# CLIENT BULLETIN

A PUBLICATION FROM

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## USING TRUSTS IN ESTATE PLANNING

Most people don't like to think about dying, yet most everyone wants their assets to pass to their heirs quickly, easily, and in the manner they intended. Take action now—advance estate planning is the best way to minimize future heartache and hassle for your loved ones.

The most typical document used in estate planning is a will, a directive that specifies how your property should be distributed upon your death. Typically, a person who is at least 18 years old and of "sound mind and memory" can create a legal will. However, the estate of any person who dies owning property in his or her own name cannot be legally distributed without first going through probate. Probate is the action or process of proving before a competent judicial authority that a document offered for official recognition and registration as die last will and testament of a deceased person is genuine. This process can significantly delay receipt of assets intended for your heirs.

In some cases, probate may be avoided by transferring all assets to a trust. A trust is an agreement between a "grantor" or "settlor," the owner of the property, and a "trustee," the party who manages the property for the benefit of a third party in accordance with the instructions of the grantor. A trust is created by private contract, and is considered an independent entity, much like a corporation. A trust, through its trustee, may own property, file tax returns and pay taxes, earn income and distribute profits, and conduct other business activities.

Trusts may be created for a variety of reasons. If any of die following are consistent with your objectives, it may be in your best interests to learn more about trusts:

- Providing a continuing source of income for heirs;
- Managing the proceeds of life insurance policies;
- Funding the education or medical needs of children or grandchildren;
- Postponing or eliminating estate taxes;
- Transferring assets to another person in the event that the grantor requires expensive medical care (transferring those assets could limit the grantor's liability for medical expenses, preserving his or her estate, and may enable him to qualify for governmental assistance);
- Addressing particular situations, such as the death of a single parent with minor children, a second marriage, or a disabled child;
- Facilitating multigenerational planning;
- Protecting a beneficiary from creditors, or from claims by future or current spouses;
- Minimizing the impact of state, estate, capital gains, and gift taxes;
- Passing property to family members who are not U.S. citizens; and
- Transferring assets for the benefit of a charitable organization or foundation.

A trust can be "testamentary" or "living." A testamentary trust is created by will. After the death of the grantor, the trust is irrevocable, that is, it cannot be changed or terminated. However, before death, the grantor may change his or her will, including any testamentary trust provisions.

A testamentary trust allows the grantor to retain unrestricted control over his or her estate. There are, however, some disadvantages. A testamentary trust is not eligible for the beneficial tax treatment given to living trusts. Because a testamentary trust is created only upon a grantor's death, the grantor enjoys no tax benefits during his or her lifetime. In addition, most testamentary trusts must go through probate.

A living trust, sometimes called an *inter vivos* trust, can be revocable or irrevocable, depending on the intent of the grantor. A revocable trust is subject to change at any time by die grantor. A living trust requires die transfer of assets during die grantor's lifetime. Legal tide is then owned by the trust. Because property in the trust is passed during the grantor's lifetime, it is excluded from the probate process upon the grantor's death.

There are several advantages to a living trust. The transfer of assets to a living trust can provide die grantor with substantial tax benefits. In addition, a living trust enables a trustee to manage those assets if the grantor becomes mentally or physically incapacitated. Finally, the assets of a living trust are not subject to estate administration upon the death of the grantor.

While a living trust can be revocable or irrevocable, only irrevocable trusts may avoid income and estate taxes. The grantor must report and pay taxes on income from assets in a revocable trust. Upon die death of grantor, property in a revocable trust will be included in the estate for the purpose of calculating estate taxes.

The establishment of a trust does not eliminate the need for a will. There may be assets received after the creation of a trust, or some defect in beneficiary or joint tenancy arrangements. A will would distribute any personal or real property not transferred into a trust, intentionally or unintentionally.

There are more than 50 different types of trusts or trust arrangements. These are among the most popular:

**Family Trusts:** Under federal law, a spouse's entire estate may pass to the surviving spouse without generating any estate tax. However, if the surviving spouse dies with assets valued at more than the exempt amount, a significant estate tax may be imposed. (This amount is being modified yearly so you should check with your attorney regarding the current exempt amount.) To reduce the estate tax burden upon the second death, it is possible to transfer the exempt amount of assets to a Family Trust. The initial exempt amount transferred, plus any appreciation between the first and second death, escapes estate tax taxation. In addition, the trustee of the Family Trust can be instructed to pay income and principal to the surviving spouse if needed. Upon the death of the second spouse, the assets in the trust can be distributed to children outright or continue to be held for their benefit.

**Grantor-Retained Annuity Trusts:** This is an irrevocable trust designed to reduce gift and estate taxes. Generally, the grantor transfers assets into the trust and receives income from die trust for a period of years or until the grantor's death, whichever occurs first. Usually, the income is a fixed percentage of the assets (an annuity). Upon termination of the trust, the balance passes to designated beneficiaries or the grantor's estate, with gift or estate tax imposed only on the remainder of the trust. The longer the term of years and the higher die income payout, die lower the remainder interest for tax purposes.

**Qualified Personal Residence Trusts:** The trust is funded by the grantor's residence or vacation home. The grantor can reside in the residence for a specified period of years, at the end of which die property passes to trust beneficiaries.

**Insurance Trusts:** An irrevocable trust that owns insurance on the lives of one or more people. The trust provides for the disposition of the proceeds. The trust must be irrevocable to take advantage of any tax benefits.

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act. This new legislation changes some 441 tax laws, and lowers rates on several types of estate tax. For example, beginning in 2002 and continuing through 2009, there will be an increase in the amount of assets that can be transferred without tax liability and in 2009, estate and other related taxes will be repealed altogether.

These changes could have a significant impact on the structure and tax liability of certain trusts. Therefore, it is important to consult with an attorney to ensure the viability of the trust arrangement and that all desired goals will be accomplished. As you consider your options, please contact our offices if we can be of service. □

## CONSUMER TIP:

## BEWARE OF BOGUS TAX SCHEMES MASQUERADING AS TRUSTS

Despite an aggressive attempt by the Internal Revenue Service (IRS) to alert the public to trust scams, certain companies offer bogus trust arrangements.

Most of these schemes involve promises of benefits that are simply too good to be true, such as no capital gains tax on sales of appreciated property, or income deductible personal living expenses. When successfully attacked by the IRS, investors in bogus trust arrangements are usually forced to pay significant penalties and interest on unpaid tax obligations. In addition, many schemes offer defective trusts instruments, putting assets and desired benefits at risk.

According to the IRS, bogus trust schemes almost always use one or a combination of the following names:

- Common law trust
- Constitutional trust
- Pure trust
- Pure equity trust
- Massachusetts trust
- Sovereign trust
- Contractual trust
- Unincorporated business organization (UBO)
- Business trust organization (BTO)
- Patriot trust

In addition, scam artists are likely to throw in the words "freedom" or "liberty" when naming a bogus trust.

To protect your assets, work with a qualified estate-planning attorney when exploring trust options.



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