An Introduction to Trusts

Establishing the appropriate trust is an integral part of any estate plan. Having the appropriate trust in place can provide the advantages of avoiding probate and unexpected tax consequences while possibly helping to reduce the size of your overall estate. In addition, establishing a trust allows for your intended wishes to be followed in caring for your heirs.

What is a Trust?

A trust is an entity created by a grantor/trustor (the person who funds the trust) for the benefit of a beneficiary, who is to receive assets and/or income from the trust. The trust is managed by a trustee acting as a fiduciary with the best interest of the beneficiary. A trust can have multiple individuals act as grantor, trustee, and beneficiary, or it can have one person act as all three. How an individual, or group of individuals, are assigned to the trust will dictate what benefits a trust can provide.

We have included a brief description of the more commonly used trusts that we encounter in our practice. Please note this is not an all-inclusive list and there are numerous trust types available for a multitude of different estate planning needs.

The Revocable Living Trust

Revocable Living Trusts are usually created by the grantor during their lifetime. Often the grantor is also the trustee and beneficiary of the trust. Revocable living trusts are often used by individuals and families as a way to avoid probate in the event of the grantor's death and to provide instruction for the disbursement of the grantor's assets. Holding the assets in the name of the trust allows the surviving beneficiaries streamlined access to the assets.

Revocable living trusts also have a few nuances that should be taken into consideration. For starters, revocable living trusts are not protected from creditor claims. The grantor of the trust is considered the owner of the trust assets and has the ability to amend or revoke the trust at any time. The grantor's personal ownership of the assets allows any claims made on the grantor to also be made on the trust. Another characteristic of a revocable living trust is the treatment of taxes. In most cases, income earned by the trust is taxable to the grantor on their personal taxes.

Simply put, a revocable living trust is similar to an individual account registration with respects to control and may add the benefit of bypassing the probate process.

Irrevocable Trust

Revocable living trusts usually become **irrevocable** upon the death of the grantor. An irrevocable trust may also be created by the grantor during their lifetime which may provide additional benefits not provided by a revocable living trust. By establishing an irrevocable trust the grantor relinquishes control and access to the assets in the trust, but potentially gains the advantage of protecting the assets from creditor claims. Additionally, establishing an irrevocable living trust may reduce the overall size of an estate and minimize tax liability. The downside of an irrevocable trust is relinquishing control of the assets held within the trust as it can no longer be altered or amended.

Marital Trust

Marital trusts (also referred to as "survivors" or "A" trusts) are used to take advantage of the unlimited marital deduction, which allows unlimited assets to transfer from a deceased spouse (the decedent) to the surviving spouse free of estate tax. With a marital trust the surviving spouse must be designated as the beneficiary with rights to take income from the marital trust during their lifetime. The surviving spouse's access to the principal is designated in the trust according to the decedent's wishes. In some cases the surviving spouse may receive a general power of appointment where the marital trust is revocable. In this case the surviving spouse has control over the distribution of both income and principal. Other times, the marital trust may be more restrictive with access to the principal in order to preserve an inheritance for the decedent's heirs. In this case the marital trust can be made irrevocable by structuring the trust as a Qualified Terminable Interest Property (QTIP) Trust.

Qualified Terminable Interest Property Trusts (QTIP Trust)

QTIP trusts are typically established by a grantor who would ultimately like to leave their assets to specific members of their family upon their passing. A QTIP passes assets to the surviving spouse without incurring a tax liability as it takes advantage of the spousal election and qualifies for the marital deduction. Typically, a QTIP is established and funded with the excess amount above the estate tax exemption ($5.43MM for 2015). A QTIP is a type of irrevocable marital trust, where the assets are segregated from the surviving spouse's assets and the surviving spouse receives the income generated from the QTIP. The QTIP's assets are designated to other beneficiaries chosen by the decedent. It is important to note that in some cases the principal assets may potentially be available to the surviving spouse during their lifetime. Upon the surviving spouse's passing, the decedent's beneficiaries inherit the assets within the QTIP. This type of trust is useful in second marriages where the grantor wishes to leave a life estate to care for their surviving spouse, while ensuring the principal assets are left for their heirs to inherit.

Exemption Trust

Exemption trusts (also referred to as "bypass" or "B" trusts) are irrevocable trusts designed to reduce taxation on a married couple's estate when the second spouse passes. When the first spouse (the decedent) passes, their portion of the marital assets is placed in the exemption trust (up to $5.43MM for 2015). The exemption trust removes the decedent's assets from the married couple's estate. The surviving spouse has limited control over the exemption trust and may only be designated as an income beneficiary while the principal amount within the exemption trust is assigned to the decedent's other beneficiaries. By assigning a non-spousal beneficiary and limiting the surviving spouse's control over the exemption trust, the assets are considered to be removed from the marital estate, therefore preserving the estate-tax exemption for the decedent's assets.

Charitable Remainder Trust

Charitable Remainder Trusts are created by the grantor during their lifetime by establishing an irrevocable trust with a current income beneficiary and a remainder beneficiary. The income beneficiary is typically the grantor and their spouse, while the remainder beneficiary is typically a charity (or charities) of the grantor's choosing. Generally, charitable remainder trusts are used to donate and sell highly appreciated assets to avoid capital gains taxation while minimizing the overall estate. An advantage provided by charitable remainder trusts, is they allow the income beneficiary to draw an income from the donated assets during their lifetime. As stated in the name, any remaining assets upon the death of the income beneficiary are distributed to the remainder beneficiary; in this case a charity or charities.

Special Needs Trust

A special needs trust is an arrangement used to transfer assets and/or provide a better quality of life to a beneficiary who is either mentally or physically disabled while not jeopardizing their ability to receive government benefits such as Supplemental Security Income (SSI) or Medicaid benefits. Special needs trusts are typically funded through inheritance, personal injury and/or medical malpractice settlement proceeds. A trustee is assigned to the special needs trust and has discretion over the assets and how those assets are spent on behalf of the beneficiary. Removing the beneficiary's ability to control any of the assets in the special needs trust, allows the beneficiary to maintain eligibility in government assistance programs where they may be qualified to receive aid. Otherwise, direct ownership of the assets by the beneficiary could potentially disqualify or reduce any government benefits.

Trusts are important tools when creating an estate plan and they assist in ensuring your heirs are cared for after your passing. There are various trusts available to meet differing estate planning needs and situations. It is often common to establish multiple trusts to meet multiple needs. Wealthy individuals and their families should meet with their estate planner every 4-5 years in addition to meeting when significant life events occur.
