Irrevocable Trusts

Just the FAQs

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First things first, what is a trust?

A trust is a legal arrangement that provides for the ownership, management, and distribution of property. Think of a trust as a box into which someone places property. The person placing the property into the trust is known as the *grantor of the trust*. The person that oversees the property in the box is the *trustee*. Finally, the person who receives the benefit of the property held in the box is known as the *beneficiary*.

What is an *irrevocable* trust?

An *irrevocable trust* is simply a trust with terms and provisions that cannot be changed by the grantor. This is distinguished from a *revocable trust*, which is commonly used in estate planning and allows the grantor to change the terms of the trust and/or take the property back at any time.

Why would I want to use an irrevocable trust?

Using an irrevocable trust allows you to minimize estate tax, protect assets from creditors, and provide for family members who are minors, financially irresponsible, or who have special needs.

How do I create an irrevocable trust?

To create a trust, the grantor enters into a written trust agreement. He or she names a trustee to hold the property according to the terms of this trust agreement. The trust agreement identifies the beneficiaries and tells the trustee when distributions of trust property (including the original assets placed in trust, as well as the income on such assets) should be made to the beneficiaries. A well drafted trust agreement should plan for certain contingencies, such as what to do if the initial beneficiaries are no longer living.

What are the trustee's duties?

The trustee is the person who is responsible for all aspects of the administration of a trust. The primary duties of any trustee are twofold: (1) to prudently invest and protect the assets of the trust, and (2) to make distributions to the trust beneficiaries according to the terms of the trust agreement. If desirable, more than one individual may be named to serve as co-trustee. Some individuals will name a family member or friend as the primary or alternate trustee. However, other individuals do not have family members or friends that they feel could (or should) take on this role. In such event, it may make sense to name a qualified bank or trust company to undertake this responsibility. The trustee is required to act in the best interest of the trust beneficiaries. This duty of loyalty is known as *fiduciary duty*, and it places a very high (and legally enforceable) standard of care and expectations upon the trustee.

Who should I name as trustee?

Any individual, other than the grantor, may serve as trustee of a trust, including the grantor's spouse, children, family members, or friends. Of course, given the fiduciary duties required of a trustee, you'll want to choose someone who is honest, diligent, and trustworthy (no pun intended!). If you would rather have an independent party act as trustee, there are a number of very well qualified professional trust companies in the community. If desirable, more than one individual may be named to serve as co-trustee.

Who can be a beneficiary of a trust?

Anyone other than the grantor may be named as a beneficiary of the Trust. Different family circumstances may dictate the need to structure the trust for different beneficiaries.

Can I amend the irrevocable trust agreement?

As the name implies, once the trust agreement is signed, it cannot be amended or revoked. However, the trust agreement should be drafted in a flexible manner to allow the trustee to address unforeseen changes in circumstances.

What are the tax benefits of establishing an irrevocable trust?

Generally, if you make a gift of an asset to a beneficiary during life, the asset is not included in your taxable estate at your death. An irrevocable trust provides an alternative to simply giving an asset to a beneficiary in order to reduce your taxable estate. With a trust, you can set the timing of distributions (i.e. when the beneficiary attains 30 years of age) as well as the reasons for distributions (i.e. for education only). Therefore, if your estate is close to or in excess of $2 million, *including life insurance proceeds*, and you are not comfortable making outright gifts to beneficiaries, you should consider setting up an irrevocable trust to take advantage of the substantial estate tax savings such a trust offers.

What are the non-tax benefits of establishing an irrevocable trust?

Another significant benefit of an irrevocable trust is that it provides substantial protection from creditors. Once assets are transferred to the trust, they no longer belong to the grantor, rather, they become the legal property of the trustee to hold for the beneficiaries. This means that the grantor's future creditors cannot place a lien on assets transferred to the trust because those assets no longer belong to the grantor. Similarly, creditors of a beneficiary of an irrevocable trust generally cannot place a lien against trust assets until such assets are actually distributed to the beneficiary.

How much can I transfer into the trust?

There is no limit to how much you can transfer into the trust. Of course, the trust is irrevocable, so once you have transferred the assets, you can't use them or benefit from those assets, and if you do, they will likely be included in your estate for tax purposes. If you transfer over a certain amount, you will be required to file a gift tax return and may be have to pay a gift tax on the transfer.

How much can I transfer without causing gift tax?

Each year, you may make a tax-free transfer of an amount up to the gift tax annual exclusion amount (see Estate Planning insert for current exclusion) to as many individuals as you desire. In order to qualify for the annual exclusion, the gift must be a "present interest" gift. A present interest gift is a gift over which the beneficiary has full control at the time the gift is made. For instance, if John gives Jane $10,000 in cash, Jane has full control over this amount immediately. Therefore, the gift will be deemed a "present interest" gift and it will qualify for the annual exclusion. However, if John gives Jane a check for $10,000 in December and does not allow Jane to cash it until the following year in February, Jane does not have immediate use of the funds when she receives the check in December. This gift is not a present interest gift and does not qualify for the annual exclusion. In this case, the entire amount of the gift is taxable even though the total dollar amount is less than the gift tax annual exclusion. A gift to a trust is generally not considered a present interest gift.

Is there a way to qualify gifts to a trust for the annual exclusion?

Yes. In order to make a gift to a trust qualify for as a present interest gift, the beneficiary must be given the right to withdraw the transferred funds for a specified period of time after the gift is made. This right to withdraw the funds is often referred to as a *Crummey Withdrawal Right* (so named after the creator of this technique, Mr. Crummey…seriously, that was his name!). Beneficiaries must be notified of this right to withdraw each time a transfer is made to the trust in order to ensure that the transfer qualifies as an annual exclusion gift.

Can I make gifts to the trust that exceed the annual exclusion amount?

Yes. In addition to the gift tax annual exclusion amount, each person may make tax-free gifts throughout his or her lifetime, or upon death, up to the gift and estate tax exemption amount (see Estate Planning insert for current exemption). People who have stock or real estate that they believe will appreciate significantly often make larger gifts to the trust to not only remove the asset from their taxable estate, but also to remove all of the future appreciation.

Do I need to file a gift tax return for transfers to the trust?

Gifts to an irrevocable trust are treated as gifts to the underlying trust beneficiaries. If the grantor's aggregate annual gifts to a beneficiary (whether through the trust or outside of the trust) did not exceed the gift tax annual exclusion amount, a federal gift tax return is not required (assuming Crummey Withdrawal Rights were given to the trust beneficiaries). However, a gift tax return is required if (1) the grantor made gifts in excess of the annual exclusion; (2) the grantor desired to use his or her spouse's annual exclusion amount (to increase his or her gift to double the gift tax annual exclusion amount per beneficiary); or (3) the trust was designed as a "generation skipping trust."

What assets can I transfer to an irrevocable trust?

Frankly, just about any asset can be transferred to an irrevocable trust, assuming the grantor is willing to give it away. This includes cash, stock portfolios, real estate, life insurance policies, and business interests. Of course, some assets are better to place in trust than others.

What are the best assets to place in a trust?

If your goal is to transfer assets into an irrevocable trust in order to reduce your taxable estate, certain assets can be used to leverage your gift tax annual exclusion. In other words, if you place highly appreciating assets in trust, you will not only transfer the initial amount, but all future growth (income and appreciation as well). Thus, some assets are "better" than others when it comes to excluding the asset from your estate and maximizing the amount that will pass tax-free to beneficiaries. For instance, if you place a certificate of deposit in trust, it may grow at a rate of 3% per year. However, if you place real estate in trust, it may grow at a rate of 6% per year. In five years, there may be a significant difference between what you retained in your estate and what has grown in the trust. Now, if you were renting the real estate, the additional net income grows in the trust and you have enhanced the initial transfer even further. Moreover, suppose you have a life insurance policy with a current value of $10,000 and a death benefit of $1 million. If you place the policy in trust, you have turned your $10,000 transfer into a $1 million tax-free benefit for your beneficiaries. The benefit of transferring life insurance policies is more fully explained below.

Can I sell assets to the Trust?

Yes. You may sell assets to your trust for fair market value.

Why would I want to sell assets to the trust?

Irrevocable trusts are often set up as *grantor trusts*, which simply means that they are not recognized for income tax purposes (all of the income tax attributes of the trust, such as income, loss, gains, etc. is passed on to the grantor of the trust). The trust can therefore purchase a grantor's asset for immediate payment or on an installment basis, with no recognition of gain and no gift tax consequences. The sale of an asset to an irrevocable trust is often recommended if the asset to be transferred is a life insurance policy, or if the asset is in excess of the annual exclusion amount and is expected to appreciate rapidly.

Can I make additions to the trust in future years?

Yes. If the grantor desires the gift to qualify for the annual gift tax exclusion, the trustee must follow the Crummey withdrawal notice procedure each time a gift is made to the trust. A copy of these notices should be kept with the trust records in the event the trust is ever audited.

What is an ILIT?

ILIT is an acronym for *irrevocable life insurance trust*. It is really nothing more than an irrevocable trust that is designed to hold one or more life insurance policies on the life of the grantor. The trust and tax laws are the same for irrevocable trusts regardless of whether they hold life insurance or any other type of asset. Because life insurance policies are so commonly transferred to (or purchased by) irrevocable trusts, such trusts have received their own name, ILIT.

Once I set up a trust, how do I actually transfer assets to the trust?

To transfer cash or securities, the trustee will open an account in the trust's name, and the grantor will instruct his or her bank or broker to move the funds from his or her account to the trust's account. For real estate, a deed is used to transfer legal title of the property from the grantor to the trust. All future insurance and property tax statements should be sent to the trustee and paid with trust funds. Finally, to transfer an existing life insurance policy, the grantor simply needs to obtain and complete a change of ownership form and change of beneficiary form from his or her life insurance company.

If I transfer my life insurance policy to a trust, are the benefits immediate?

No. The insurance policy must be transferred to the trust at least three years before the insured's death. This *three year rule* prevents people from giving away life insurance policies on their deathbeds and "cheating" the IRS out of the estate tax on the proceeds. The three year rule, however, only applies to gifts of policies, not sales of policies. To avoid the three year rule, many clients prefer to transfer cash to the trust and then have the trust purchase the policy from them. Because the trust is a grantor trust, there is no income tax consequence to this type of sale and the three year rule is effectively avoided.

Can I use a trust to purchase a new life insurance policy?

Absolutely. In fact, it is recommended that you establish the trust and then have the trustee apply for life insurance on your life. However, if you have begun the process and applied for the insurance under your own name, you can still proceed with the trust formation.

Are there any special responsibilities placed on an ILIT trustee?

If the trustee considers the existing life insurance to be a good investment, then the trustee's responsibilities are primarily to hold the policy, receive annual cash transfers to cover policy premiums, keep trust beneficiaries informed, and ultimately, ensure that policy premiums are paid timely. After the insured dies, the policy proceeds are paid to the trustee, and the trustee's focus shifts from maintaining the policy to managing trust investments and making distributions to trust beneficiaries.

Does the trust need to file annual income tax returns?

Yes. Trusts are separate legal entities and are required to file annual income tax returns. Generally, if income is not distributed to the beneficiaries, it is reported by the trust. If income is distributed to the beneficiaries, it is reported by the beneficiaries. However, trusts are often designed as grantor trusts, which require the grantor to report all income earned by the trust on the grantor's individual return. This provides several benefits: (1) it doesn't erode the amount the grantor has gifted to the trust, thus allowing the trust to stay as fully funded as possible; (2) it allows the grantor to pay the tax at the grantor's tax bracket, which is often less than the highly compressed trust tax brackets; and (3) it allows the grantor to sell assets to the trust without recognition of gain.

How do I get started setting up an irrevocable trust?

The first step is to contact one of the attorneys in our Estate Planning & Probate Group. We will send you some background information and an initial questionnaire to get you started with the process. We will then set up a time to meet to discuss your family circumstances, specific estate planning goals, and tax issues.

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