SELECT PORTFOLIO MANAGEMENT, INC.
Integrated Wealth Management
A Registered Investment Advisor

White Paper

Customizing Trusts

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Table of Contents

Customizing Trusts 3
What is customizing trusts? 3
What is a Crummey provision? 3
What is a spendthrift provision? 5
What are discretionary provisions? 5
What are sprinkle/spray provisions? 6
Disclosures 7

Customizing Trusts

What is customizing trusts?

A trust is created when you (the grantor, settler, or donor) transfer property to another person or persons (a trustee or trustees, which could also be you) for the benefit of a third person or persons (the beneficiary, which could also be you). The trustee manages the property for the beneficiary and distributes income and principal according to terms of the trust agreement. There are many types of trusts, and they are used for many different purposes (e.g., to provide for management of property, to provide income to beneficiaries, to avoid probate, or to obtain favorable tax treatment). Trusts are extremely popular because they are flexible and can be customized to meet your particular goals and objectives. Trusts are customized by including particular provisions that are intended to accomplish the purpose(s) of creating the trust in the first place.

There are many types of trust provisions. The four common customization provisions being discussed here are (1) Crummey provisions, (2) spendthrift provisions, (3) discretionary provisions, and (4) sprinkle/spray provisions.

> **Caution:** These provisions must be carefully drafted. The wrong wording can nullify the provision and derail your intentions, so be sure to have an experienced attorney draft your trust agreement.

What is a Crummey provision?

First of all, to understand what the Crummey provision is, you must understand what the annual gift tax exclusion and the present interest rule are. The annual gift tax exclusion allows you to give a certain amount free of gift tax to each donee (persons you give to), each year. The annual exclusion amount is currently $13,000 (in 2009, up from $12,000 in 2008). The present interest rule says that in order to qualify for the annual gift tax exclusion, the gift must be a present interest. This means that the donee must be able to immediately possess, use, or enjoy the gift. In the case of gifts made to a trust, it means that the beneficiaries must be able to immediately withdraw the funds from the trust.

Second, a Crummey provision is not a provision that stinks, or is lacking in some way. Crummey is the name of a party to a lawsuit that brought this provision into being. A Crummey provision qualifies gifts made to a trust for the annual gift tax exclusion. This Crummey power (as it is called) gives the beneficiary of the trust the right, for a limited amount of time each year (usually 30 days), to withdraw his or her share of the money from the trust. This temporary ability to withdraw magically turns the gift into a present interest gift. If the beneficiary does not exercise the right to withdraw the money, it stays in the trust. But that's OK. As long as the beneficiary has the right, the gift qualifies for the exclusion. The right need not actually be exercised. Each beneficiary may hold Crummey powers, resulting in multiple annual gift tax exclusions. As you can now see, a Crummey provision is a pretty important little estate

planning device because it allows you to transfer large amounts of wealth, tax-free in any year, or in every year, to a trust. However, the provision must be carefully drafted, and there are certain rules and procedures that must be followed to the letter. The IRS actually hates the Crummey loophole and is ever vigilant when it is used. By all means, take advantage of Crummey provisions, but be sure to satisfy all of the following requirements.

Beneficiary must have unrestricted right to withdraw

Carefully draft the trust document to clearly state that Crummey withdrawal rights are given. This withdrawal right must be unrestricted except as to the time (e.g., the beneficiary has 30 days to withdraw it after the property is transferred to the trust) and as to an amount no greater than the annual transfer to the trust. Of course, you may make it clear to your beneficiary that you are only including Crummey powers in the trust to obtain the annual gift tax exclusion, and that you do not want him or her to actually exercise this withdrawal right. But make this a verbal agreement. Do not put it in the trust document or in any other written form. Any legal restriction, beyond those noted, on the beneficiary's right to withdraw results in the loss of the exclusion.

Beneficiary must be given a reasonable period of time in which to exercise that right

It is necessary for the beneficiary to have a reasonable opportunity to exercise the power of withdrawal prior to its lapse. A power that is exercisable for an unreasonably short period of time will be disregarded by the IRS as illusory. You may permit the beneficiary to exercise the power either: (1) for a specified number of days following notice of transfer of funds into the trust or (2) at any time during the year in which the transfer is made, allowing a certain minimum period for withdrawals made near the end of the year.

- Specified number of days following notice--This is the safer of the two allowance methods. Unfortunately, the specified number of days needed is not set in concrete. Here is some guidance, though. Annual gift tax exclusions have been upheld by the tax court where the period of withdrawal allowed was only 15 days. The IRS has privately ruled that 30 days is sufficient.
- At any time during the taxable year--Care must be taken with this allowance method. For example, where the beneficiary is allowed to withdraw in December, gifts you make in September will probably qualify. However, if your beneficiary is allowed to withdraw in March, and you make a gift in September, it is unlikely that the IRS will see this as passing the present interest rule, and the exclusion will probably be denied. Again, there is no hard-and-fast rule here.

Beneficiary must have reasonable notification of the existence of the right

The basic requirement is that actual written notice must be made in a timely manner. It is best to give written notice to each beneficiary at least 30 to 60 days before the expiration of the withdrawal period.

Example(s): A typical Crummey provision might read "The beneficiary shall have the right to withdraw from the trust an amount of the property originally transferred to the trust, not to exceed the annual gift tax exclusion amount, by giving written notice within 30 days of his or her receipt of a copy of this document, to the trustee, of the exercise of such right. The trustee shall promptly give written notice to each beneficiary of the receipt of any property that is transferred into the trust. The beneficiary may withdraw additions to the trust by giving written request to the trustee."

Caution: A Crummey withdrawal power is treated as a general power of appointment. Its exercise, release, or lapse is treated as a gift by the beneficiary holding the power, and may be subject to gift tax.

Tip: Crummey withdrawal rights can be given to minor children and incompetent individuals (who are legally incapable of making a withdrawal) as long as there is nothing in the trust instrument preventing a guardian from exercising the right on the beneficiary's behalf.

What is a spendthrift provision?

A spendthrift clause is a provision that protects a trust beneficiary from creditors or other parties (e.g., a divorcing spouse). Generally, in the absence of a spendthrift provision, a beneficiary is able to transfer his or her interest in the trust. That being so, creditors of the beneficiary can attach that interest. A spendthrift clause specifically prevents the beneficiary from transferring his or her interest and eliminates the ability of a creditor to obtain the interest.

A spendthrift provision may be desirable if you want to restrict your beneficiary's ability to sell or give away his or her interest in the trust. This may be the case if you believe your beneficiary is immature or may make unwise financial decisions (e.g., you are afraid Johnny might give away his interest in the trust to that religious cult he's been following lately). A spendthrift provision can be drafted to be all-purpose or it can include specific exclusion language.

Example(s): A typical all-purpose provision might read "No interest under this trust shall be assignable by any beneficiary. Cash or other property distributable hereunder shall not be subject to claims of any creditors, or any beneficiary, nor to the claims for alimony or maintenance."

Caution: Spendthrift clauses are not valid in a few states.

What are discretionary provisions?

A discretionary provision gives the trustee authority to decide when, how much, and to whom to distribute income and/or principal to the beneficiaries. This discretionary authority allows the trustee the flexibility to accumulate or distribute income according to the overall circumstances of the beneficiaries. In contrast, a trust that provides for a rigid scheme of mandatory distributions is inflexible

and may not meet the needs of the beneficiaries. Additionally, some income tax savings may be possible if the trustee is given discretion to distribute income among several beneficiaries (for example, more to a beneficiary in a lower tax bracket and less to a beneficiary in a higher tax bracket).

Although giving the trustee discretion over distributions may sound good to you, it probably won't go over so well with the beneficiaries. Looking at it from the beneficiaries' point of view, the trustee's ability to say "no, you don't get any" is something less than satisfactory. This situation may cause conflict between the trustee and the beneficiaries. It may be a good idea to leave directions to the trustee in a letter of instruction that encourages the trustee to communicate often with the beneficiaries regarding the status of the trust, the needs of the beneficiaries, and the plans for distribution. The provision that authorizes discretionary distributions can be drafted in a variety of ways. It can be expressed so as to limit the discretion the trustee is given, or, conversely, it can be expressed to provide "absolute," "unlimited," or "uncontrolled" discretion to the trustee. Be advised that giving the trustee broad and unfettered discretion may not be in the best interest of the beneficiaries. Such a provision severely limits the court's supervisory role because the only inquiry it can make is whether the trustee acted arbitrarily, capriciously or dishonestly. Thus, the trustee is not allowed to act "beyond the bounds of reasonable judgment," but will be protected by a court if he has not abused his discretion.

> **Example(s):** A typical limiting discretionary provision might read: "The trustee shall distribute so much of the income and principal of the trust to or for the benefit of my surviving spouse as the trustee believes is desirable to provide for his or her support, maintenance, education, and general welfare. The trustee is authorized to make distributions to one or more of my issue in unequal amounts and to exclude one or more of them from such distributions. In making decisions regarding distributions, I direct the trustee to give primary consideration to the needs of my surviving spouse and secondary consideration to the needs of my issue, and to give appropriate consideration to the resources and income of each beneficiary apart from the beneficiary's interest in this trust."

A typical absolute discretionary provision might read: "The trustee is given the power, in his absolute and uncontrolled discretion, to pay out net income to the income beneficiaries of the trust or to accumulate such income."

> **Caution:** A trust will not qualify for the unlimited marital deduction if the trustee is given discretion to distribute income to your surviving spouse or is given authority to distribute income or principal to someone other than your surviving spouse during his or her lifetime.

What are sprinkle/spray provisions?

A sprinkle/spray provision allows the trustee to make distributions of income, and/or principal in shares that are not equal. The advantage of a sprinkle/spray provision is that the trustee may use the funds as the needs of the various beneficiaries are determined. A sprinkle/spray provision can provide flexibility to a single trust fund, with more than one beneficiary. This is particularly helpful if the trust fund is not large enough to meet all the needs of all the beneficiaries. The trustee can evaluate the current

circumstances and "sprinkle" or "spray" distributions of income to the beneficiaries, according to the relative needs of each beneficiary, and the overall best interest of the beneficiaries as a group.

Sprinkle/spray provisions may relate to either trust income, trust principal, or both. Therefore, there are several variations of provisions from which you may choose. Here are some examples of common sprinkle/spray designs:

- Trustee may distribute both income and principal on a sprinkle basis.
- Trustee is directed to pay income in equal shares, but distribute principal on a sprinkle basis.
- Trustee may distribute income on a sprinkle basis, but is directed to distribute principal in equal shares.
- During the term of the trust, the trustee may distribute both income and principal on a sprinkle basis. Upon termination of the trust, trustee is directed to distribute the remainder in equal shares.
- Trustee may distribute both income and principal on a sprinkle basis. As each beneficiary reaches age 25, that beneficiary receives 25 percent of whatever principal remains until the youngest, whose share represents the final distribution of principal, reaches age 25.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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