A guide to trusts for estate planning

Trusts are a common tool in estate planning, and for good reason. They can be incredibly effective in helping fund education, provide for heirs, donate to charities and more. For high net worth individuals, trusts are also an important strategy to reduce taxes.

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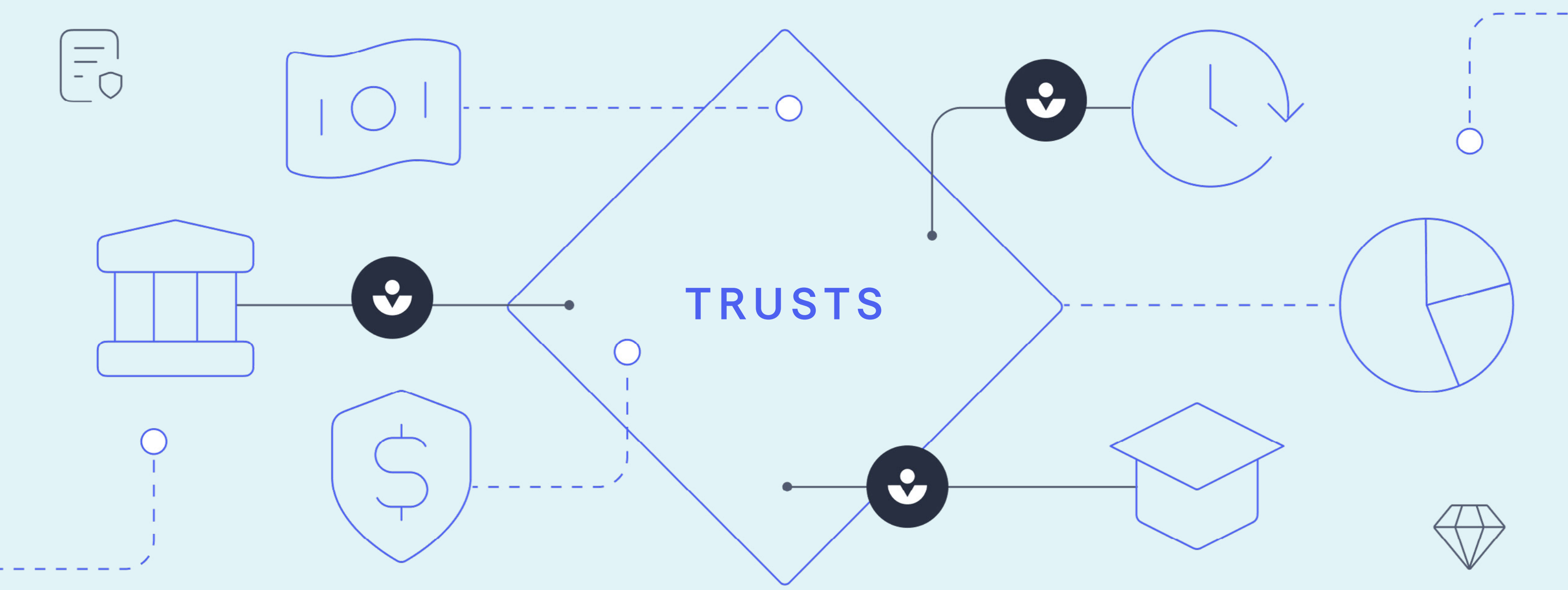


i. The basics: What are trusts?

Trusts are legal entities, much like corporations, which are considered distinct from the various parties involved. Trusts come in many forms, but in essence they are fiduciary arrangements in which, as the IRS states, "one person (the trustee) holds title to property or assets…for the benefit of another (the beneficiary)." The person who creates the trust is called the settlor, sometimes also referred to as the grantor or trustor. Sometimes the settlor is also the trustee, while in other cases the trustee is a third party. Trusts can be used to dictate the flow of a person's assets during life, after death, or both.

There are many reasons people choose to employ trusts as a part of their financial and estate strategies. For one, trusts are typically not subject to probate, the court supervised process triggered upon a person's death which involves the appointment of an executor or personal representative and the administration and validation of their will (if one exists). This process can be time consuming as well as expensive – and the probate process is a public process, meaning anyone can find out to whom and how much you've left behind. So, those wishing to keep the assets of their estates private, often place them in a trust.

Another reason for using trusts is control, both during life and after death. When a trust is created, the person setting up the trust dictates the terms of that trust, including who will receive distributions from the trust, when those distributions will occur, and on what terms. Additionally, depending on the type of trust, trusts can also be a valuable tool for tax planning

QUICK-REFERENCE DEFINTIONS:

Settlor (or grantor)
The person who creates the trust.

Trustee
The person who manages the property or assets in the trust.

Beneficiary
The person or people who will receive the assets in the trust.

ii. Revocable vs irrevocable trusts

There are two large categories of trusts: **revocable** – those that can be altered by the settlor during their lifetime – and **irrevocable** – those in which the settlor relinquishes all control over the trust assets and that are unable to be changed once the trust is created. While all trusts share certain similar characteristics, these two primary categories of trusts have very different uses.

REVOCABLE TRUSTS

Flexibility	Control	Estate Tax	Protection
Terms can be changed during lifetime	You retain total control over your assets	Taxed on assets above exemption amount at death	Not protected from lawsuits or creditors

IRREVOCABLE TRUSTS

Flexibility	Control	Estate Tax	Protection
Terms are locked in at creation of trust	You give up total control over your assets	No tax on assets	Protection from creditors and lawsuits

ii. Revocable vs irrevocable trusts (continued)

REVOCABLE TRUSTS

What is a revocable trust?

A revocable trust is commonly thought of as a substitute for your Last Will and Testament. When using a revocable trust, you typically also have a simple "Pour-Over Will" that directs any assets not titled in the name of your revocable trust into your revocable trust at your death. The trustee of your revocable trust then disposes of your assets as directed in the trust agreement. It is important to remember that during your lifetime, you can serve as the trustee of your revocable trust, you control all decisions regarding the property owned by the revocable trust, and you can amend or revoke your revocable trust at any time.

Common reasons a person would choose to use a revocable trust rather than a Will, are:

① **Privacy** The terms of a Will are part of the public record, whereas the terms of a revocable trust are not. Therefore, the majority of your estate plan should remain private with proper planning.

② **Limited Judicial Oversight** If you retitle assets in the name of your revocable trust during your life, those assets do not have to pass through a probate proceeding after your death. Probate can be complex, expensive, and time consuming. In addition, many administrative matters during probate are subject to judicial approval and oversight. Revocable trusts are not typically subject to judicial supervision.

③ **Incapacity** If you ever become incapacitated, the named successor trustee of your revocable trust can step in and manage the assets titled in the name of your revocable trust immediately. This can lead to a smooth transition of assets.

Pros and cons of a revocable trust

Revocable trusts can be changed anytime during the settlor's lifetime, and the settlor continues to have access to the assets in the trust, making them more flexible than irrevocable trusts. Revocable trusts are typically used for planning purposes as well as peace of mind (knowing that should the settlor become incapacitated or incompetent, there will be a successor trustee to step in and help manage the trust assets). They are also used to avoid probate when the settlor dies. However, while they offer a greater level of flexibility, they do not remove assets from the settlor's taxable estate, and thus are not as effective in reducing tax liability.

IRREVOCABLE TRUSTS

What is an irrevocable trust?

An irrevocable trust is a legal arrangement in which a person (the settlor) transfers assets to a trustee, who oversees and manages them on behalf of beneficiaries. As the name suggests, once established, an irrevocable trust generally cannot be modified or revoked by the settlor without the consent of the beneficiaries. This type of trust can be designed to provide a variety of tax benefits (both income and estate tax), as well as, asset protection benefits. Lastly assets are considered outside of the settlor's estate and are therefore not subject to probate.

Pros and cons of an irrevocable trust

An irrevocable trust offers several advantages, including asset protection, as assets placed in the trust are shielded from creditors and lawsuits. It can also be a useful tool for reducing estate taxes, by shifting assets outside of an estate. Additionally, an irrevocable trust may aid in Medicaid planning, as assets transferred to the trust might not be counted towards Medicaid eligibility. However, establishing an irrevocable trust comes with drawbacks. One major downside is the loss of flexibility, as the settlor cannot make changes to or revoke the trust once it's created. Additionally, the settlor may not have direct access to the trust's assets, limiting personal use.

iii. Frequently asked questions about trusts

Should I leave my assets in trust or outright to my spouse or kids?

When considering whether to give your spouse assets outright or in trust at your death, you should consider a number of factors, such as:

Creditor Protection: By placing the assets in a trust, it provides a layer of protection for your assets that is not available if your spouse receives those assets outright. For example, if your spouse is a professional (e.g. doctor, lawyer, etc.), and is sued in their personal capacity, their individually owned assets may be subject to the claims of the creditor. Another example would be if your spouse was in a car accident and was sued by the injured party; their individually owned assets may be subject to the claims of the creditor. Additionally, if your spouse remarries, any assets in trust will be protected from division in a divorce.

Control Over Remainder: By placing the assets in trust, you can control who receives the remainder of the trust at your spouse's death. For example, if you have children from a prior relationship, and you want them to receive the assets after your spouse passes away, a trust allows you to direct that the remaining assets in the trust go to your children at your spouse's death. If your spouse receives the assets outright, your spouse will be free to spend or give away the assets to whomever they please during life and at their death.

Tax Planning: A trust allows you to maximize the benefit of your tax exemptions (e.g. the gift and estate tax exemption), which you may otherwise be unable to fully use if you gave your spouse the assets outright.

It is important to note that if you leave your spouse assets in trust, the trust has to be drafted to ensure that it qualifies for the unlimited marital deduction between spouses. If the trust does not contain specific provisions, it may inadvertently result in the trust not qualifying for the unlimited marital deduction, therefore leaving the assets subject to estate tax at the first spouse's death.

iii. Frequently asked questions about trusts (continued)

What trust is right for my family?

Every family is unique, so the right trust structure for your family is dependent on your family's wants and needs. We will discuss high-level the different types of trust structures offered by Vanilla, and hopefully provide you with a starting point for choosing the best trust structure for your family.

Trust for Surviving Spouse: You can select to give your assets to your surviving spouse either outright or in a trust structure. Under the trust structure, the assets received by your surviving spouse will be held in a trust for their benefit. Using a trust protects your surviving spouse from potential creditors, allows you to maximize your tax exemptions at your death, and provides that the assets will pass to the recipients you have designated (absent your spouse's exercise of their limited power of appointment - a tool that generally provides flexibility to your surviving spouse to adjust an estate plan, in a limited way, to accommodate circumstances that were not known when the estate plan was executed).

Trusts for Descendants: There are primarily two different options when determining the trust(s) that will hold your descendants' inheritance.

First, there are the *separate trusts for descendants* - If you select separate trusts for your descendants, you are providing for the beneficiaries of each trust to be each of your children, and that child's descendants. Using this structure protects your children (and their descendants) from potential creditors and allows you to maximize the use of your tax exemptions. You can additionally allow a child to be the sole trustee of their own trust, effectively giving them total control over the trust assets, while still providing creditor protection. Upon a child's death, their trust is divided into shares for their descendants, to be held in further trust.

This is the most common type of trust structure used by families with children.

Second, there are *pot trusts* - If you select a pot trust for your descendants, you are providing that all of your descendants are beneficiaries of a single trust, of which they are all discretionary beneficiaries, meaning that no one beneficiary has an absolute entitlement to either income or principal. This trust will terminate when required by state law, and at that point, the remaining trust assets will be divided among your descendants that are then living.

This structure is typically used by a family who wants to ensure that all descendants (children, grandchildren, great-grandchildren) have equal access to the trust assets.

What is right for me: Joint revocable trust vs. individual revocable trust?

A joint revocable trust is the most common option for married couples with children from the same marriage, who live in community property states, and who do not have significant separate property. A joint revocable trust treats you and your spouse as a single unit and is easy to manage for couples who own assets jointly. A joint revocable trust allows you and your spouse to specify how your assets should be handled during your lifetimes, as well as how they are distributed upon each of your deaths. Assets can be added or removed from the trust throughout your lifetimes and the trust can be amended as needed. Even if you are married in a community property state, a joint revocable trust may not be the right selection if:

- this is a second marriage and you have children from the prior marriage
- you have significant separate property
- expect to receive significant separate property (i.e. a large inheritance)
- you have a premarital agreement

An individual revocable trust is the most common option for individuals (including married couples) who reside in a separate property state. An individual revocable trust allows you to specify how your individual assets should be managed during your lifetime, as well as how they are distributed upon your death. Assets can be added or removed from the trust throughout your lifetime and the trust can be amended as needed.

iv. Common trusts used in estate planning

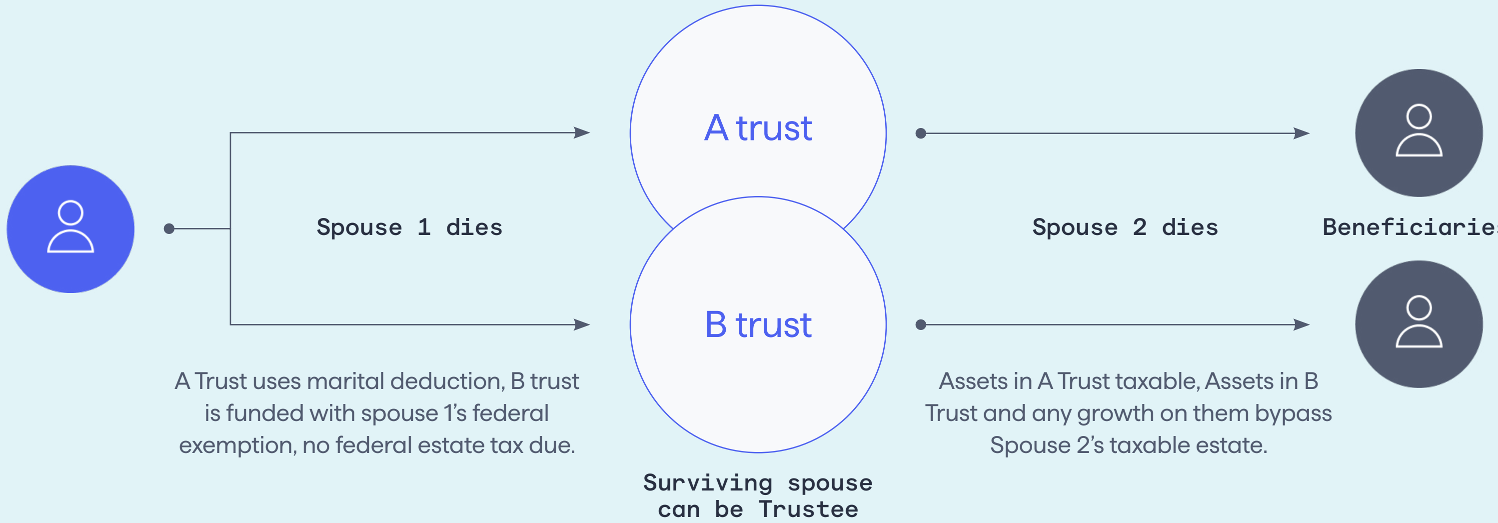
A/B trust arrangement: Marital trust and credit shelter trust (a.k.a bypass trust)

A common trust arrangement used by married couples to minimize estate taxes for the surviving spouse after one spouse passes away the A/B trust arrangement, also known as a “spousal and bypass trust” or “marital and bypass trust,” incorporates the use the two trusts: the marital, or “A” trust and the bypass trust, or “B” trust.

Upon the death of the first spouse, the estate is divided into two portions. The Marital trust “aka A trust” portion holds the assets intended to benefit the surviving spouse while they are alive, while ensuring that after the death of the surviving spouse the remaining assets are ultimately distributed according to the settlor’s wishes. The surviving spouse can receive income from the trust and, in some cases, have access to principal for their needs. The A trust is typically not subject to estate taxes upon the death of the first spouse due to the unlimited marital deduction, effectively delaying any payment of estate tax until the death of the surviving spouse.

The Bypass trust / credit shelter trust (aka B trust) holds the assets usually up to the federal estate tax exemption amount, effectively using the deceased spouse’s federal exemption. The assets in the bypass trust and any subsequent growth on those assets are shielded from estate taxes upon the surviving spouse’s death, as they are not considered part of their estate, essentially “bypassing” the surviving spouse’s estate. The surviving spouse can still benefit from the trust’s income and, upon their death, the remaining assets pass to the designated beneficiaries, often the couple’s children.

This A/B trust arrangement allows married couples to maximize the use of their federal estate tax exemptions and potentially reduce the overall tax burden on their estates. It also ensures that the intended beneficiaries, often the couple’s children or other designated individuals, receive the remaining assets after both spouses have passed away.



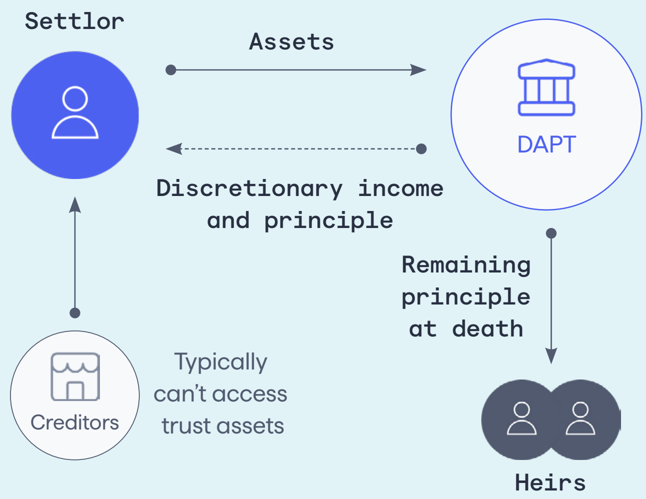
Disclaimer trust

A Disclaimer Trust allows a spouse to refuse (or disclaim) part or all of an inheritance. This refusal helps to minimize estate taxes and control asset distribution. The disclaimed assets pass into an irrevocable trust, and keep the assets out of the spouse’s taxable estate. Disclaimer trusts offer flexibility to adjust the estate plan post-death, depending on the circumstances at the time, including the spouse’s financial situation or changes in tax law. It’s critical to execute the disclaimer properly, within a certain time frame, to avoid adverse tax implications.

iv. Common trusts used in estate planning (continued)

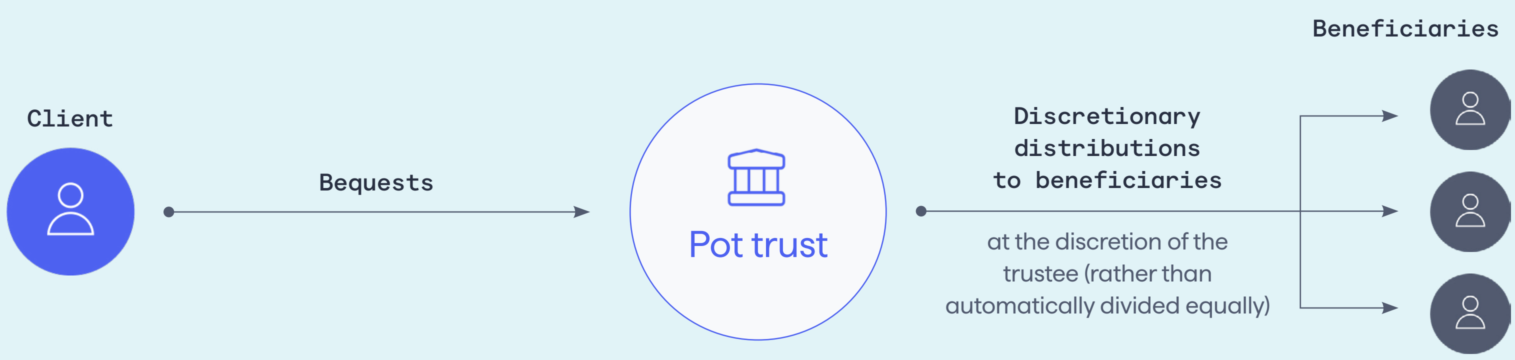
Domestic asset protection trust (DAPT)

A Domestic Asset Protection Trust (DAPT) is a type of trust established in certain states that provides asset protection benefits for the settlor. With a DAPT, the settlor transfers assets into the trust while retaining certain beneficial interests. The key feature of a DAPT is that it offers protection against creditors, meaning that the assets held within the trust are shielded from potential future claims or legal actions. Unlike traditional trusts, a DAPT allows the settlor to be a discretionary beneficiary, enabling them to access the trust's assets if needed. However, it's important to note that the effectiveness of a DAPT may vary based on the specific laws and regulations of the state in which it is established.



Pot trust

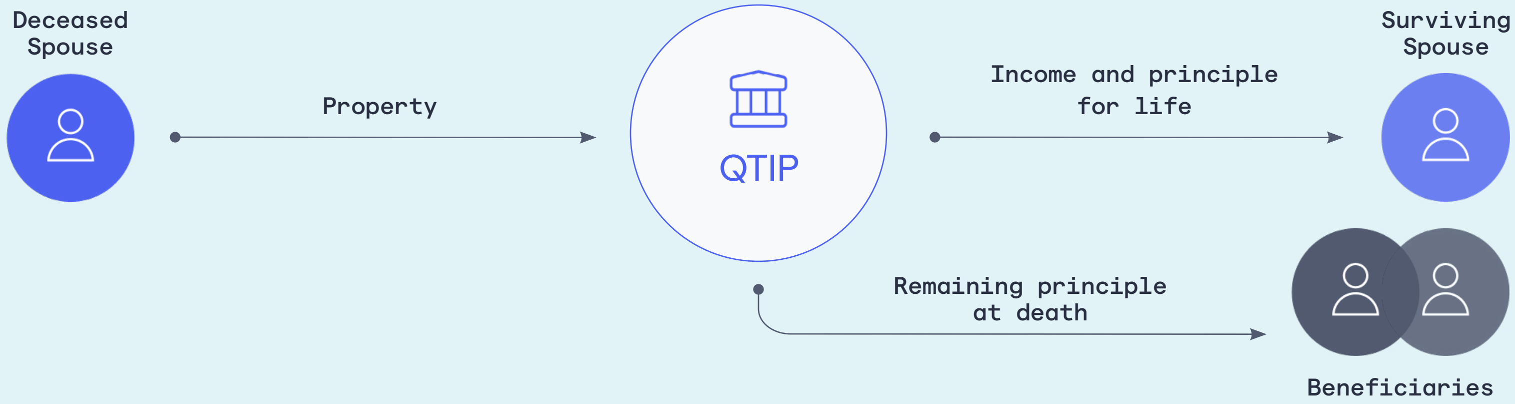
A pot trust is a single trust for all beneficiaries (typically children and more remote descendants). Distributions can be made to any beneficiary at the trustee's discretion. This trust structure allows for greater flexibility in managing the needs of all descendants collectively. For example, one branch of the family may have greater needs than another branch of the family. By using a pot trust, it allows the trustee to provide more resources to the branch that has greater needs. This trust continues until required to terminate by state law.



iv. Common trusts used in estate planning (continued)

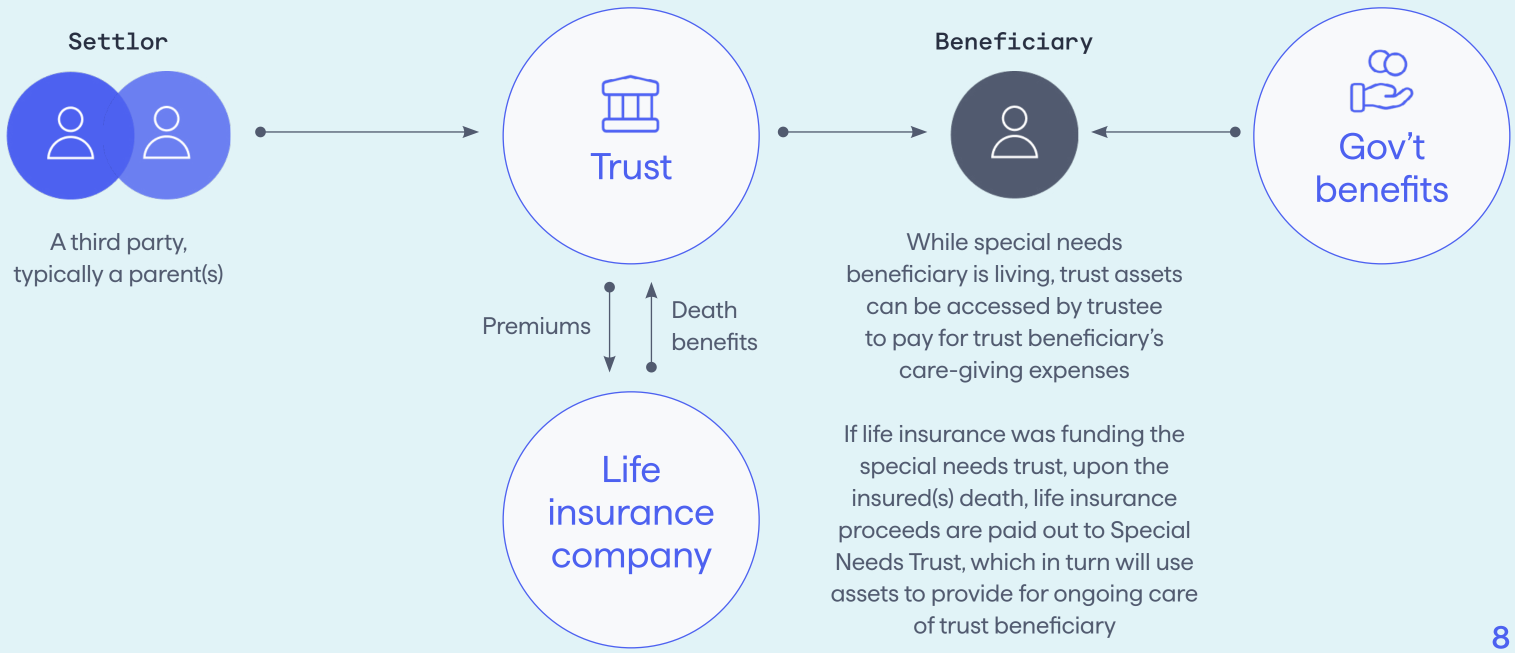
Qualified Terminable Interest Property (QTIP) Trust

Often a marital trust is structured as a qualified terminable interest property (QTIP) trust. In a QTIP trust, the surviving spouse receives income from the trust during their lifetime, and upon their death, the remaining assets are distributed to the beneficiaries designated by the settlor. This type of trust allows the settlor to provide financial security for their spouse while maintaining control over the final distribution of assets, making it a useful tool for estate planning and minimizing estate taxes.



Special needs trust

A special needs trust, also known as a supplemental needs trust, is a legal arrangement established to provide for individuals with disabilities or special needs. The trust is designed to hold assets and provide for the financial well-being of the beneficiary without jeopardizing their eligibility for government benefits like Medicaid or Supplemental Security Income (SSI). The trust is managed by a trustee who disburses funds to supplement the beneficiary's needs not covered by public assistance programs. This may include medical expenses, education, therapy, personal care attendants, transportation, and recreational activities. By ensuring continued access to vital government benefits while providing additional support, special needs trusts can enhance the quality of life and care for individuals with disabilities.



v. Advanced strategies: Trusts for taxable estates

Charitable remainder trust (CRT)

In a charitable remainder trust, a settlor makes an irrevocable gift to the trust. During the trust term, the settlor receives an annual payment back from the trust, and at the trust's termination all remaining assets are distributed to charities designated in the trust. The settlor receives a current income tax deduction for the gift to the trust. The amount of the income tax deduction is the present value of the future interest that the charity will ultimately receive at the end of the trust term as determined using a predetermined rate set by the IRS.

Client transfers appreciated asset or property to the Charitable Remainder Trust

Client receives an income tax charitable deduction = to present value of remainder interest passing to charity

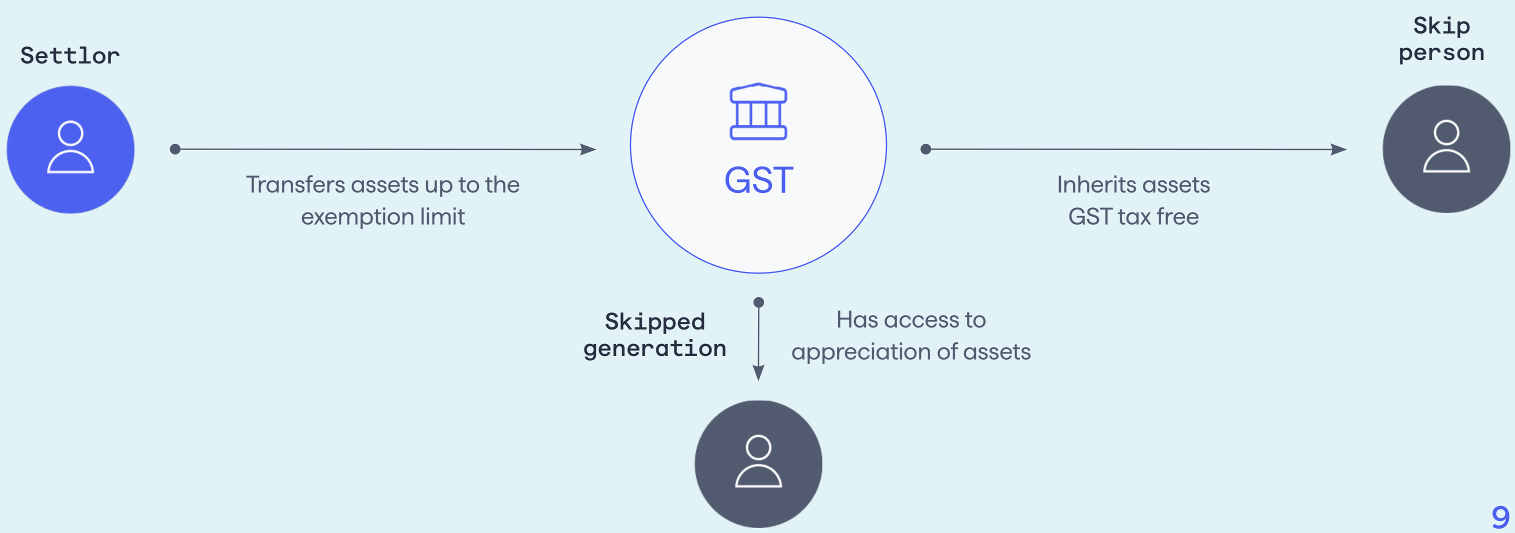
Your Trustee sells the asset or property, trust does not pay income tax tax, but the income beneficiaries could. The proceeds from the sale are invested.

Your Trustee pays you income for a term of years or life.

At the end of the trust term, the remaining trust assets go to one or more charities that you selected.

Generation skipping trust (GST)

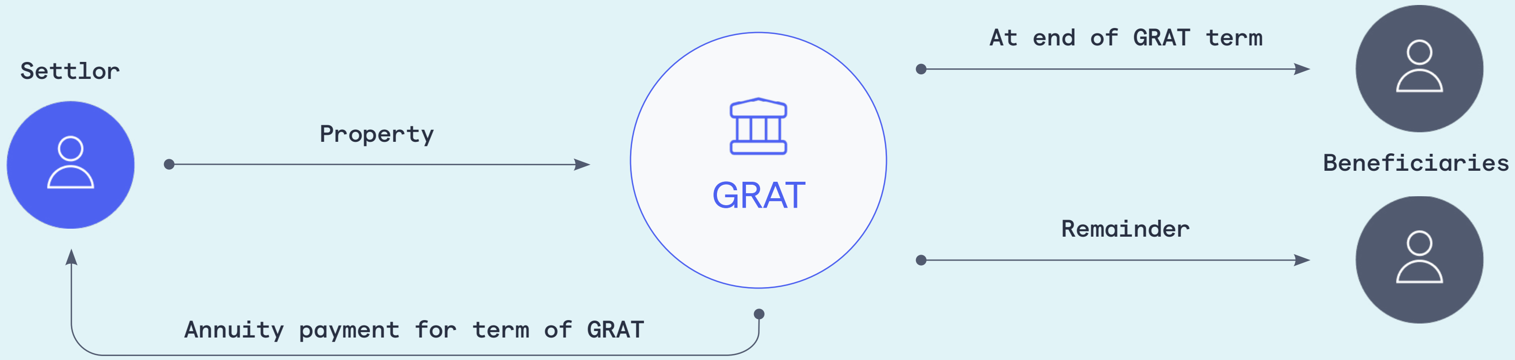
The generation-skipping transfer tax (or "GSTT") imposes an additional 40% tax on assets gifted to a grandchild or great-grandchild, or anyone unrelated who is 37.5 years or more younger than the donor. The GSTT is imposed on gifts made directly to those individuals, but is also on gifts to certain trusts that can benefit those individuals. The GSTT was established to combat people getting around the estate tax by putting a large pool of assets into a multi-generational trust, which would then never be taxed again. A generation skipping trust can be used to help minimize the estate and GST taxes when passing assets and money on to a later generation.



v. Advanced strategies: Trusts for taxable estates (continued)

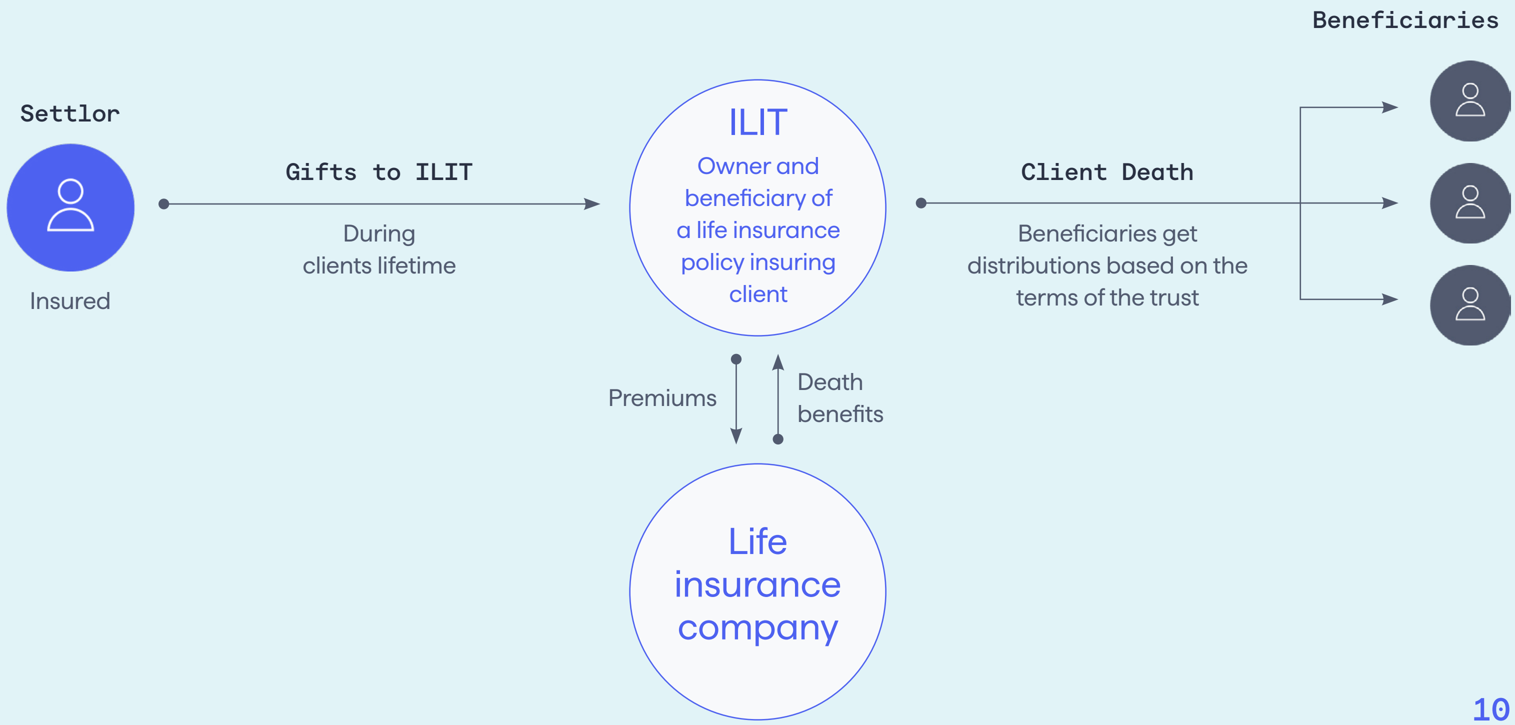
Grantor retained annuity trust (GRAT)

A grantor retained annuity trust allows the grantor to put appreciable assets in a trust and receive an annual annuity payment for a specified term of years. At the end of the specified term of the GRAT, if the grantor survives the trust term, the remaining assets will be transferred to the named remainder beneficiary free of transfer tax.



Irrevocable life insurance trust (ILIT)

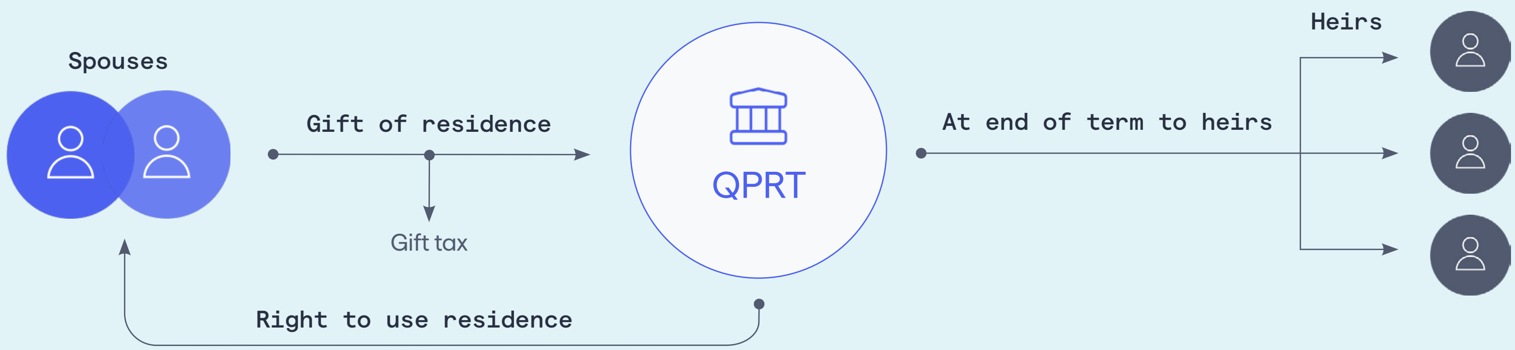
In an irrevocable life insurance trust, the settlor transfers or buys a life insurance policy in a trust, so it is then fully "owned" by that trust and no longer considered a part of his or her estate for esatate tax purposes. When the trust is created, it will outline how benefits will be distributed upon the insured's death – or sometimes upon a second death (a spouse). Once an ILIT is created, being an irrevocable trust, it cannot be altered.



v. Advanced strategies: Trusts for taxable estates (continued)

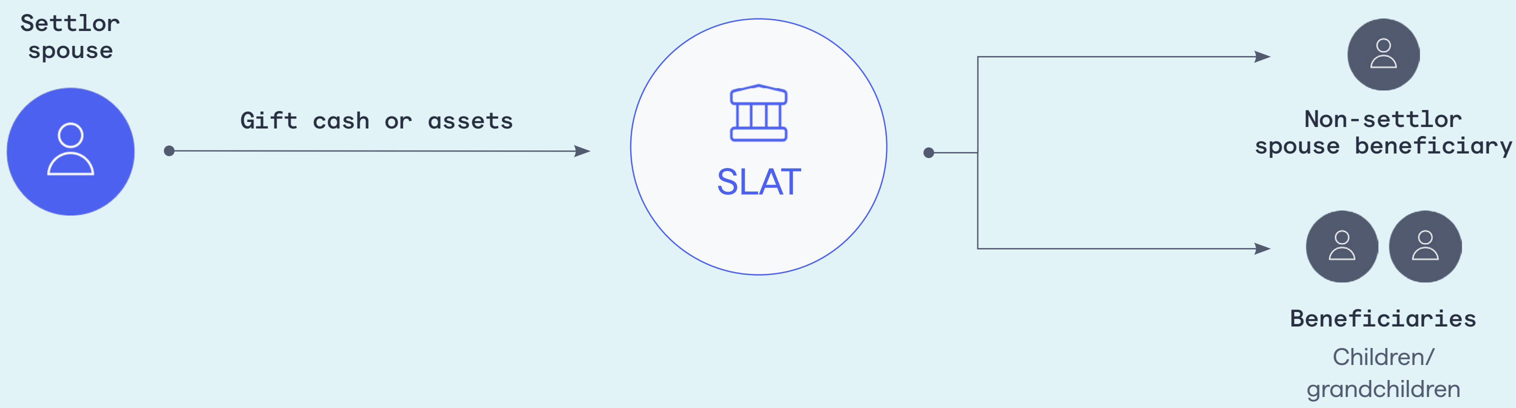
Qualified personal residence trust

A Qualified Personal Residence Trust (QPRT) is a legal tool that allows a homeowner to transfer their primary residence or vacation home into a trust while still living in it for a predetermined period. This enables the homeowner to remove the property's value from their taxable estate, potentially reducing estate taxes. At the end of the trust term, the property passes to the trust beneficiaries, typically family members, at a lower value for gift tax purposes. If the homeowner dies during the trust term, the property is brought back into their estate. It is important to note, that at the end of the trust term, the settlor/homeowner will need to rent or lease the property from the beneficiaries in order to continue using the property.



Spousal lifetime access trust (SLAT)

The spousal lifetime access trust is an irrevocable trust in which one spouse (the settlor) puts assets into the trust that the other spouse (the beneficiary) can then access. This takes the assets in question out of the settlor's taxable estate but still allows the spouse to access the funds at will. It's implied that the settlor may also be able to access those funds through their spouse, thereby giving the couple the flexibility to make use of the money when needed while keeping it out of the taxable estate or the reach of creditors.



vi. Simplifying the complexities of estate planning

There are many kinds of trusts, and it's not uncommon for people to use several different trusts as a part of their estate plan. It can get complicated to understand the implications and the flow of funds. That's why it's important to work with a top-notch financial advisor and estate attorney, bolstered by the right technology. Vanilla can help by enabling you to visualize the full scope of your balance sheet and estate plan, using easy to understand graphs and charts to show the flow of funds and highlight opportunities. Financial advisors interested in Vanilla can schedule a demo to learn more.

The Vanilla estate advisory platform

Built by advisors for advisors, Vanilla is more than just a place to create trusts, wills, and estate planning documents. It's built for powering the most important advice you can give your clients — how to craft and manage their legacy.