

IX Use of Trusts in Estate Planning

The Composition of The Trust

A trust is nothing more than an arrangement whereby one person agrees to hold and manage property for another. Trusts are extremely important and popular planning tools during an individual's lifetime as well for the management of a person's assets after death. A major advantage of trusts is that all transactions are private unlike the probate administration of a will which is made public. The property held in the trust avoids probate and the trust provisions are extremely difficult to contest. The person creating the trust can include any provisions and conditions which will meet their objectives. It is the only document that can manage a person's assets during their lifetime as well as after their death.

Operation of The Trust

Following are the four components that must be inclusive in all trust documents.

- The *grantor* is the individual who creates the trust to meet a specific planning need. The grantor is responsible to determine what the provisions of the trust document will be and for whose benefit the trust is established. The grantor will also choose the person or entity to manage the trust and decide on what property is to be placed in the trust
- The *beneficiaries* of the trust are for whom the trust document was created. They will receive all benefits of the trust according to the provisions that the grantor specified. They do not have the right to change any of the provisions made except in the case of a judicial order. Trusts are especially important if minor children are to be the beneficiaries of large sums of money

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- The *trustee* is the person appointed by the grantor to hold and manage the assets placed into the trust and to adhere to the trust provisions. The trustee manages the trust for the benefit of the beneficiaries and must act in a *fiduciary capacity*. A *fiduciary* acts in a trusting and competent manner and is held to a high degree of accountability and responsibility. The beneficiaries' interest is always held first and foremost. If it is determined that the trustee has breached their fiduciary duty, then the beneficiaries have the right to legal recourse. The trustee could then be responsible to compensate them for any losses incurred. A successor trustee should always be named in the event that the first trustee is unable to serve. Often a bank's trust department is named as trustee, since *corporate trustees* have unlimited life, are impartial and have more experience managing and investing assets. They can also be held to the highest degree of accountability.
- The *corpus or principle* is comprised of the *assets that the grantor* has conveyed to the trust. The corpus plus all growth and interest is referred to as the trust fund. The corpus is then managed by the trustee for the benefit of the beneficiaries. In many cases the trustee must invest the trust assets to provide for growth of the initial investment or an income stream depending on the provisions of the trust

How to Create a Trust

The trust document must first be written by the grantor or the grantor's representative. It is always advisable to have a competent attorney write the document to make sure that the provisions meet the grantor's objectives and adhere to state law. Once written the trust document must be signed, notarized and recorded. It is important to note that if the goal of the trust is to avoid probate, the grantor must legally convey all probate property to the trust. In many circumstances, the trust is written

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with probate property remaining outside of the trust which will then be subject to probate administration upon the grantor's death.

Classification and Types of Trusts

A *revocable trust* is one in which the grantor reserves the right to revoke after it becomes effective. In addition, the grantor is given the right to change any of the terms or conditions as well as the beneficiaries of the trust at any time. The trust is effective during the lifetime of the grantor and upon the grantor's death becomes irrevocable and no changes to the document can be made at that time. All trust assets will avoid the probate process.

Revocable Living Trusts

This trust is created during the grantor's lifetime and is also referred to as an *inter-vivos or living trust*. Revocable living trusts are a popular planning tool and one of the most widely used trusts today. A major reason why they are so popular is that when the grantor passes away, the trust assets are free from probate administration and all transactions remain private. In addition, the trust document provides for a successor trustee in the event of the initial trustee's incapacitation or disability. The grantor initially establishes the trust and places all money and property into the trust. In most revocable trusts, the grantor is also the trustee as well as the beneficiary. The trustee manages the trust by simply adhering to the provisions and establishing one or more trust bank accounts to handle the financial transactions. Following are some disadvantages of the revocable living trust.

- Creditors may not be cut off as quickly as in probated estates.
- More effort is required to transfer assets into the trust and newly acquired and existing assets may not have been conveyed to the trust making them subject to probate administration.

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- The attorney will charge a higher fee to establish a living trust as opposed to a will or testamentary trust. There may also be ongoing administrative charges.
- Upon death of the grantor, the value of the trust assets is includable in their gross estate.
- All income from the trust is taxed at the grantor's tax bracket.

Irrevocable Trusts

An *irrevocable trust* does not give the grantor the right to revoke the trust document or change any of the terms or provisions once created. It is very inflexible and should only be used when no future changes are anticipated. The trusts are mainly used for estate planning purposes and for protection of the grantor's assets. Following are situations where the use of irrevocable trusts are indicated.

- The trust can be used to hold assets which were a result of a property settlement or divorce decree.
- High net worth individuals use the trust to protect their property from creditors.
- Assets that are placed in the trust and held for more than five years are not considered when applying for Medicaid. If eligible, Medicaid will pay for one's stay in a nursing home.

Types of Irrevocable Trusts

- *Irrevocable life insurance trusts* (commonly referred to as ILITs) are used to exclude estate taxes on life insurance proceeds. The trust is designed to be the owner and beneficiary of life insurance policies on the life of the grantor. Since the grantor retained no incidences of ownership in the policies, the proceeds received are not includable in the grantor's estate or

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subject to probate. Depending on the amount of the death benefit, this can literally save the heirs thousands of dollars in estate taxes. If an existing policy owned by the grantor is transferred to the trust, there is a *three year waiting period* for the proceeds not to be includable in the grantor's estate. If a policy is to be purchased on the life of the grantor to pay the federal estate tax, the trust should be written prior to the application and be the applicant, owner as well as the beneficiary of the life insurance. In most situations, the husband and wife are co-grantors.

- A *testamentary trust* is usually written to prevent large sums of money from being distributed to young adults or minor children if both parents are deceased. The trust is made part of the grantor's will and therefore the property passing to the trust will be subject to probate administration. The provisions of the trust will determine how the assets are to be distributed to the beneficiaries. It is not uncommon for the trust to be the beneficiary of the grantors' life insurance policies. A testamentary trust is less expensive for an attorney to write than a revocable living trust but the trustee is subject to probate court supervision for the duration of the trust. The husband and wife are usually are co-grantors
- A *credit shelter trust* is designed to minimize federal estate taxes by providing that both spouses are taking advantage of their *unified credit* or *exemption* amount which is currently at **\$5,000,000**. Married couples qualify for the *unlimited marital deduction*, which allows the deceased spouse the right to leave all property to the surviving spouse free from federal estate taxes. There will be no taxes payable on the first spouse's death, but when the surviving spouse passes away, the estate will now be taxed on the value of both spouses' property. In this scenario, the first spouse did not take advantage of their

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unified credit and lost the right to transfer \$5,000,000 of assets tax free. By not taking advantage of the unified credit, the estate of the second spouse will now have to pay additional taxes on any transferred amount over \$5,000,000. To avoid this from occurring, the spouses will set up a credit shelter trust in their wills. The trust stipulates that upon the first spouse's death, property in the amount of the unified credit will be transferred to the trust. The surviving spouse will have some control over the transferred property and at the surviving spouse's death, the property will transfer to the named beneficiaries without tax liability on the amount of the unified credit.

- *Portability* - For the tax years of 2011 and 2012, if any part of the unified credit is not used by the first spouse's estate, then the unused portion can be carried over to the surviving spouse. For example, if a married couple had property totaling \$8,000,000 and one spouse passed away, all the property would now be in the surviving spouse's estate. With the portability provisions, the spouse's new unified credit will now be \$10,000,000 and upon the surviving spouse's death, there would be no tax liability on the transfer. Due to the additional \$3,000,000 of unified credit, the estate would save \$1,050,000 in federal estate taxes. It is important to note that this provision sunsets in 2012.
- A *special needs trust* is established for a physically or mentally handicapped person that is receiving government benefits such as SSI. The government places a strict restriction on how much money the person can have and if the threshold is exceeded, the benefits will cease. To avoid this from happening, assets are placed in the trust which can be used for the person's support and welfare with no effect on their eligibility to receive benefits.

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- A *charitable remainder trust* allows one or more non-charitable beneficiaries to receive designated annual payments during their lifetime or a fixed term of years. At the death of the grantor, the charitable organization will receive the remainder of the property. The value of the remainder interest is deducted from the estate of the grantor as a charitable contribution.