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Estate Planning Part 6: Trusts

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What Is a Trust?

A trust is a legal entity that a person creates. It can be a flexible and useful tool in estate planning and can be designed in a variety of ways.

A trust provides financial benefits for people and/or organizations designated in the trust document. The document also provides the details and instructions for the trust. The trust document should be written by a professional who has experience in writing trusts and who is familiar with current trust laws. The tax consequences of trusts should also be considered; trusts do not save money for your estate in all situations.

Trusts hold titles to real and personal property that is deeded or transferred to the trust. The person creating the trust is referred to as the *trustor* or *grantor*. The person who receives the benefits from the trust (it can be more than one person) is called the *beneficiary*. The person designated to manage the property held by the trust is called a *trustee*.

You should give careful consideration to the type of trust you create and your choice of trustee.

Every trust document needs to have instructions for the termination of the trust at some point. Trusts cannot continue indefinitely, although a trust can continue for several years after your death. If you establish a trust, you will also need to know at what point you want the trust to end.

Why Do People Have Trusts?

There are many reasons for establishing a trust. Most people use trusts to minimize estate taxes.

Providing benefits for someone who cannot manage their own assets is another reason to create a trust. These people might include minor children (those under 18), disabled children, or aged parents.

Some people create a trust to provide support and property management for a surviving spouse and minor children.

A trust can also be established to provide money to educate children and/or grandchildren.

What Are the Different Types of Trusts?

Trusts work in two ways. They can be *revocable* or *irrevocable*. The conditions of revocable trusts can be changed while you are living, but they cannot be changed once you die. Revocable trusts give you the flexibility to make changes as tax and estate laws change.

Trusts can be revocable or irrevocable. The conditions of revocable trusts can be changed while you are living, but they cannot be changed once you die. Irrevocable trusts cannot be changed once they are set up, even while you are living, without the consent of all beneficiaries.

Irrevocable trusts cannot be changed once they are set up, even while you are living, without the consent of all beneficiaries. You cannot easily revoke or terminate irrevocable trusts. An irrevocable trust has some tax advantages, but most irrevocable trusts should be approached with caution because tax and estate laws change. Before you establish an irrevocable trust, be certain that this is the best trust for you.

Here are some terms to be familiar with as you explore trusts with your estate-planning team:

Living trust — this is a trust you create and activate while you are living. The Latin term *inter vivos* (between people who are living) is applied to this kind of trust.

Testamentary trust — this type of trust becomes effective at your death. It is usually contained within a will. Because testamentary trusts take effect at death, they are irrevocable trusts. Common testamentary trusts include those that benefit a spouse, minor children, or a charity or other organization.

Credit shelter trust — one way married couples can reduce the burden of federal estate taxes is to leave property to a trust instead of the surviving spouse. This arrangement is commonly referred to as a *credit shelter trust*. The beneficiaries of such a trust are usually the children. However, the surviving spouse has the right to use the property for the remainder of his or her life, including any income generated by it. At the second person's death, the property transfers to the named beneficiaries without being considered part of the taxable estate.

Life insurance trust — this type of trust is included in some estate plans. A life insurance trust transfers ownership of a life insurance policy. If the trust owns the policy, you do not control it, and its value is not part of your taxable estate. This trust would be useful when you have no close relative to be the beneficiary of your policy. You can designate the estate as the beneficiary. Ownership by the trust would keep the value of the life insurance out of your estate tax calculation. However, it still provides money for liabilities to your estate.

Q-TIP trust (qualified terminable interest property trust) — this trust allows a married person to name the surviving spouse as the life beneficiary of the trust property. When the first spouse dies, all of the property in the trust is exempt from estate tax, no matter what value it has. The Q-TIP trust is a method of postponing estate taxes, not eliminating them. All of the income from the Q-TIP trust must be distributed annually to the surviving spouse. The principal of the trust cannot be used for anyone but the surviving spouse. In many respects the Q-TIP trust is similar to a life estate document, which allows use (but not ownership) of property by a beneficiary during their lifetime. Q-TIPs follow very precise tax law requirements and should be drafted by an experienced estate planner. If you are considering this type of trust, work out the possible tax consequences for the surviving spouse's estate before you decide that it is right for you.

Other trusts in addition to the ones described above are available — charitable remainder trusts, generation skipping trusts, and crummey trusts, for example. All of them have advantages and disadvantages. Consult a knowledgeable professional to determine which trusts are best for your situation.

You need to work with an attorney or other estate-planning professional(s) to outline the purpose of the trust, designate the beneficiary, choose a trustee, and prepare the trust document. The trust document puts all of your ideas in writing in accordance with state law.

What Are the Advantages of a Living Trust?

The revocable living trust is popular as a way to avoid the probate process at your death. You retain control of your assets and affairs. Taxes on a living trust are almost the same as those that result from filing an individual tax return. If you become disabled by a stroke, old age, or other illness, your designated successor trustee will take over the management of your affairs.

If you decide on a living trust, you should also have a pour-over will. The pour-over will states that anything that you own at your death passes to the trust. This document takes care of any assets that may not have been transferred to the trust while you were living.

How Are Trusts Taxed?

The tax laws relating to trusts are complex. If you are planning a trust, it is vital that, in order to learn the tax consequences of creating a trust, you work with a certified public accountant (CPA) and an attorney who are up-to-date on the current tax laws. A trust may or may not give you a tax benefit.

Under most circumstances, trusts are taxed in much the same way as an individual is taxed — on the income that accumulates in the trust. Taxes on income and other assets distributed to the beneficiaries are the responsibility of the beneficiaries.

Tax laws relating to trusts allow for several deductions. The rules vary depending on the type of trust and the instructions in the trust. The size of your estate affects the amount of tax savings a trust would provide. Be sure you explore the details of taxes and trusts with your estate-planning team.

What Does the Trustee Do?

The trustee is the person who manages the trust, following the instructions specified in the trust document. Your selection of a trustee is a critical part of establishing the trust. A trustee should:

- Have the ability to manage money and other assets in such a way that they maintain or increase in value
- Be sensitive to the needs of the beneficiaries of the trust
- Be congenial with the beneficiaries
- Not have a conflict of interest that would take advantage of the beneficiaries

Being a trustee is a big responsibility. To diffuse responsibility, some people set up co-trustees. A financial institution may sometimes be named as a co-trustee to help with the investment aspects of the trust, although it may not meet some of the other criteria for trusteeship.

State law usually specifies the powers of a trustee. It is a good idea to also specify some of those powers in the trust document itself. Non-family members and financial institutions serving as trustees are typically paid for their services. The amount of pay is usually decided by the value of the trust. If a family member is the trustee, they often waive reimbursement for trustee services.

Before You Set Up a Trust

Before establishing a trust, think about your financial and estate-planning objectives. Discuss ways to meet your objectives with estate-planning professionals. Know the advantages and disadvantages of the alternatives before making a decision.

The Estate Planning Series

This publication is part of a ten-part series on estate planning. The publications in this series are:

Part 1: *Getting Started* (FCS5-420)

Part 2: *Your Records and Personal Information* (FCS5-422)

Part 3: *Selecting Your Team* (FCS5-423)

Part 4: *Financial Planners* (FCS5-424)

Part 5: *Wills and Probate in Kentucky* (FCS5-425)

Part 6: *Trusts* (FCS5-426)

Part 7: *Federal and State Estate Taxes* (FCS5-427)

Part 8: *Planning Your Digital Estate* (FCS5-465)

Part 9: *How to Settle an Estate* (FCS5-436)

Part 10: *A Glossary of Terms* (FCS5-428)

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