Wealth Transfer Planning? There's a Trust for That

By Claire E. Toth, JD, MLT, CFP™
Point View Wealth Management, Inc.
ctoth@ptview.com
(908) 598-1717
September 26, 2014

When most people hear the word "trust," they think complicated setups with big tax savings. That may or may not be the reality. A trust, like a corporation, is merely an entity. Calling something a trust tells you very little about how it works or what its purpose is. People tend to create one of three basic sorts of trusts: for themselves, for loved ones, or for a combination of charity and themselves or their loved ones. Each of these three basic types of trust has different purposes, different tax consequences, and operates differently.

Every trust has three different players: the grantor, who creates the trust and moves assets into it, the trustee, who runs the trust, and the beneficiary, on whose behalf the trust is created. A person can wear one, two, or all of these hats at once.

Revocable Trust/Living Trust

These two terms are used interchangeably and mean the same thing. Typically, you create a trust for your own benefit, transfer your assets into it, and run the trust for yourself. Thus initially, you play all three roles. If at some point during your life, you choose not to or can no longer manage your own money, the successor trustee you have appointed steps in and manages the assets for your benefit. This trust also acts as like a will, stating who receives your assets at your death (for other reasons, you still need an actual will). The trust assets go directly to those beneficiaries, without going through the probate process that otherwise occurs at death.

Importantly, a revocable trust does not save taxes. You are treated as owning all of the assets during your life. You report all of the trust income on your tax return, and if you are subject to estate tax, you are considered to own all of the trust's assets.

So why set up a revocable trust? There are many non-tax reasons. If you live in a state where probate is long, complicated, and expensive (think Florida, New York, California, and New Hampshire, among others), using a revocable trust is standard operating procedure. Trust assets can move directly to heirs without the cost and delay of probate. If you own a vacation home or other real property outside of the state where you live, put it in a revocable trust—otherwise it must go through a probate process in the state where it is located. If you choose to disinherit a family member, a trust can typically better withstand a court challenge than can a will.

More important than these benefits is the benefit to you while you are alive. Most of us who live long enough reach the stage where we shouldn't manage our own financial affairs unassisted. An adult child or other trusted person can far more easily manage your affairs as trustee of a trust than by using a power of attorney (which you still need for many other reasons). Banks, brokerages, and other financial institutions deal with trusts all the time; it is much more awkward for another person to deal with them on your behalf using a power of attorney. Investors who have reached retirement age should seriously consider incorporating a revocable trust into their estate plans.

Trusts for Others

When most people think of trusts, this is what they conjure up: a rich relative leaving a huge pile of money to heirs, with a bank running the show. Planning professionals speak of these trusts as protecting the beneficiary from "creditors and predators."

Trusts for others can be established during the grantor's life, or at death, under a will or another trust (such as that revocable trust). The trust usually pays out regularly to the beneficiary—its income or a fixed percentage of its value on a regular basis. The trust principal may be distributed as well, when the beneficiary reaches a certain age, or if it's needed to buy a home, pay medical bills, or fund an education.

As this suggests, trusts for others are almost endlessly flexible. The beneficiary often—but not always—is not considered to own the trust assets. This can save estate tax when the beneficiary dies. During his lifetime, it keeps trust assets out of the hands of creditors, ex-spouses, and the like. Some trusts are set up to last for generations, passing access to—but not legal ownership up—significant money for several decades.

If you live in a state with an estate tax—that includes New York, New Jersey, and Massachusetts, among others—chances are your estate plan includes a trust for the surviving spouse. It may be called a bypass trust or a disclaimer trust. This works to maximize the amount a married couple can exclude from the state estate tax, while still making all the assets available to the survivor.

Special purpose trusts also exist. Life insurance trusts own the policy on the grantor, keeping any proceeds free of estate taxes. Special needs trusts benefit disabled family members without disqualifying them for government assistance programs.

Trusts for Charities

Trusts that benefit both charity and people must follow very specific rules. The trust is divided temporally between the two classes of beneficiaries. If payments to the charity come first, it's known as a charitable lead trust. If the people are paid first, it's a charitable remainder trust. In each case, the first series of payments must be either a percentage of the trust's value or a fixed dollar amount.

Tax law requires that each interest be valued using an interest rate tied to that paid on Treasury bonds. With interest rates at historic lows, this tends to overstate the payments coming out first and understate the remainder. As a result, if you set up a charitable lead trust and leave the remainder to your children, you may be able to transfer significant wealth to your children at a large discount for gift and estate tax purposes.

Charitable trusts come with costs and complicated tax rules. They can make sense if you intend to transfer at least $1 million. For smaller amounts, non-trust alternatives will likely serve better.