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TO: OUR CLIENTS AND FRIENDS

FROM: JACKSON M. PAYNE

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RE: FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

DISTINGUISHING BETWEEN LEGITIMATE AND SHAM TRUSTS

In this newsletter, we alert you to the availability of legitimate trusts for tax and estate planning and to steer you away from the use of trusts identified by the IRS as sham trusts, i.e., trusts that don't produce claimed tax benefits and can trigger interest and penalties.

Legitimate trusts that may properly be used to accomplish specific tax and estate planning objectives include:

(a) Marital deduction trusts that can be used to transfer amounts to your spouse without paying gift or estate tax while ensuring that the trust assets will be available for children on the spouse's death;

(b) Grantor retained annuity trusts (GRATs), grantor retained unitrusts (GRUTs) and qualified personal residence trusts (QPRTs), any of which can be set up during life to lower gift and estate tax costs of transferring property to your children;

(c) Charitable remainder annuity trusts (CRATs), charitable remainder unitrusts (CRUTs) and pooled income funds that will yield income, gift and estate tax charitable deductions and that can benefit you and your family members;

(d) Special types of trusts that you can use to you can use to make gifts to your children of amounts that would qualify for the gift tax annual exclusion and yet minimize the risk that your children will squander the funds;

(e) Life insurance trusts that can be used to keep life insurance proceeds that are subject to federal estate tax from being taxed in the insured's estate;

(f) Trusts to make gifts of S corporation stock to your minor children to save income and estate taxes while maintaining trustee control and management of the S stock;

(g) Revocable trusts that provide a benefit in having property pass to beneficiaries on the death of the owner without having to go through the probate process; and

(h) <u>Most importantly, the spousal lifetime access trust that is used for the spouse’s lifetime benefit while taking advantage of the high estate and gift tax exemption (currently $12,920,000) before that exemption is rolled back on January 1, 2026.</u>

On the other hand, in considering your trust options, you should know that the IRS has identified a number of sham trusts including (1) so-called business trusts, (2) equipment or service trusts, (3) family residence trusts, (4) certain purported charitable trusts, and (5) certain trusts located in foreign countries.

The so-called business trust arrangement makes it appear that an individual has given up control of his or her business in an attempt to secure a reduction in income and self-employment taxes and an elimination of estate tax on the business owner's death. This arrangement does not provide the claimed tax relief.

The equipment trust is formed to hold equipment that is rented or leased to the business trust, often at inflated rates, and the service trust is formed to provide services to the business trust, often for inflated fees. These trusts seek to reduce income taxes in different ways but the IRS warns that they do not work.

With a family residence trust, an individual transfers the family residence, including furnishings, to a trust, which rents it back to the individual. The trust deducts depreciation and the expense of maintaining and operating the residence including, pool service and utilities. These expenses are not deductible and the IRS will not allow them.

The purported charitable trust involves a transfer of assets or income to a trust claiming to be a charitable organization. The trust or organization pays for personal, educational, and recreational expenses on behalf of the transferor or one of his or her family members. The trust then claims the payments as charitable deductions on its tax return. The IRS says that many of these organizations are not exempt from tax and contributions to these trusts are not deductible.

Some individuals say that tax can be avoided by using trusts located in foreign countries that impose little or no tax on trusts and provide financial secrecy. Abusive arrangements enable taxable funds to flow through several trusts or entities until the funds are ultimately distributed or made available to the original owner. The trust promoter claims that this distribution is tax-free. But the IRS says that the income from these arrangements is fully taxable.

Needless to say, you should avoid doing business with promoters of these sham trust schemes. On the other hand, the legitimate trusts can accomplish a particular tax or estate planning objective for you and your family.