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TYPES OF TRUSTS

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In this article, we'll dive into more detail about the types of trusts that can be established, and the pros and cons of each.

Revocable Trusts

Revocable trusts (living trusts) can be changed or canceled at any time by the grantor (trustor, creator), who often acts as the initial trustee. All income generated is reported on your personal return and all assets are includible in your estate. Revocable trusts or a portion of becomes irrevocable when one of the trustors dies.

Pros

- Trust can be amended or revoked during lifetime
- Lowers the costs and hassle of probate, making preparing your estate easier
- Provide access to trust assets giving your family better financial protection
- Retain control over assets and how assets pass to beneficiaries
- If joint trust, the surviving trustee automatically becomes trustee and retains control
- Privacy – probate is public
- Provides vehicle if disabled without having a court conservator appointed

Cons

- Separate trusts may be advisable if married to allow for better creditor protection
- Your beneficiaries have less control over what they would inherit
- No court supervision in acrimonious estate administrations
- Estate tax may need to be paid.

Irrevocable Trusts

Irrevocable trusts cannot be modified or revoked by the grantor without the permission of all its beneficiaries. Once an irrevocable trust is established the grantor relinquishes ownership and control of assets included in the trust, which are then excluded from the estate

Pros

- Minimizes estate tax by removing asset appreciation from your estate
- Protects assets from creditors
- Provides for family members who are under 18 years old, financially dependent or may have special needs

Cons

- When assets are placed into the trust, they are no longer yours
- Income earned from the trust is not distributed to you
- Requires filing of an income tax return
- Requires filing of a gift tax return

Testamentary Trust

A testamentary trust is created through a provision in your estate planning document. It's used to appoint a trustee to manage and distribute your assets upon your death. After the probate process determines the will's authenticity, the executor transfers the assets into the testamentary trust. The testamentary trust does not take effect until your passing.

This type of trust allows you to set limitations and stipulations on when and how the beneficiaries can access the assets. For example, it can stipulate when children or minors have access to funds for education.

Pros

- Your will outlines how the trust should be created and allows for more control

Cons

- The trust cannot take effect until after you die
- This type of trust must be probated

Bypass or Credit Shelter Trust

A Bypass trust (also referred to as a Credit Shelter trust) allows affluent couples to minimize or even eliminate their estate tax bills by transferring assets from the decedent spouse's estate to the surviving spouse's estate.

The assets funded into the Bypass Trust won't increase the spuse's estate value as these assets are excluded from the surviving spouse's estate. However, the surviving spouse has the right to access the assests in the trust as necessary for the surviving spouse's maintenance, education, support, and health.

When the surviving spouse dies, the assets are not subject to estate taxes when transferred to the remaining beneficiaries, who are normally their children.

A Bypass trust splits your assets into "Trust A & B." Trust A is a revocable marital trust that the surviving spouse retains full ownership of. Trust B is an irrevocable trust of which the surviving spouse doesn't own the assets but can receive income from them during their lifetime.

Spouses can inherit each other's assets tax-free, but when the second spouse dies, any assets remaining in Trust A (beyond the then-current tax-exempt limit) are taxable at a current rate of 40 percent.

Pros

- Assets in Trust B are not subject to estate tax upon surviving spouse death.
- Allows for more control if one individual dies, so assets funded into Trust B are eventually distributed to your beneficiaries.
- Provides surviving spouse with current income

Cons

- With the current lifetime federal gift and exemption at $11.7 million, this exemption is not as useful.
- Trust B is irrevocable and generally cannot be changed without the consent of all beneficiaries
- Any appreciation in Trust B is subject to income or capital gains tax by the beneficiaries when the beneficiaries sell the appreciated assets
- Requires a separate tax return
- Your heirs do not receive property funded into this trust until the surviving spouse dies

Qualified Terminable Interest Property (QTIP Trust) or Marital Deduction Trust

A QTIP trust (also known as Marital Deduction Trust) is an additional trust that is created upon the first spouse's death. It is utilized to avoid estate tax on the first spouse's death. A common approach is to allocate income from the trust to your spouse upon your death and then to your children when your spouse dies. A QTIP trust normally restricts your spouse from accessing the full principal amount of the assets, but instead allows access to income from this trust for the remainder of their lifetime.

Pros

- Avoids estate tax upon first to die
- Allows for more control if one individual dies, so assets funded into trust are eventually distributed to your beneficiaries
- Provides surviving spouse with current income
- Should we add that they qualify for unlimited spousal bequests and larger possible portability election for the surviving spouse

Cons

- All assets funded into trust are included in surviving spouse's estate
- Requires a separate tax return
- Your heirs do not receive property funded into this trust until the surviving spouse dies

Disclaimer Trust

A provision in your revocable trust that allows the surviving spouse to disclaim assets and fund a bypass trust. If not disclaimed all assets are funded into survivor's trust,

Pros

- Ability to create bypass trust upon the first spouse to die in the event that assets are more than the then current lifetime exemption amount
- Allows for deceased spouse's unused estate exemption amount to be utilized by surviving spouse
- Allows for second step-up in tax basis upon surviving spouses' death

Cons

- Potential for estate tax on surviving spouses' death
- Surviving spouse can change trust terms and beneficiaries

Charitable Trust

A charitable trust is established during the trustor's lifetime and distributes assets to the chosen charity or non-profit organization upon the trustor's death. This type of trust account provides charity with assets or income and avoids or reduces estate taxes.

A charitable trust can also be incorporated into a standard trust, so that the trustor's heirs receive part of the estate, and the charity receives the remainder.

Charitable trusts benefit a charitable organization and its beneficiaries. There are two main types of charitable trusts: charitable lead trusts (CLTs) and charitable remainder trusts (CRTs).

Pros

- You can choose what assets and amounts go to charity and what assets and amounts go to other beneficiaries
- Can reduce or eliminate estate tax

Cons

- Not suitable for small charitable bequests

Special Needs Trust

A special needs trust is established to meet the financial requirements of a dependent with special needs and appoints them as the beneficiary. It funds the beneficiary's medical care or day-to-day needs while retaining the dependent's entitlement to government benefits. There are two main types of special needs trusts: first-party and third-party. Special needs trusts allow you to leave assets to a loved one with special needs while maintaining their eligibility for certain government benefits.

Pros

- Allows for additional financial support for the individual
- Control over how the assets will be used for the individual
- Trust can be customized to provide for the individual's specific needs

Cons

- Requires a corporate trustee who has knowledge of public benefit programs and how trust distributions may affect eligibility
- Incorrect administration may cause the loss of benefits

Life Insurance Trust

A life insurance trust is an irrevocable trust designed to hold the proceeds of your life insurance policy. The main benefit of this kind of trust is that it allows your life insurance payouts to be invested and distributed by the trustee without incurring estate taxes for the beneficiaries.

Pros

- The assets can be transferred to beneficiaries immediately to pay estate costs
- This can eliminate estate tax concerns as proceeds are excluded from the estate
- Avoid large sums of money left to minors or irresponsible adults and provide additional protection to your assets

Cons

- Once you've transferred your life insurance policy into the trust, you can't change your named beneficiary or borrow against the policy
- Requires independent trustee

Intentionally Defective Grantor Trust (IDGT)

An IDGT is an irrevocable trust most often established to benefit of the grantor's spouse or descendants. The trust is irrevocable by design to remove the underlying trust assets from the grantor's estate. It should be established with a non-interested party as trustee to avoid accidental inclusion in the grantor's estate.

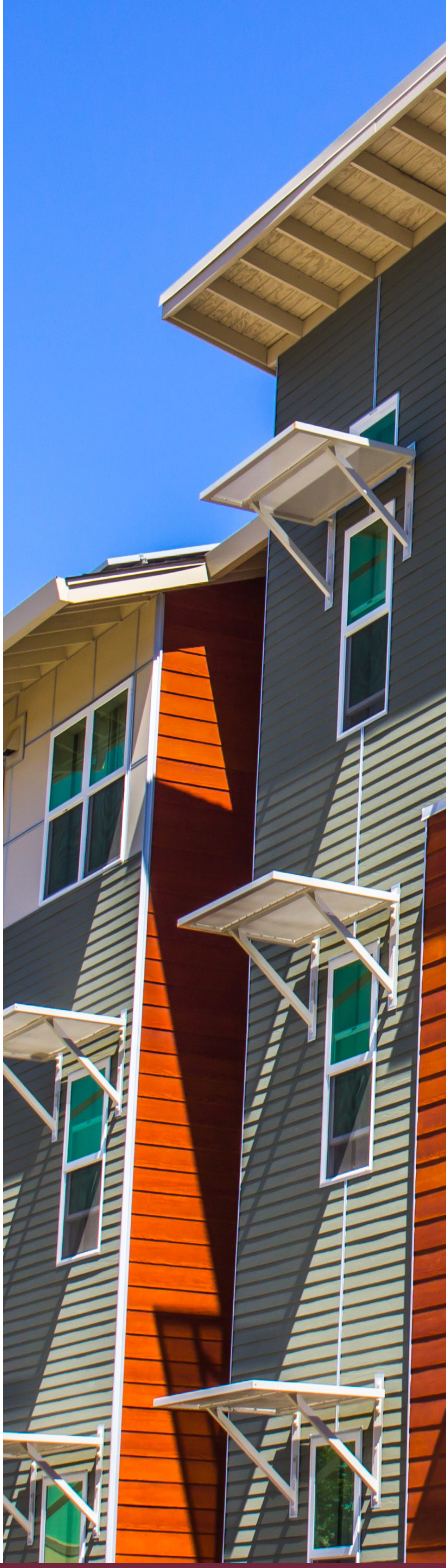
Also, for the grantor to maintain income tax liability, the trust instrument must contain one grantor trust provision from IRC sections 671–679, making it tax "effective" for estate tax purposes but tax "defective" for income tax purposes. In other words, the trust income will be taxed at the grantor level, rather than the trust level.

Pros

- The assets transferred, including all future appreciation, is excluded from your estate.
- Trust assets continue to grow as the grantor is responsible for current income
- Ability to substitute trust assets

Cons

- Income tax paid by the grantor
- Grantor must have necessary means from other sources other than the trust to pay tax generated by trust income
- Income tax on appreciation paid either by trust or eventually by beneficiaries



Note: Any changes to your estate plan must be drafted by your attorney.

About KROST's Estate and Gift, Trust, and Probate Services

Our estate planning team assists with the transition of family wealth and estate succession. Our team of experts has over 80 years of combined experience working with family-owned and privately held companies, as well as high-net-worth individuals. Our primary goal is to assist individuals and their attorneys to effectively transfer wealth while minimizing unnecessary estate, gift, and generation-skipping taxes. In addition, we can coordinate all of your Trust, probate, and estate planning needs to ensure a smooth transition while minimizing emotional, tax, and administrative burdens.

We are offering a free preview of the planner for download. Schedule a call to assess your situation for access to the full book.

There is no better time to start, and it is never too early.

Would you like assistance with your Estate Plan? Richard Umanoff and Doug Venturelli are available to review your current estate plan, provide recommendations, and consult with your estate attorney.

About the Authors

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