The Fundamentals of Trusts

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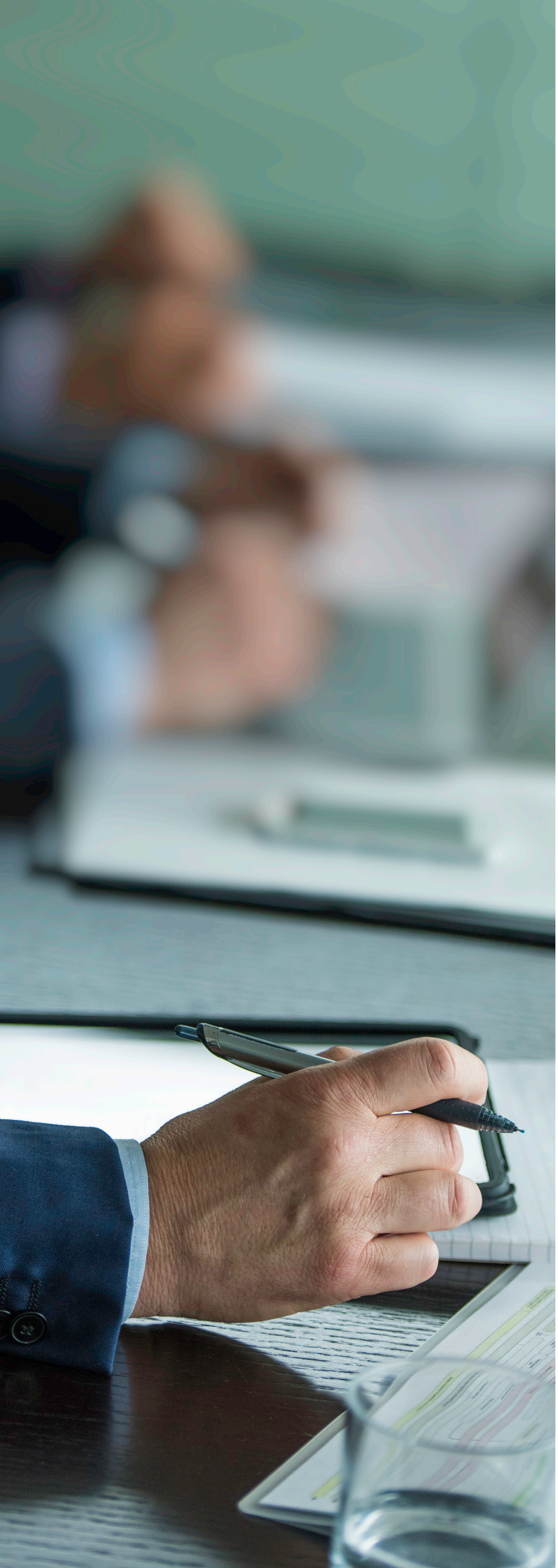


In This Brochure

Why Create a Trust

One of the most frequently utilized strategies in estate planning is the use of trusts. Trusts were once associated with high net worth individuals as a way to pass money to heirs or charitable organizations, but they are fast becoming a popular tool for everyone. The main reason people create a trust is to have control over who receives their assets. Trusts can offer other advantages such as keeping your estate private, protecting your legacy and avoiding probate.

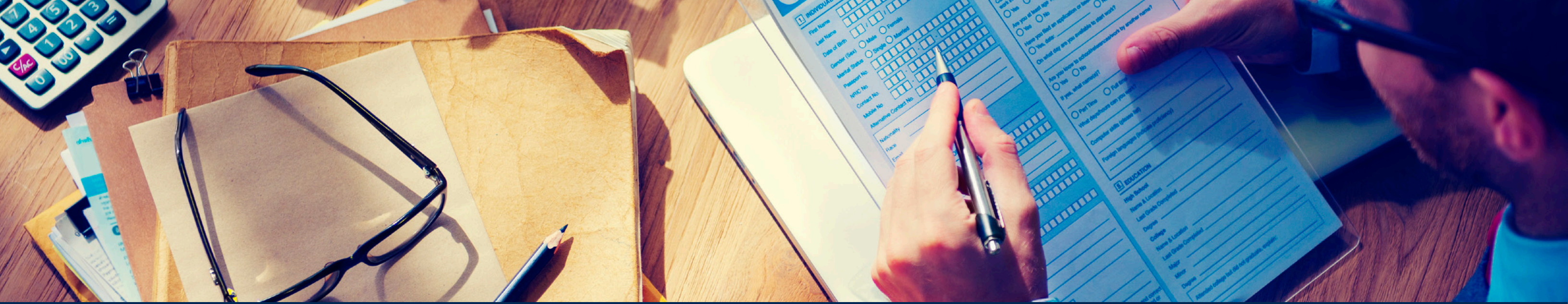
Probate: The legal process of distributing and settling an estate according to the law. Any interested party can see what you owned and who will receive your assets.

Reasons to Consider a Trust

- Tax planning purposes
- Concerns of a spendthrift beneficiary
  - ***Spendthrift Beneficiary:*** A beneficiary who spends money recklessly
- To avoid probate
- To plan for an underage or special needs individual
- Charitable planning
- Simply for privacy

Three Ways to Create a Trust with an Attorney

1. **Drafted Trust:** Living trust
2. **Sub-Trust:** Springs from an existing trust
3. **Testamentary Trust:** Contained within a last will and testament



Trust Terminology

Trust:

A fiduciary arrangement in which one party (the trustor) gives another party (the trustee) the right to manage property for the benefit of another party.

Living Trust: *A legal document through which assets are placed into a trust during an individual's lifetime, then transferred to the designated beneficiaries at their death.*

Trustee:

The individual appointed with the legal responsibility of managing property for the benefit of someone else. They are responsible for executing the directives of the trust and managing the trust assets. A trustee can be an individual or a corporation that provides trustee services.

- A trustee is a fiduciary. They have a legal duty to care for property and act in a manner that follows the strict principles and standards set by law.
- Every trust should have a successor trustee in the event the trustee is unable or unwilling to perform his or her duties.

Grantor:

Also known as a trustor, is the individual who creates the trust. After transferring property to the trust, the grantor can no longer have interest in the trust assets, but the terms of the trust are directed by the grantor.

Trust Beneficiary or Beneficial Owner:

The individual who receives the benefits from the trust either in the form of income or remainder assets. The trust may have more than one beneficiary and they have no administrative powers over the trust.

- ***Income Beneficiary:*** A designated beneficiary who is entitled to income from the trust.
- ***Remainder Beneficiary:*** A designated secondary beneficiary who receives assets if the primary beneficiary is ineligible.

Trust Document:

The written legal arrangement that outlines the duties of the trustee, and the rights of the trust beneficiaries. A trust is drafted by an attorney during the life of the grantor.

Trust Categories

All living trusts are either revocable or irrevocable. Both types of trusts avoid probate. Assets held in these trusts will pass directly to the named beneficiaries.

Revocable:

Also referred to as an inter vivos trust, it can be changed or terminated by the trustor during their lifetime, and can be modified using a trust amendment. If the trustee and grantor are different people, the grantor retains all powers under the trust and trust assets.

Advantages

- Plan for mental disability
  - The grantor can name a successor trustee to take over the trust if he/she becomes mentally incapacitated.
- Maintain control over assets
  - You keep full control of your assets. You can make changes and even cancel your trust.

Disadvantages

- Creditors
  - Assets in a revocable trust are not protected from creditors. They can be ordered to be liquated if the owner of the trust is sued.
- Taxable estate
  - Assets remain in the grantor's taxable estate.

Revocable living trusts can be created to cover spouses. These trusts are known as, joint revocable trusts. In the case of a joint revocable trust, the trust will not become irrevocable until both spouses pass away.

Irrevocable:

A trust that cannot be amended by the grantor once the agreement has been signed and the trust has been formed and funded. At death of the trust grantor, every revocable trust becomes irrevocable.

Advantages

- Estate tax reduction
  - Property that has been transferred to an irrevocable living trust does not contribute to the gross value of your estate for estate tax purposes.
- Charitable giving
  - If the trustee donates money to charity through a trust they may receive a tax deduction.
- Creditor protection
  - Since your trust owns your property and assets, they are safe from creditors.

Disadvantages

- Loss of control
  - Once an irrevocable trust is established, the grantor loses ownership of the trust property.
- Taxes
  - An irrevocable trust is a separately taxable entity. If the trust earns an income of at least $600 in the tax year, the trustee must file federal income taxes and pay taxes out of the trust.[1]

Irrevocable living trusts are created while the grantor is still alive. Irrevocable testamentary trusts go into effect when the grantor has died.

[1] Carnes, David. "What Are the Disadvantages of an Irrevocable Trust?" LegalZoom, 18 July 2016, info.legalzoom.com/disadvantages-irrevocable-trust-20406.html.

Types of Trusts

All trusts have a:

- Grantor
- Trustee
- Income Beneficiary
- Remainder Beneficiary

There are many different types of trusts. The following are several of the most common.

Credit Shelter Trust (CST):

An irrevocable trust that allows a person to leave an amount, up to the estate tax exemption, to heirs. It can be funded during the life of the grantor with a gift of assets to the trust. A CST does not exist until the death of the first spouse.

The purpose of this trust is to maximize spousal estate tax exclusions and provide income to the surviving spouse.

How does it work?

An amount up to the current federal estate tax exclusion is transferred to the trust upon the death of the first spouse. The surviving spouse has the right to income and can access principal under certain circumstances set by the trust. Since the trust is managed by the trustee, the surviving spouse never actually takes control of the trust assets. The value of the trust is passed to the children without transfer tax. The transfer does not add to the surviving spouse's taxable estate.

Benefits:

- Allows you to maximize use of the estate tax exclusions.
- Shelters trust appreciation from transfer tax.
- Provides the surviving spouse with income.

Qualified Terminable Interest Property (QTIP) Trust:

This type of trust is setup to provide income to a surviving spouse, while avoiding disinheriting the heirs of the deceased spouse.

A QTIP trust is commonly used by people who have children from a prior marriage. It ensures that the grantor can pass his or her assets to both the current spouse and the children.

How does it work?

Upon the death of the first spouse, the QTIP is funded. Then the surviving spouse receives payments from the trust for the rest of their life. The spouse has limited access to the trust's assets and is never the true owner of the property. At the death of the surviving spouse, the assets in the trust become property of the listed beneficiaries. The surviving spouse cannot change the beneficiaries set by the grantor.

Benefits:

- Protects the beneficiaries.
- Controls the spouse's access to assets in the trust while still allowing for the estate tax marital deduction.

The unlimited marital deduction provision allows an individual to transfer an unrestricted amount of assets to his/her spouse at any time, including at death of the transferor, free from tax.

Generation Skipping Trust (GST):

A legally binding trust agreement in which assets are passed down to the grantor's grandchildren (or anyone that is 37 ½ years younger than them) to skip beneficiaries. This type of trust helps to avoid the estate taxes that would have been applicable if the assets were transferred directly to the grantor's children. It minimizes the generation skipping transfer tax and maximizes the use of the Generation-Skipping Tax exemption.[2]

How does it work?

Upon the death of the first grandparent, the trust is funded and the income is paid to the surviving grandparent. Upon the death of the surviving grandparent, the grandchildren will receive the remaining trust assets.

Benefits:

- Reduces the generation skipping transfer tax.
- Reduces taxes, since any amount accumulated in the trust would be free of any additional GSTT when it is paid out to the beneficiaries.

- *Congress enacted the GST tax in 1976 to prevent families from avoiding the estate tax for one or more generations by making gifts or bequests directly to grandchildren or great grandchildren. It imposes a second layer of tax on wealth transfers to recipients who are two or more generations younger.*
- *The Generation-Skipping Tax Exemption is the amount that can be directly transferred to grandchildren or into a generation-skipping trust for the benefit of grandchildren without incurring a federal GSTT. It shares the same lifetime exemption as the federal estate and gift taxes as of 2018. As of January 1, 2018 the exemption for individuals is $11.2 million and for couples is $22.4 million.*

[2] Owner of Site. "Generation-Skipping Trust." Investopedia, 9 May 2018, www.investopedia.com/terms/g/generation-skippingtrust.asp.

Grantor Retained Annuity Trust (GRAT):

A type of irrevocable trust that allows the grantor to potentially pass a significant amount of wealth to the next generation at a discounted gift tax value. It also shifts future appreciation to the trust beneficiary free of gift and estate tax.

This trust is utilized to minimize taxes on large financial gifts to family members.

How does it work?

The trust is created to pay the grantor annuity payments for a specified number of years. The transfer of assets to the trust are gift taxable up to the projected present value* of the remainder interest at the end of the trust term. At the end of the trust term, the remaining trust assets pass to the beneficiaries free of gift tax. If the grantor dies before the trust term, the remaining payments from the trust become part of their taxable estate and the beneficiaries receive nothing.

Benefits:

- If the grantor survives through the end of the trust term, the beneficiaries will receive the proceeds free of additional gift or estate tax. If the assets in the trust appreciate and the beneficiaries receive more than the original gift tax calculation projected, the excess amount is not subject to gift taxation.

Charitable Trusts:

A type of irrevocable trust that provides the grantor a way to make a delayed charitable gift while receiving a current income tax deduction, an income stream, a reduction in their taxable estate and avoid a capital gains tax on the sale of assets transferred to the trust.

How does it work?

When the trust is drafted the assets are gifted to the trust. By transferring those assets, the grantor receives a partial income tax deduction. The grantor then receives an income stream from the trust for the duration of the trust. At the death of the grantor/annuitant, or at the end of the trust term, the remaining assets pay out to the charity.

Charitable trusts can be structured so that the charitable interest commences immediately (Charitable Lead Trust) or after a specified time or upon death (Charitable Remainder Trust)

Benefits:

- During the trust term the grantor receives an income stream.
- The grantor receives a current income tax deduction for a future gift to charity.
- The remaining assets that are left to the charity at the end of the trust term, or death of the annuitant will be excluded from their taxable estate.

Charitable trusts are exempt from capital gains taxes, but any income that pays out of the trust is taxed in the following order:

- Ordinary Income
- Capital Gains Income
- Tax-Exempt Income
- Trust Corpus

* The projected present value of the income stream to the grantor is calculated using current interest rate assumptions (IRS 7520 rate).[3]

[3] Owner of Site. "Section 7520 Interest Rates." IRS, 7 November 2018, https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates.

Special Needs Trust:

This trust is established to separate assets from a special needs individual in order to maintain eligibility for benefits such as Social Security Income (SSI) and Medicaid.

The proceeds in this trust cover the percentage of a person's financial needs that are not covered by public assistance payments.

How does it work?

This type of trust is funded at the death of the individual who cares for the individual with special needs. The assets pass to the trust, thus avoiding being owned by the special needs individual. The proceeds from this trust will typically be put towards medical caretaker expenses. The proceeds do not count towards qualifying for public assistance. The trustee will supervise the distribution and management of the funds. Assets put into the trust originally belonging to the special needs individual may be subject to Medicaid's repayment rules.[4]

The special needs trust must be established before the beneficiary turns 65.[5]

Benefits:

- Provides control over assets for an individual who may not be able to handle them on their own.
- Ensures that the special needs individual maintains eligibility for SSI and Medicaid benefits.
- Guarantees that the proceeds will be used for their intended purpose.
- Assets provided to the trust by a parent or other third party are not subject to Medicaid's repayment rules.

Irrevocable Life Insurance Trust (ILIT):

A type of trust set up to own a life insurance policy. Ownership can be transferred to the ILIT after it has been formed or the trust can purchase the policy directly. An ILIT cannot be rescinded, amended or changed in any way once it is created.

How does it work?

The trust is typically designated as the primary beneficiary. When the insured dies, the death benefit is deposited into the ILIT. It is then held in the trust for the benefit of the individuals named in the trust document to receive the money. A trustee acts as a supervisor for the trust and distributes the assets in accordance with the terms of the trust set by the grantor.

Benefits:

- The proceeds from the death benefit will not be part of the insured gross estate, therefore not subject to state and federal estate taxes.
- Avoids gift tax consequences, if drafted properly.
- The trustee can have discretionary powers to make distributions and control when beneficiaries receive proceeds of the policy.

[4] The information provided on Special Needs Trusts is not intended to give legal, tax or Medicaid advice. It is important to consult with an attorney specializing in special needs issues when creating this type of trust.
[5] Owner of Site. "Special Needs Trust." Investopedia, 2018, www.investopedia.com/terms/s/special-needs-trust.asp

Important Trustee Considerations

Health

Your trustee's poor health could impede their ability to execute their duties

Relationship

A trustee that is a family member may have a difficult time being presented with a conflict of interest

Financial Intelligence

Your trustee should have enough financial knowledge to be able to evaluate and understand how to make financial decisions

Get Started Today

Trusts are flexible, varied and complex. Each type has its advantages and disadvantages, but having a basic understanding of the different types and how they work can be advantageous to both you and your heirs. No matter your financial situation, setting up a trust is an excellent financial tool to ensure your estate is well served.

Contact your Oppenheimer Financial Advisor to assist you in creating a comprehensive estate plan to help you feel more confident about the future and that your loved ones will be taken care of.

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