EXHIBIT E

DESIGN DECISIONS

TRUSTS FOR ANNUAL EXCLUSION GIFTS

2014 Skills Training for Estate Planners
Sponsored by the Real Property, Trust and Estate Law Section of the American Bar Association

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MATTERS TO CONSIDER IN DRAFTING TRUSTS FOR ANNUAL EXCLUSION GIFTS

When you notice repetition, please treat that as reinforcement!

A few comments are included about reporting gifts and administering trusts

I. Qualify for gift tax annual exclusion?
   a. Not if a large gift is intended
   b. Not generally if donor does not want any possibility of withdrawal
      i. Consider 2503(b) – mandatory annual income, no principal distributions – if withdrawal rights are unpalatable but annual exclusion is desired
      ii. Note that mandatory income may not be desirable and may give access to beneficiary’s creditors
   c. 2503(c) – one-time demand right over all trust property at age 21
      i. Trust to continue after age 21 if beneficiary fails to exercise withdrawal right – continue until stated age or for life
      ii. Single lifetime beneficiary (therefore gradual funding)
         1. Trust property, if any, remaining at beneficiary’s death must be included in estate of beneficiary
         2. Not effective for multi-generation planning unless beneficiary’s estate, including remaining trust property, will be under estate tax threshold
      iii. Distributive standard must be fairly broad – cannot limit to education, for example. Can limit to ascertainable standard
      iv. Only need notice of withdrawal right one time
   d. Crummey annual demand rights – more flexible than trusts that depend on statutory exclusion
      i. Can extend trust for any term, including lives of multiple generations.
      ii. Can have one or multiple beneficiaries, in one or more than one generation
      iii. Pot trust or separate shares
      iv. Distributive standard can be narrow if desired
v. Annual notice burden in any year of additional contribution

II. Design decisions for trusts with annual withdrawal rights (Crummey)

a. Beneficiaries

i. One current beneficiary?

ii. Multiple separate shares – see below at II.d.iv for considerations about distributive standards

iii. Pot trust for multiple beneficiaries, same generation or multiple generations

   1. Sprinkle income?
   2. Spray principal?
   3. Same distributions for all currently entitled, or may Trustee exclude one or more beneficiaries from a distribution? Note that institutional trustees may not wish to have discretion to exclude
   4. True-up shares of beneficiaries at division or termination of trust?

iv. Pot trust until later division (certain age or event) (same considerations for distribution among multiple beneficiaries or separate continuing shares)

b. Duration and termination of trust

i. For life of beneficiary; until occurrence of an event; or until a given age or ages?

   1. How old is old enough?
   2. 25 – 30 – 35?
   3. Note creditor protection concerns

ii. Any mandatory distributions of principal at certain ages or stages? If yes, consider “delay of distribution”

iii. If trust is to last longer than one generation, consider whether to allocate GST exemption of donors

iv. Include statement of intention regarding GSTT exempt status

v. If trust not intended to last beyond one generation, consider whether single withdrawal right at age 21 will fit donor’s wishes and family
1. For trusts established by grandparents, consider situation of parents and rule out distributions that could satisfy a legal obligation of trustee or of beneficiary parent (potential for estate tax inclusion for parent/trustee and potential for income tax inclusion)

2. Note that creditors of a beneficiary with withdrawal right may have access to trust property when that right matures

   vi. Consider giving non-interested\(^1\) Trustee or Protector power to terminate

c. How many donors?

   i. If single donor, grantor trust? \(^2\)

      1. Who should hold grantor powers: donor? Third party? Protector?

      2. Note which powers must be held in nonfiduciary capacity (e.g. 675(4)(c) power to reacquire trust assets and substitute others of equivalent value

      3. Beware grantor trust powers that could lead to estate inclusion in grantor’s estate

      4. Beware giving powers to non-US persons that might make trust a foreign trust

   ii. If there are donors who are assigned to different generations, GSTT rules will treat each gift as its own separate trust for GSTT purposes; this does not require separate shares

   iii. Include ability of donor to make gifts subject to a condition and ability of trustee to accept gifts subject to a condition to manage type of property contributed, withdrawal rights, GSTT status, etc.

d. Withdrawal rights

   i. Who should have?

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\(^1\) “Interested” would include Donor, Beneficiary, in some cases parent of Beneficiary. Section 672( c) treats as “related or subordinate” certain relatives, employees, and controlled companies. An interested person in this context could have a negative consequence for income tax or estate tax inclusion by reason of power or discretion afforded under the trust instrument. In some cases, an interested person may be nominated in the first place, subject to appropriate limitations on exercise of discretion, but may not be nominated later by donor or beneficiary. See Vak, 973 F. 2d 1409 (8th Cir. 1992), Wall, 101 T.C. 300(1993), Rev. Rul. 95-58.

\(^2\) Grantor trust powers are at sections 671 – 678 of the Internal Revenue Code. Some are more appropriate than others for tax reasons, and some will fit better than others given donor preference and/or beneficiary’s family situation. Choice of which powers to use is important and needs analysis for any trust.
1. Count beneficiaries until multiple of annual exclusion gives desired amount (e.g. to cover life insurance premiums)
   a. Beware naked power holders
   b. Place holders?

2. Remainder beneficiary need not have vested interest: current or contingent beneficiaries OK (*Kohlsaat, Cristofani*)

ii. Avoid appearance of prearranged understanding

1. Make sure there will be property to distribute to satisfy a withdrawal right until the right lapses
   a. For insurance trusts, age contributions prior to premium payment
   b. Note ability to assign portion of policy if need be

2. Donor, trustee, others should not tell beneficiary not to exercise

iii. Beneficiary must have a reasonable time after receipt of notice to exercise withdrawal right. 15 days has been found acceptable, 30 days is common. If notice comes near the end of a calendar year, the exercise period may extend into the next year.

iv. Written notice?

1. *Crummey* decision did not involve written notice, but trust should call for written notice

2. Send notice close to time of gift where practicable. For insurance trusts with monthly payments, notice once a year in arrears has worked.

3. Where there is actual notice (as opposed to current written notice), consider a letter confirming that beneficiary had actual notice at or near time of gift

4. Beneficiary should confirm receipt of notice but should not indicate whether or not he or she will exercise

5. Beneficiary should not waive future notice

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3 TAM 9532001
6. Trustee should maintain records of sending notice and also retain beneficiary confirmations of notice
   a. Keep records of any questions from beneficiary
   b. Follow up when beneficiary does not confirm receipt
v. Trustee should be able to satisfy withdrawal right from any property of the trust, not only the most recent contribution
vi. Trust instrument should include a statement to the effect that satisfaction of withdrawal rights is paramount and all investment, distribution, etc. decisions should be made in light of that
vii. To whom give notice for minor or incapacitated beneficiary
   1. Natural guardian?
      a. Note concern for some clients that natural guardian for a grandchild could be a son in law or daughter in law who is an ex and/or who is out of favor
      b. If natural guardian is donor, rule out
   2. Legal guardian –
      a. Usually only if no natural guardian is living.
      b. Note concerns indicated above for natural guardians
   3. Adult individual nominated by Trustee – may include the Trustee
viii. Lapse of withdrawal rights – consider “hanging powers” (even though IRS does not like them) so that withdrawal rights only lapse to the extent of the greater of $5,000 or 5% of trust property

III. Distributive standard during trust term – for property not withdrawn pursuant to withdrawal right
   1. Mandatory income? Unitrust? Greater of all net income or unitrust amount?
      a. Creditors of beneficiary may be able to take any mandatory distribution
      b. Beneficiary circumstances can change
c. Clients may assume “income” will be significant. Test that assumption.

2. Mandatory principal at any age or ages?
   a. Creditors of beneficiary can take any mandatory distribution
   b. Divorce complications
   c. Predictably, circumstances can change unpredictably

3. Mandatory principal for any purpose? Most common examples are below
   a. Tuition
   b. Start a business
   c. Pay for wedding
   d. Downpayment on a residence, or first residence

4. “Delay of distribution” (control behaviour)
   a. Discretionary – if trustee is not a parent or other interested person
   b. Mandatory delay if certain events occur (incarceration, bankruptcy, felony conviction, documented substance abuse, etc.)

5. Discretionary distribution of income and/or principal
   a. Ascertainable standard: most common, but not only, words are: “necessary for health, education, maintenance or support” –
      i. Safe harbor from general power of appointment (section 2041) for beneficiary who is a trustee
      ii. Beneficiary may have right to enforce in some states
      iii. May be overly restrictive given goals of some clients
      iv. In some states, a beneficiary who is also trustee will be limited to this standard regardless of the language in the trust instrument
6. “Consider other assets” – may enable Trustee to say “no,” preserve trust assets for future, slow down distributions.

   a. In some states, this is part of the law even if the trust instrument does not so provide

   b. Limit Trustee’s burden to gather information (e.g. “may rely upon information provided by or on behalf of the beneficiary”)

b. Upon death of a beneficiary?

   i. Estate tax reimbursement if include any portion of the trust assets in estate of beneficiary?

   ii. Default distribution to issue of beneficiary? Or to siblings of beneficiary?

      1. Outright, or in continuing trust

      2. Note potential skip for GSTT purposes if assets pass to a lower generation (versus siblings, e.g.)

      3. Include savings language to avoid inadvertent GST Tax?

         a. e.g., force estate tax via contingent general power of appointment or ability of third party to confer power of appointment

         b. may be preferable to incur GST Tax if state estate tax would apply

   iii. Beneficiary limited power to appoint, either hard-wired or via Protector or other third party?

   iv. Beneficiary general power of appointment (if yes, note estate tax inclusion)

IV. Trustee provisions

   i. Identity of trustee and named successors

      1. Discourage donors from serving if they volunteer (some may insist)

      2. Discourage donors from naming parent of beneficiary
3. No matter who is named in the instrument, include savings language to avoid unintended inclusion for an “interested” individual trustee.

ii. Consider administrative trustee if individual is to be trustee

iii. Provisions for multiple trustees

1. Unanimous decision for two – tie breaker?
2. Majority rule for more than two
3. Individuals can remove/replace/outvote institution?

iv. Ability to appoint co-trustees and/or successor trustees

1. Donor
2. Beneficiary
3. Majority of current beneficiaries, if there are multiple

v. Donor ability to remove and replace trustee

1. Remove “with or without cause”
2. Remove “for any reason or for no reason”
3. Limit replacement to those not viewed as “controlled” by donor or by beneficiary pursuant to section 672(c) (see FN 1)

vi. Beware donors who wish to be the trustee

1. If desired, donor can be investment director (but no power to vote stock, see IRC section 2036(b). If donor is investment director, make the Trustee a “directed trustee” as to investments (where that is available) for the Trustee’s protection

2. Can have the title, but most of the discretion must be stripped away to avoid income tax issues (for minor children or other beneficiaries to whom a legal duty is owed) and/or estate inclusion. Note that the title itself could attract undesired IRS attention to the trust when included with gift tax return and/or with donor’s estate tax return (as it would have to be if still in existence at donor’s death)

b. Protector? Can hold powers that Donor, Trustee and/or Beneficiary should not have

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4 See footnote 1
i. To accelerate or postpone distribution

ii. To add or subtract beneficiaries

iii. To exercise certain grantor trust powers

iv. To affect trustee succession (remove/replace/fill vacancy)

v. To move trust to another jurisdiction

V. **Precatory language, statements of intention, savings clauses**

a. **Precatory** – states a wish but not a direction
   
i. “I request but do not require”
   
ii. Statement of intention
   
iii. Avoid creating unwanted burden on trustee, e.g. policing beneficiary behavior
   
iv. Express preference for exercise of distributive discretion without violating rules for a given type of trust, e.g. 2503(c)

b. **Intention** – guide to trustee, help to accountant
   
i. Grantor trust status for income tax
   
ii. Generation-skipping transfer tax exemption – allocate or not
   
iii. Guidance for exercise of discretion to distribute
   
iv. Challenge to send helpful signals without creating ambiguity

c. **Savings** – overcome unintended implications of form language (specific provisions generally govern over general language)
   
i. Avoid creating incidents of ownership if trust can own insurance on life of trustee
   
ii. Avoid risk of inclusion of trust property in estate of trustee
   
iii. Avoid risk of income taxation to trustee who has legal obligation to provide something for which trust income could be used (e.g. support of minor child and, in some states, education)

VI. **Some state law issues in drafting gift trusts**

a. **Community property**
b. Homestead rights

c. Uniform Trust Code: “qualified beneficiary” status, access to notices, etc.

d. State fiduciary income taxation

e. Consider facilitating “decanting”

   i. Trustee ability to distribute up to 100% in continuing trust, including a trust established by the trustee

   ii. In states where available, include express decanting power

f. Assume the trust may one day be governed by the laws of a different state than the one where it began, or that governing law may change.