume a great deal of their inheritance if the separate share drafting approach is used.

- (3) Unitary or “Sprinkling” (Pooled Asset) Trust Followed By Separate Shares. Where the testator has children (or other beneficiaries) whose ages vary greatly, the best approach is often to use a pooled trust, where the funds are held in one combined trust fund. Using a pooled trust, the portion of the estate designated for the testator’s children is held in one combined trust fund until the youngest child reaches a specified age, perhaps age 21 or 25. In this way, the trustee manages all of the decedent’s trust funds for the common benefit of the testator’s children, until all children have reached the minimum age specified by the testator. At that point, the pooled trust is ordinarily divided into equal shares, and each child then receives outright distribution of his respective equal share.

2. Special Needs Trusts.

- a. “Special Needs” trusts allow the testator to place assets in trust for a disabled person, such as a retarded child, so that those assets will continue to benefit the handicapped person after the testator's death. These trusts are ordinarily designed to supplement benefits provided through Medicaid or other governmental assistance.
- b. The “Special Needs” trust is a management tool and includes a spendthrift provision and other strict limits on distributions so that the disabled person does not lose Medicaid benefits or eligibility.

3. For Control of Asset Disposition.

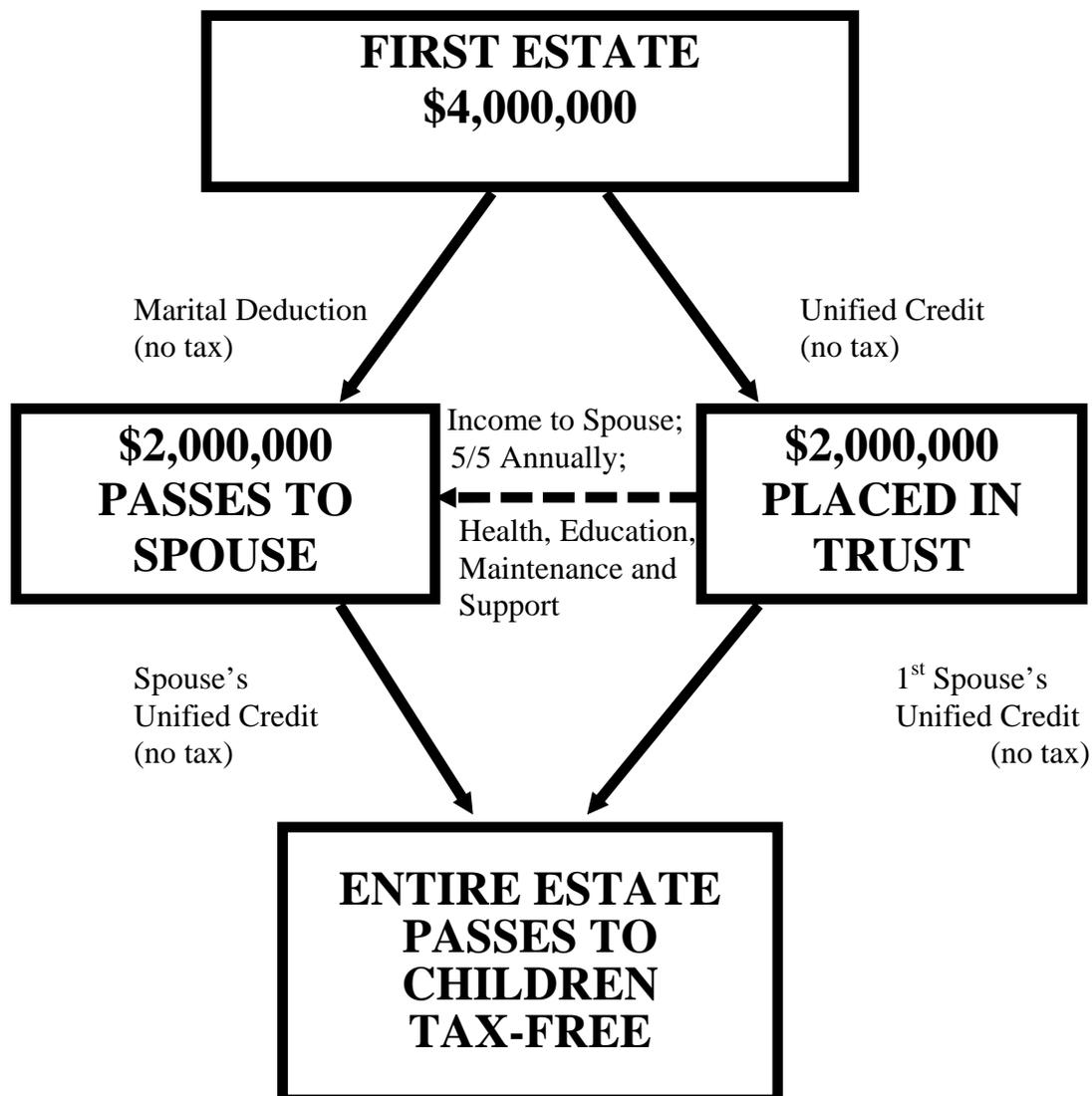
- a. Commonly used when one or more of the spouses have children by former marriage, or when the testator is concerned about the possibility of the surviving spouse remarrying or disinheriting the children.
- b. Use of an independent trustee or co-trustees is advisable and should be considered.

X. ESTATE PLANNING FOR SERVICE MEMBERS.

A. When is more detailed estate planning necessary?

1. Gross estate > unified credit.
2. Non U.S. spouse.
3. “Mixed or blended” families.
4. Minor children or a disabled child.

B. Effective Use of the Unified Credit.



The key to maximizing the effective use of the unified credit is to have a measured amount of the estate (i.e., Currently \$2,000,000) go to a "credit shelter" trust. This trust is taxed at the first spouse's death, with the tax being paid by the deceased's unused unified transfer credit. This "bypass trust" may provide a life income interest to the surviving spouse as represented above by the dotted line.

The same estate without estate tax planning would result in a federal tax liability of approximately \$780,800 at the death of the second spouse.

C. Methods using the Unlimited Marital Deduction.

1. Outright gift of qualifying property.
2. Trusts.
 - a. Estate Trust - distributes to surviving spouse's (SS) probate estate at death, for estate tax and probate purposes. Not favored except where important to have income accumulated in trust and not paid out during SS's life. This is only type of marital deduction trust that allows income accumulation. All assets in this trust are in SS's estate for estate tax purposes and are subject to probate.
 - b. Marital Trust – (sometimes referred to as an “A Trust”) Spouse has the right to all income plus the right to say during life and / or at death who receives the remaining principal.
 - c. Qualified Terminable Interest Property (QTIP) Trust (Appendix B) - Spouse has the right to all income during life. No one else can benefit from the principal, but the donor (or decedent) can direct who will get the principal at the surviving spouse's death.

D. Methods using the Marital Deduction and Unified Credit.

1. Credit Shelter Trust (a.k.a. “By-Pass Trust” or “Exemption Trust”)
 - a. The credit shelter trust or A-B trust is designed to make certain that the unified credit of each spouse is used, while allowing the surviving spouse to have the use of the deceased spouse's assets during the remainder of his or her lifetime.

- b. A decedent can pass any size estate to his/her spouse without concern for the federal estate tax because of the unlimited marital deduction. However, when the surviving spouse later dies and passes the combined estate to his/her heirs, there is only the surviving spouse's unified credit to reduce the estate tax. This results in the first spouses unified credit amount being wasted.
- c. Because of tax deferral of the unlimited marital deduction, the taxation occurs at the death of the second spouse (if estate exceeds unified credit).
- d. To preserve the unified credit of the first spouse to die, many couples use a credit shelter trust. When the first spouse dies, an amount equal to (or less than) the unified credit is placed in the credit shelter trust. This trust is not taxed at that time or later at death of the surviving spouse, even though it may appreciate greatly in value.
- e. The surviving spouse can have access to the income from the credit shelter trust for life, and can use the principal if necessary for health, education, support and maintenance.
- f. Result:
 - (1) At the death of the surviving spouse the amount in the credit shelter trust is not included in the estate of the second spouse to die. The second spouse to die can then pass an estate to his/her beneficiaries up to their unified credit amount with any estate taxation.
 - (2) The credit shelter trust (Trust B) is generally not taxed at the death of either spouse. The marital share (Share A) is generally taxed when the surviving spouse later dies, but an estate less than the unified credit will result in no estate taxes payable.

2. Disclaimers (I.R.C. § 2518).
 - a. Can be used as an after-death planning tool. Can be used to shift property to a younger generation while avoiding a gift tax liability to the disclaiming party.
 - b. Beneficiaries are not forced to take what is coming to them under another person's will. The beneficiary disclaims a bequest.
 - c. If a qualified disclaimer is made by someone who does not wish to accept an interest in property, the interest disclaimed will be treated for federal tax purposes as if it had never been transferred to that person, and he / she will not be treated as having made a gift, for either gift or estate tax purposes, to the person to whom the interest passes by reason of the disclaimer.
 - d. A surviving spouse can make a valid disclaimer even though the property disclaimed goes to a trust in which he / she has an income interest, so long as this result is without the surviving spouse's direction. As a result, a provision is included in the decedent's will directing the disposition of any disclaimed property.
 - e. Mechanics of disclaimers.
 - (1) To be effective for tax purposes, a disclaimer must be qualified. A qualified disclaimer is an irrevocable and unqualified refusal to accept an interest in property.
 - (2) A qualified disclaimer must satisfy four requirements:
 - (a) The refusal must be in writing;

- (b) The refusal must be received by the transferor, his or her legal representative, or the holder of legal title to the property not later than nine months after the day on which the transfer is made;
 - (c) The person who disclaims must not have accepted the interest or any of its benefits before making the disclaimer; and
 - (d) The interest disclaimed must pass to someone other than the person making the disclaimer without any direction on the part of the person making the disclaimer.
- f. Both state and federal law applies to disclaimers.
 - (1) State law determines ownership.
 - (a) The extent to which disclaimers are effective for nonprobate transfers is unclear in many jurisdictions.
 - (b) Both the UPC and the tax law recognize disclaimers of nonprobate transfers. UPC § 2-801; Treas. Reg. § 25.2518-2(c)(4).
 - (2) Federal law determines tax consequences.
- g. Disclaimers and Joint Tenancy Interests.
 - (1) In general, an individual must make a qualified disclaimer of the interest to which the disclaimant succeeds upon creation of the joint tenancy within nine months after the creation of the tenancy. Treas. Reg. § 25.2518-2(c)(4)(i).

(2) However, a qualified disclaimer of the survivorship interest must be made no later than nine months after the death of the first joint tenant to die. The timing for disclaiming the survivorship interest is not affected by the power of the disclaimant to unilaterally sever the tenancy under local law. *P.M. Kennedy*, CA-7, 86-2 USTC, rev'g TC, 51 TCM 232, CCH Dec. 42,804, TC Memo. 1986-3. Similarly, *J.S. Dancy Est.*, CA-4, 89-1 USTC, rev'g TC, 89 TC 550, CCH Dec. 44,184; *G.L. McDonald*, CA-8, 88-2, USTC, rev'g TC, 89 TC 293, CCH Dec. 44,118, cert denied.

(3) Special rules apply to disclaimers of joint tenancy interest in bank, brokerage, and investment accounts. The transfer creating the survivorship interest in a cotenant's contributions occurs on the death of the cotenant only if the cotenant possessed the right to unilaterally regain sole possession of the contributions. In such case, the surviving cotenant may make a qualified disclaimer within nine months of the deceased cotenant's death. Treas. Reg. § 25.2518-2(c)(4)(iii). In addition, a joint tenant may not make a qualified disclaimer of any portion of the joint interest attributable to consideration furnished by that tenant.

h. For a good analysis of the law and case law of disclaimers, see, *Disclaimers: New Developments, Opportunities, and Unsettled Areas*, by Virginia F. Coleman, ALI-ABA Course of Study Materials, Advanced Estate Planning Techniques, Volume I, February 1999, available on LEXIS.

3. Credit Shelter or By-Pass Disclaimer Trust.

a. The will first makes an outright gift of all the desired property to the surviving spouse followed by an express provision that any property that the surviving spouse disclaims passes into a bypass trust for the surviving spouse's benefit.

b. The benefit for the bypass disclaimer trust is that the surviving spouse can examine the actual situation at the time of the deceased spouse's death and make the best decision.

4. Qualified Terminable Interest Property Trust (QTIP Trust) (a.k.a. “A-B-C Type Trust”) (I.R.C. § 2056(b), see Appendix B).
 - a. Sometimes a third trust is added to the A-B Trust called a QTIP trust.
 - b. The QTIP allows the first spouse to die to give lifetime benefits (like income earned on the trust assets) to his / her spouse, while still retaining the right to name the persons who will ultimately receive the trust assets.
 - c. Useful in protecting children of a prior marriage from being cut off by the surviving stepparent.
 - d. Reduces the possibility of estate passing to a subsequent marriage partner or “close friend” of the surviving spouse.

5. Qualified Domestic Trust (QDOT) (I.R.C. § 2056A).
 - a. Transfers at death to a non-citizen spouse will not qualify for the unlimited marital deduction unless the assets pass to a QDOT.
 - b. If a QDOT is not used, then all assets above the decedent’s unified credit amount are taxable upon transfer to a non-citizen spouse.
 - c. The QDOT rules require a U.S. Trustee and other measures that help ensure collection of estate tax at the surviving non-citizen spouse’s later demise.
 - d. Gift Tax Note: Can gift up to \$100,000 per year to non-citizen spouse during life. (\$128,000 in 2008) *See* Rev. Proc. 2007-66.

e. QDOT Requirements:

- (1) Essentially a QTIP with QDOT language established in the will;
- (2) At least one trustee us s U.S. citizen / domestic corporation;
- (3) Any distribution of corpus is subject to estate taxation while income is not;
- (4) Trustee must make irrevocable election on estate tax return;
- (5) If the trust assets are over \$2 million certain security arrangements required.

XI. TRUSTS FOR FEDERAL ESTATE TAX PLANNING

- A. To reduce or eliminate the impact of the federal estate tax, several different types of trusts are often used. For persons dying in 2006 through 2008, the federal estate tax may apply if the decedent's gross estate exceeds \$2,000,000. Under current law this exemption is rising incrementally and will reach \$3,500,000 in 2009, there will be no tax in 2010, and it will return to \$1,000,000 in 2011.
1. Bypass Trusts. These are sometimes called "credit shelter trusts" or "family trusts." This type of tax-saving trust is designed to take advantage of the decedent's federal estate tax exemption (\$2,000,000 for years 2006-2008). Assets held in a Bypass Trust avoid federal estate tax upon the death of the surviving spouse, even though the surviving spouse and children ordinarily receive income and discretionary principal benefits from the Bypass Trust during the widowhood of the surviving spouse. In this way, the assets of the Bypass Trust are not included in the gross estate of the surviving spouse at the time of her subsequent death. This arrangement permits a married couple to pass as much as \$4,000,000 (assuming death in years 2006-2008) by taking maximum separate advantage of the \$2,000,000 exemptions available to each spouse.

2. Marital Trusts. Unlike a Bypass Trust, which avoids federal estate tax through use of the decedent's \$2,000,000 exemption, a Marital Trust merely postpones federal estate tax during the lifetime of the surviving spouse. Marital Trusts that meet certain requirements at the first death qualify for the marital deduction, which defers the federal estate tax on the property of the Marital Trust until the death of the surviving spouse. To qualify for the federal estate tax marital deduction the Marital Trust must be subject to federal estate tax at the death of the surviving spouse. Traditionally, this was accomplished by giving the surviving spouse a general power of appointment, which is the unrestricted power to direct the disposition of the property at the second death, or by directing that the property of the Marital Trust be added to the probate estate of the surviving spouse at the time of her death. However, this approach had little appeal for spouses in second marriages, where the first-to-die husband ordinarily wished to benefit his children from his first marriage, following the death of his second wife. In the past decade or so, so-called "QTIP" Trusts (qualified terminable interest property trusts) will now qualify for the marital deduction provided that the executor makes the "QTIP election" at the first death. In this way, the surviving spouse receives the sole income and principal benefits of the QTIP Trust during her lifetime. At the second death the property of the QTIP Trust passes as specified in the Will or trust agreement of the first spouse to die.

3. Annual Gift Trusts. Under § 2503 of the Internal Revenue Code of 1986, gifts of up to \$12,000 per donee, per calendar year, are exempt from the federal gift tax. Irrevocable trusts that are funded using this "loophole" are often used in order to accumulate funds for children or other beneficiaries. Even more frequently, such trusts are used to acquire and hold life insurance policies on the life of the settlor. In this way, the life insurance death benefits can avoid being taxed in the settlor's federal gross estate (assuming that the insurance was acquired initially by the trust, or that more than three years have passed since the settlor irrevocably transferred ownership and control of the life insurance to the irrevocable trust).

4. Generation-Skipping Trusts. Trusts that are designed to avoid the federal estate tax upon the death of the trust beneficiary are generally called “generation-skipping.” For persons with large estates whose children also expect to be wealthy in their own right, such generation-skipping trusts are used to protect the trust assets from federal estate tax upon the subsequent death of the child/ beneficiary. To curb the use of this technique, the Congress enacted a special generation-skipping transfer tax, which has the effect of imposing a 55% excise tax on such trusts. However, there is a \$2,000,000 (per donor) lifetime exemption from this tax. This exemption can be allocated on the donor’s federal gift tax return to exempt all or part of a trust from the imposition of the generation-skipping transfer tax. Beginning in 2004 the exemption is pegged to the estate tax exemption. (\$1.5 million in 2004 & 2005; \$2 million in 2006, 2007, & 2008; \$3.5 million in 2009 (IRC § 2631(c), as amended by P.L. 107-16).

XII. NON-TAX USES OF INTER-VIVOS TRUSTS.

- A. Offshore Asset Protection Trusts. While there are virtually no U.S. tax benefits for a U.S. citizen who establishes a trust in a foreign jurisdiction, such trusts are nevertheless beneficial to U.S. persons who desire to shield their assets from creditors, including estranged or former spouses and others. Many former British colonies and other countries having a British common law heritage recognize the legal use of a trust for the management and ownership of property. Many of these “tax haven” jurisdictions have made a special effort to enact laws that make it extremely difficult for foreign creditors to enforce judgments against trust assets under any circumstances. Some of the more popular offshore jurisdictions include the Cayman Islands, Gibraltar, and the Cook Islands (near New Zealand). U.S. citizens and aliens who have the right of permanent residence in the U.S. (i.e., “green card” holders) should be advised that all income from foreign sources, including income from foreign trusts and bank accounts, is subject to U.S. income taxation under most circumstances.
- B. Revocable or “Living” Trusts.
 1. Used as a probate-avoidance mechanism.
 2. Used to plan for the eventual incapacity of the Grantor.

3. Used to provide current management of assets by a qualified person or institution.

XIII. “LIVING” TRUSTS V. TESTAMENTARY TRUSTS.

A. Introduction. Consider state law probate procedures and costs. Community property law in certain states may make it necessary to use a revocable trust in those jurisdictions in order to accomplish federal estate tax planning.

B. Characteristics of Revocable Trusts.

1. Definition.

- a. A revocable trust, sometimes called a “living trust,” is a trust created during the grantor's life by a lifetime transfer of property into a trust over which the grantor retains a power to revoke.
- b. Upon the grantor's death, the trust becomes irrevocable, and the beneficiaries change from the grantor to his intended beneficiaries, usually the spouse and children or other descendants.
- c. The revocable trust agreement ordinarily provides for the management and disposition of property, both during the grantor’s lifetime and after his death.
- d. A pour-over Will is utilized in conjunction with the revocable trust agreement in order to add the residue of the grantor’s probate assets, if any, to the trust.

2. Structure of the Revocable Trust.

- a. The grantor, and sometimes the grantor's spouse as well, is the income beneficiary of the trust during his or her lifetime.

- b. The grantor is often the Trustee, either alone, or with an independent party or spouse as Co-Trustee.
 - (1) The grantor may act as sole Trustee as long as he or she is not also the sole beneficiary of the trust, in which case merger of the legal and equitable interests in the trust property may be deemed to have occurred.
 - (2) The grantor expressly retains the power to amend or revoke the trust at any time, making it a “grantor trust” under § 676 of the Internal Revenue Code of 1986 (“IRC”). Under federal income tax law all income of a “grantor trust” is reported on the grantor’s Form 1040.
3. Power to Revoke and Amend.
- a. The retention of the power to revoke and amend must be made expressly in the trust agreement.
 - b. The grantor may retain the power to revoke alone, with the consent of another, or may vest the power entirely in a third party.
 - (1) Requiring the consent of a third party will not affect the trust's classification as a “grantor trust” under IRC § 676 and the trust assets will still be included in the grantor's gross estate as a revocable transfer under IRC § 2038.
 - (2) The trust will no longer be a grantor trust under IRC § 676, however, if the consent required is from a party whose interest is adverse to the power to revoke.
 - (3) If a third party has the exclusive power to revoke, then the trust is still a grantor trust under IRC § 676(a) as long as the party does not have an adverse interest to the power to revoke, and the trust is considered a revocable trust under IRC § 2038. Treas. Reg. § 20-2038(a)(3).

- (4) Unless otherwise expressly provided, all of the trust property will typically revert back to the grantor upon exercise of the power to revoke.

C. Truths and Misconceptions Surrounding Revocable Trusts.

1. Avoiding Probate.

a. Cost of Probate.

- (1) Probate costs typically include filing fees, attorney fees, and fees for the executor or personal representative. However, the attorney and fiduciary fees will often be comparable even when a revocable trust is used because much of the work involved is for preparing the various tax returns, which are required regardless of whether a living trust is used.
- (2) Probate expenses, in most instances, are tax-deductible.
- (3) Probate fees are ordinarily small in contrast to the value of the supervisory role which the court provides during the estate's settlement.

b. Delays and Hassles of Probate.

(1) Probating a Will.

- (a) Depending upon state law and procedure, probate of a Will that is properly executed usually takes only a few days or weeks to accomplish.
- (b) In estates large enough to require a federal estate tax return, costs and delay more often emanate from the federal estate tax filing rather than from the probate process itself.

- (2) Distribution of Assets. Depending upon state law, a revocable trust does not necessarily expedite the distribution of assets upon death.
- (a) Once a Will is admitted to probate, the estate's assets are ordinarily available for distribution, at the discretion/risk of the executor.
 - (b) After death, certain assets, such as life insurance, may take time to process and collect, which will delay the distribution of those assets the same for the trust beneficiaries as for the estate's beneficiaries. Funding the revocable trust with liquid assets, however, may be advantageous if such assets will be needed by the family immediately after death.
 - (c) Even though the Trustee of a living trust is not required to file an inventory of assets as is an Executor, it will probably still be necessary to inventory the decedent's probate assets as they are collected.
 - (d) The length of post-mortem estate administration is mostly attributable to the collection of information necessary for the death tax returns, preparation of those returns, and then waiting for the federal and state governments to review those returns. Death tax returns are usually due within nine months of death, and review of those returns can take between six to 18 months after that, explaining the length of probate. The federal estate tax return filing requirement is not eliminated merely because the assets are held in a revocable living trust at the grantor's death.

- (i) Ancillary Probate. The transfer of real property into a living trust will generally avoid the need for an ancillary probate proceeding where the property is located in a state outside of the decedent's domicile. Senior v. Braden, 295 U.S. 422 (1935); Scott on Trusts § 130 (1939). Interests in foreign real and tangible property held in a living trust may be converted into intangible trust interests, but they do not avoid estate taxation by the state where the real estate is situated.

2. Protecting the Grantor's Assets.

- a. Avoiding Creditors. Generally, a living trust will not protect the grantor's assets from claims by creditors, because the grantor is deemed to be the owner of the trust's assets by virtue of the right of revocation.

- (1) Some states will also not allow the Trustee to defeat claims of creditors by distributing assets upon the grantor's death. Matter of Granwell, 281 N.Y.S.2d 783, 228 N.E.2d 779 (1967).
- (2) The Trustee of a living trust is personally liable for any federal estate taxes attributable to trust property. IRC § 6324(a)(2). Although the Trustee can apply to be discharged from personal liability under IRC § 2204, the discharge will only be granted after the estate's Executor has been discharged under IRC § 2204(a).
- (3) Statutory period for presentation of claims and barring claims not timely presented is not available to protect Trustees of a living trust as it is for Executors.

- b. Avoiding the Spousal Elective Share. In some states, it may be possible to defeat a spouse's statutory right to a portion of the decedent's estate by funding a revocable trust during the grantor's lifetime. In a case where the decedent transferred assets to a revocable trust excluding his surviving spouse as a beneficiary, Connecticut has held that the transferred assets were excluded from the probate estate and not subject to the spouse's right of election. Cherniack v. Home National Bank and Trust Co. of Meriden, 151 Conn. 367, 198 A.2d 58 (1964).

3. Management of Assets.

- a. During the Grantor's Lifetime. It is appropriate and desirable to establish a revocable living trust for a client if he or she intends the Trustee to manage his or her assets.
 - (1) A professional Trustee may be advisable for someone who is inexperienced in investment decisions.
 - (2) However, many clients do not want to lose control over their assets and are fully capable of managing them.
 - (a) Upon the Grantor's Incapacity. The living trust is a useful tool for the management of assets upon the grantor's incapacity since it provides continuity and avoids the need for a court-appointed conservator or guardian for the management of property.
 - (i) A durable power of attorney will also avoid the need for a conservatorship or guardianship proceeding upon incapacity. The power of attorney may authorize funding of the revocable trust.
 - (ii) For older clients with an increased probability of incapacity, a fully funded revocable trust may make more sense than for younger, healthier clients.

4. Avoidance of Probate Contests. The validity of a living trust can be subject to challenge as well as a Will.
5. Privacy. The contents of a Will are made public record when the Will is admitted to probate, while the provisions of a living trust are sometimes less subject to public scrutiny.
6. No Tax Savings. Revocable trusts do not save any income or estate taxes that are not otherwise available through proper drafting of the decedent's Will.

D. Tax Consequences.

1. During the Grantor's Lifetime.

a. Federal Income Taxes.

(1) A living trust is not a separate taxable entity for income tax purposes.

(a) Income, including capital gain income, is taxed to the grantor under the grantor trust rules. IRC § 671-677.

(i) Power to revoke. IRC § 676.

(ii) Power to control beneficial enjoyment of trust property. IRC § 674.

(iii) Right to receive income for life. IRC § 677.

(a) All of the trust's income and deductions are reported by the grantor on his or her personal income tax return as if the property had never been transferred to the trust.

- (i) Generally, the transfer of assets to a revocable trust will not trigger the imposition of gift taxes, since the grantor's power to revoke the trust renders the gift incomplete. Treas. Reg. § 25.2511-2.

2. Upon the Grantor's Death.

- a. Federal Income Taxes. At the grantor's death, the revocable trust becomes irrevocable and is treated as a separate entity for income tax purposes.

- (1) Fiscal Year. Under IRC § 645, all trusts must use the calendar year as their fiscal year, whereas the decedent's estate may select its own fiscal year. It is possible to elect to include the income of the trust in the estate's fiduciary income tax return for the first two years post-mortem.
- (2) Personal Exemption. Under IRC § 642(b), a trust has a \$100 exemption if it is a complex trust and a \$300 exemption if it is a simple trust, whereas an estate has an exemption of \$600.
- (3) Upon the grantor's death, there is a "stepped up" basis attributed to any assets transferred to the trust during the grantor's life or "poured over" from the grantor's estate upon his or her death. IRC § 1014.
- (4) The trust is entitled to the same reprieve from filing estimated tax payments for the first two tax years ending after the grantor's death as is the decedent's estate under IRC § 6654(1), as long as it also fulfills one of the following:
 - (a) the decedent's residuary estate "pours over" into the trust; or

- (b) where no Will has been admitted to probate, the trust pays all debts, taxes and expenses of administration. IRC § 6654(1)(2)(B).
- (5) Depreciated Assets. If a Trustee sells assets to a beneficiary at a price less than the asset's basis, such loss is disallowed to the trust. IRC § 267(b)(6). Losses between Executor and beneficiary, however, are allowed. Likewise for deemed sales under IRC § 643(e)(3).
- (6) Charitable "Set Aside." Trusts, unlike estates, are not entitled to deductions for amounts "set aside" for charity. IRC § 642(c)(2).

E. Funding the Revocable Living Trust.

1. Questionable Assets to Transfer:

a. S Corporation Stock.

- (1) Estates are allowed to be S Corporation shareholders until completion of estate administration. IRC § 1361(b)(1)(B).
- (2) Revocable trusts may also hold S corporation stock, but only for two years after the grantor's death. IRC § 1361(c)(2)(A)(ii).
 - (a) This time limit will not apply if the trust is a qualified Subchapter S trust ("QSST"). (IRC § 1361(d)).

b. Passive Activities. As discussed above, assets which generate passive activity losses and are transferred to a revocable trust are not eligible for the IRC § 469(i) \$25,000 deduction for rental real property losses as well as the IRC § 469(g) ability to treat a passive loss as an ordinary loss.

- c. Small Business Stock. Small business stock may lose ordinary loss treatment if transferred to a revocable trust. IRC § 1244(d)(4).
 - d. Stock Options. Restricted or qualified stock options, or stock acquired by exercising options during the holding period, lose their tax benefits if transferred to a revocable trust. Treas. Reg. § 1.425-1(c).
2. Registration of Assets.
- a. Stocks and Registered Bonds.
 - (1) Stock certificates and bonds should be delivered to the grantor's stockbroker, who will obtain reissued stock certificates and bonds registered as follows:
 - (a) "The John Doe Revocable Trust, dated March 7, 1998, John Doe and Jane Doe, Trustees."
 - (b) Unregistered (Bearer) Bonds.
 - (i) With unregistered bonds, it is best to open a safe deposit box in the trust's name, put the bonds in an envelope marked in the trust's name, and place the envelope in the box.
 - b. Certificates of Deposit and Savings Accounts.
 - (1) Existing certificates and accounts should be transferred into the trust and new accounts should be opened, or certificates purchased, by the trust.
 - (2) To accomplish registration of these items, the trust should be brought to the financial institution where these accounts are held, or where the accounts are to be opened.

- c. Insurance Policies. If the trust is to receive proceeds from any insurance policy, then a change of beneficiary form should be obtained and the trust designated as beneficiary.

XIV. CONCLUSION

APPENDIX A

QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP)

The unlimited marital deduction is not available for property passing to the surviving spouse if the interest will terminate or fail because of a lapse of time or the occurrence of an event or the failure of an event to occur and then pass to some other person (I.R.C. • 2056(b)). If the surviving spouse's interest will terminate upon his/her death or remarriage, the interest is terminable and does not qualify for the marital deduction. It will not be included in the surviving spouse's estate. This terminable interest rule ensures that property escaping estate tax on the death of the decedent spouse will be subject to tax on the subsequent death of the surviving spouse.

For decedents dying after 1981, The Economic Recovery Tax Act of 1981 introduced the QTIP concept. Under this concept, if the bequest passes to a QTIP trust and the decedent's executor elects QTIP treatment, taking the marital deduction, such deduction will be allowed. To qualify, the surviving spouse must be entitled to receive all the income from the trust, payable at least annually, for life, and no one may have the power to appoint the property to any third person during the surviving spouse's lifetime. Because this type of bequest does not require the surviving spouse to have the ultimate power of disposition over the trust assets, many estate owners prefer it to the outright bequest. By using a QTIP trust, the decedent can leave the surviving spouse the income only during the survivor's life and the remainder to the children on the surviving spouse's death. This device enables the decedent to defer the estate tax until the surviving spouse's death, without giving the surviving spouse control over the ultimate disposition of the marital deduction bequest.

The value of the bequest to a QTIP trust qualifies for the marital deduction only if the decedent's executor elects to take it on a timely filed federal estate tax return. The election is irrevocable (I.R.C. § 2056(b)(7)(B)(v)). It may not always be beneficial to make the QTIP election, because the assets in the QTIP trust will be includable in the surviving spouse's estate (I.R.C. § 2044).

Consider a situation where Husband's will divides his \$4,000,000 estate into two trusts: \$2,000,000 in a QTIP trust; \$2,000,000 in a left over or residuary trust. The provisions of both trusts are identical: income to Wife for life, principal to Children upon Wife's death. Wife has no other powers over, or interests in, either trust. When Husband dies, his executor elects to have the QTIP trust qualify for the marital deduction. Husband's estate pays no tax (\$2,000,000 marital deduction and \$2,000,000 exemption equivalent to the credit). When Wife dies, while the value of the QTIP trust is taxed in Wife's estate because of the election made by Husband's executor. The wife may recover any increase in her estate tax from the rest of the QTIP Trust. However, this inclusion may also fall with the Wife's own unified credit.

APPENDIX B

BASIC FORMS OF GIFTS TO MINORS COMPARED

Item Compared	Outright Gift	Custodianship	Guardianship	Trusts		
				Regular	Sec 2503(b)	Sec 2503(c)
Use of income for minor	Generally, no	Yes	Yes	Trust controls	Mandatory Distribution	Discretionary
Use of principal for minor	Generally, no	Yes	Yes	Trust controls	Trust controls	Discretionary
Close judicial supervision	No	No	Yes	No	No	No
Accounting	No	Record kept; possible accounting	Yes	Generally, only private records kept		
Investments	Unlimited	Limited	Generally, unlimited	Generally, unlimited--within donor's control		
Minor gets title when:	Immediately			On termination or earlier distribution of income or principal		
Minor gets possession when:	Immediately	Age of majority		Trust controls		Generally, age of majority
Minor can dispose of gift property	Generally, at majority; younger for money	Age of majority		Trust controls		
Fiduciary's death	No fiduciary	Possible inclusion of fund in fiduciary's estate	No effect, except on successor appointment	No effect, generally, if trust is irrevocable and settlor retains no interest; otherwise includable in settlor's estate		
Minor's death	Heirs of minor take unless minor has will effective under local law			Trust controls		Estate of minor or appointees
Tax liability--distributed income	Minor*	Minor is generally taxable except as it is used to discharge parent's obligation of support (then taxable to parent)				
Tax liability--undistributed income	Minor*			Trust	Must distribute	Trust
Gift tax annual exclusion	Yes	Yes	Yes	If present income interest	Yes	Yes
Exclusion of gift from donor's estate	Yes	Yes, except if donor is custodian	Yes	Yes, except if settlor dies possessing forbidden powers or rights		Yes
Cost	None or minimal	None or minimal	Legal fees, bonding costs, possible guardian fees	Legal fees varying with complexity, size of trust and other factors, possible trustee fees		

* Unearned income of a minor under the age of 18 in excess of \$1,700 annually is taxed at the parent's top rate, assuming the parent's rate is higher than that of the child.

APPENDIX C

COMMON TRUST TYPES - BENEFITS & TAXATION

Trust Type	Characteristics	Nontax Benefits	Tax Treatment		
			Income	Estate	Gift
Irrevocable Living	Settlor gives up property forever.	Supervised control & investment; avoids probate.	Currently distributed. Taxed to Bs. Accumulated first to trust, then to B on dist.	Not in settlor's estate unless life ins. on life transferred within 3 years of death.	Taxable to settlor. Annual exclusion available for present gift of income interest, not remainder.
Revocable Living	Settlor can revoke. May be funded or unfunded.	Same as above.	Taxable to settlor.	Includable in settlor's estate.	No liability.
Testamentary	Created by will.	Supervised control & investment.	Same as for irrevocable living trust.	Includable in creator's estate. Can avoid tax on death of life B.	No liability.
Grantor Retained Interest Trust (GRIT), GRAT, GRUT	Grantor reserves a qualified term interest in the form of an annuity or unitrust under I.R.C. § 2702, after which principal passes to remaindermen.	Often negligible.	Taxable to settlor (grantor).	Not taxable in grantor's estate unless grantor dies w/in reserved income term, subject to special rules under I.R.C. § 2702.	Tax based on value of remainder at time of creation of trust.
Standby	Generally revocable, but may be irrevocable on settlor's permanent disability.	Supervised control and investment on settlor's disability or absence.	Taxable to settlor.	Includable in settlor's estate.	No liability.
Pourover	Living trust, revocable or irrevocable, funded or unfunded.	Receptacle for employee benefits, life ins. proceeds, estate assets.	Taxable to settlor.	Same as irrevocable or revocable trust depending on revocability.	No liability.

GRAT, Grantor retained annuity trust: a trust to which the grantor transfers income-producing property in exchange for the right to receive a fixed cash annuity for a specified term of years or for the grantor's life (the grantor's retained interest).

GRUT, Grantor retained unitrust: identical to the GRAT, except that, the grantor retains the right to receive a fixed percentage of trust value annually.

