PENSION & WEALTH MANAGEMENT ADVISORS

IMPROVING FINANCIAL SECURITY

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THE BASICS OF TRUSTS

What is a trust?

A trust is a legal structure that operates as a separate entity or person under the law, and has the ability to effectively protect, control and transfer assets. The majority of trusts are customized to meet varying personal, tax, financial, investment and estate planning needs.

What are the potential benefits of a trust?

There are many reasons why you might consider establishing a trust:

- **Control Assets** - As grantor, you control each major aspect of your trust. You, along with your attorney, create the language used to govern the trust, so you dictate how distributions are made (and to whom) and you instruct how trust assets are used or continuously managed. You also name the trustee and beneficiaries. You decide how to fund the trust to provide wealth management benefits during your life or after your death.

- **Continuity of Management** - Trusts can provide you and your beneficiaries with uninterrupted management of your assets. With a trust, your personal and financial affairs can be maintained should you become incapacitated or unable to manage them.

- **Safeguard Assets** - Assets transferred to many trusts can be protected from family disputes, spendthrifts and creditors.

- **Avoid Probate** - Probate is the court-supervised process of transferring assets by your will at the time of your death. Assets you own in your name will generally be subject to the probate process in your state of residence. Contractual assets like life insurance policies and retirement plans do not have to be probated, nor do jointly owned assets and assets held in trust. Probate processes vary from state to state. Probate can take several months to several years to complete. Probate is a matter of public record. Assets in most trusts avoid the time delays and publicity of probate, though of course, assets must be retitled in the name of the trust, which may take time.

- **Transition Assets** - Most trusts are used to transfer assets to beneficiaries in a prompt and efficient manner.

- **Reduce Tax Liabilities** - Assets placed in most irrevocable trusts are not counted as part of your taxable estate (thus reducing estate tax liabilities), and certain trusts can be provide you with significant tax deductions. There may be gifted taxes on the transfer of assets to the trust.

- **Professional Asset Management** - If the trustee for your trust is affiliated with an asset management organization, your trust can receive full-time management services.

- **Assistance with Life-Changing Events** - Trusts are typically established or updated in conjunction with life-changing events, such as births, marriages, serious illnesses or deaths, or to help address financial issues such as inheritances, the sale of a business, significant savings needs (e.g., retirement or college), special needs of a disabled family member or tax law changes.

Are there different kinds of trusts?

There are many kinds of trusts and strategies to help protect and transfer your assets among your immediate family:

- **Revocable Living Trust** – A revocable living trust is a flexible estate planning tool whose primary purpose is to help individuals avoid probate and have a plan in place for incapacity or death. It is a “living” trust because it is created during your lifetime. Upon your death, however, the trust becomes irrevocable. Surprisingly, many individuals who create revocable living trusts with their attorney fail to fund the trust, thus losing the financial and estate planning benefits associated with the trust. You should periodically check the title of your assets to verify they are held in the trust’s name.

- I**rrevocable Trust** – An irrevocable trust can be a tax-planning tool. Unlike a revocable trust, assets placed in a irrevocable trust are generally not counted as part of your estate, thus saving on estate taxes. Certain irrevocable trusts can also provide income savings. Unlike a revocable trust, with an irrevocable trust you cannot change the provisions of the trust once it is established. However, you can usually change the trustee of an irrevocable trust.

- **Testamentary Trust** – A testamentary trust differs from a living trust because it is established under your will or under a trust and does not go into effect until your death. Assets funding a testamentary trust are subject to probate because they are being transferred via your will. Testamentary trusts become irrevocable at death, but until then, like any other provision of your will, they can be changed at any time.

- **Children’s Trusts** – There are several different types of trust that are used to make significant controlled gifts to children. Minor’s trusts, known as 2503(c) trusts, often provide more flexibility and control of college savings accounts than direct gifts and custodial savings accounts (“UGMAs”/”UTMAs”).

- **Credit Shelter Trust** – A credit shelter trust has several related names: bypass trust, unified credit trust, family trust and A/B trust. The purpose of this tax-saving transition tool is to ensure that each spouse’s exemption from estate tax is used. Typically funded at death, this trust is usually established as a testamentary trust under the terms of a will or a revocable living trust. The assets being transferred to the credit shelter trust are usually in an amount equal to the estate tax exemption amount that each individual has available to them.

  Credit shelter trusts often pay income to the surviving spouse for life. In addition, the trustee often has the right to invade principal for certain health, support and maintenance needs of the surviving spouse and/or the children. Upon the death of the surviving spouse, the total amount of assets remaining within the credit shelter trust often will bypass the estate of the surviving spouse and will be either distributed outright to designated beneficiaries, typically children, or be held in further trust for those designated beneficiaries until some later time, federal estate tax-free.

- **QTIP Trust** - A qualified terminable interest property trust (“QTIP”) is a trust for the benefit of the spouse that qualifies for the estate tax marital deduction. A QTIP trust allows the deceased spouse to provide lifetime income for the surviving spouse and still control the ultimate distribution of trust assets for selected beneficiaries. A QTIP trust may help the decedent spouse to protect his or her assets from being transferred to the surviving spouse’s beneficiaries at his our her death against the wishes of the decedent.

Are there other family gifting strategies?

Gifting wealth within the family is a common way individuals transfer their estate. There are several very effective gifting strategies available that not only allow you to transfer significant assets to family members, but also retain some control over the process and the use of those assets, too. Some of these gifting strategies include the following:

- **Grantor Retained Annuity Trust** - A sophisticated gifting strategy employed by wealthy individuals as the grantor retained annuity trust. This irrevocable trust “freezes” the value of assets transferred to the trust for tax purposes at the time the trust is established. As the grantor, you still retain an interest in the assets transferred to the trust. The “gift” is the remainder interest in the trust assets that is calculated to go to the named beneficiaries of the trust. If the trust assets appreciate over the term of the trust, the excess appreciation passes tax-free to your beneficiaries.

  The tax-advantaged transfer to transfer to the trust is accomplished by the grantor retaining a stream of payments from the trust during its term, which is usually a set number of years. The grantor must survive the trust term for the gift (transfer) to be considered completed.

- **Qualified Personal Residence Trust** - As one of the largest components of your estate, your home (or vacation home) may be an estate tax liability all by itself. A qualified personal residence trust (“QPRT”) may allow you to remove the value of your home from your estate while maintaining the right to live in the home for a number of years before ownership is transferred to your children, as beneficiaries of your trust, or another trust beneficiary.

  A QPRT may hold title to your principal residence or vacation home, if it qualifies as a personal residence, for a term of years that you select. At the end of the term, the trust terminates and the residence is transferred to a beneficiary you name in the trust. During the term of the trust, you may continue to live in your home as you did prior to the transfer of it to your trust. When the home is transferred to a beneficiary, you can arrange to continue to live in the home if you agree to pay rent to the trust beneficiaries. The rent must be fair market value rent for a property in that location. As long as you outlive the term of the trust, the home’s value will be excluded from your taxable estate. Plus, you will have transferred the home to your beneficiary and paid gift taxes on only part of its fair market value in determining the size of the gift made to the beneficiary. If the home increases in value, the appreciation will not be subject to estate taxes.

- **Planned Giving Strategies** - Since the early 1900s, Congress has encouraged philanthropy within the private sector by granting favorable tax treatment to most charitable contributions made by individuals. Charitable contributions made by individuals today are far and away the biggest source of annual donations. Individual donors generally make up the lion's share of charitable contribution sources because of the tax advantages available for making such gifts. Planned giving arrangements not only ensure that your favorite charity or institution receives a portion of your estate, but they also provide you and your family with a tax-efficient way to leave a lasting legacy.

- **Outright Gift** - An outright gift to a favorite charity can provide an income tax deduction if the gift is made during your lifetime, or can reduce your taxable estate if the gift is made at your death. However, you generally have no control over how the gift is used nor can you receive any other financial benefits from this gifting strategy.

- **Donor-Advised Fund** - As a tax-qualified public charity, a donor-advised fund allows you to recommend (but not command) how contributions will be distributed to various charitable organizations you select. Contributions to a donor-advised fund are tax deductible in the year the contribution is made. A donor-advised fund does not provide you with an income stream from the contributions you make to the fund.

- **Charitable Gift Annuity** - With a charitable annuity, you can receive guaranteed distributions for life in exchange for making a direct gift to a charity. Distributions are paid in the form of an annuity, which means each payment you receive will be for the same amount. Part of each payment is a return to you of your gift, so only a portion is taxable as ordinary income. Regardless of when you begin receiving the income tax deduction, you can take a charitable income tax deduction in the year you make the gift, but the deductible amount is reduced by the value of the annuity you retain.
- **Charitable Remainder Trust** - Created by Congress in 1969 (Tax Reform Act of 1969), a charitable remainder trust represents a powerful wealth transition planning tool used by families looking to provide for charity while at the same time providing an economic benefit to themselves. Charitable Remainder Trusts are irrevocable trusts that can help you:

    1. **Defer capital gains taxes on the sale of highly appreciated assets** - Because a charitable remainder trust is a tax-exempt trust, appreciated assets that you transfer to it may be sold by the trustee within the trust without incurring immediate capital gains taxes.

    2. I**ncrease spendable income from unproductive investments while diversifying those investments** - Proceeds from the internal sale of assets transferred to the trust can be reinvested in more diversified, income-producing investments. You, your spouse or other beneficiaries that you name can receive distributions from the trust for either a term of years, not to exceed 20, a lifetime or, in some cases, for multiple lifetimes. The distributions can either be an annuity interest (charitable reminder annuity trust) or a unitrust interest (charitable reminder unitrust).

       For example: A $1,000,000 charitable remainder annuity trust with a payout rate of 7% would provide you and any other income beneficiaries with $70,000 of annual income. Using the same example for a charitable remainder unitrust, the first year's payout would also be $70,000, but beginning with the second year, the trust's assets would be recalculated before determining your payout amount for that year. If the assets in the charitable remainder unitrust increase from $1,000,000 to $1,100,000, you would receive $77,000 ($1,100,000 x .07).

What is the right strategy?

It is important to work with both your advisor and your attorney to ensure that your assets are managed efficiently and effectively. Each individual has their own goals and objectives that when articulated, will provide your team of advisors with the information they need to establish the appropriate trust arrangements for you and your family.

Please note that Pension & Wealth Management Advisors does not render advice on tax or legal matters. You should discuss any tax or legal matters with the appropriate professional.