USING TRUSTS IN ESTATE PLANNING

How trusts can help you provide for your family when you're gone.

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What is a trust?

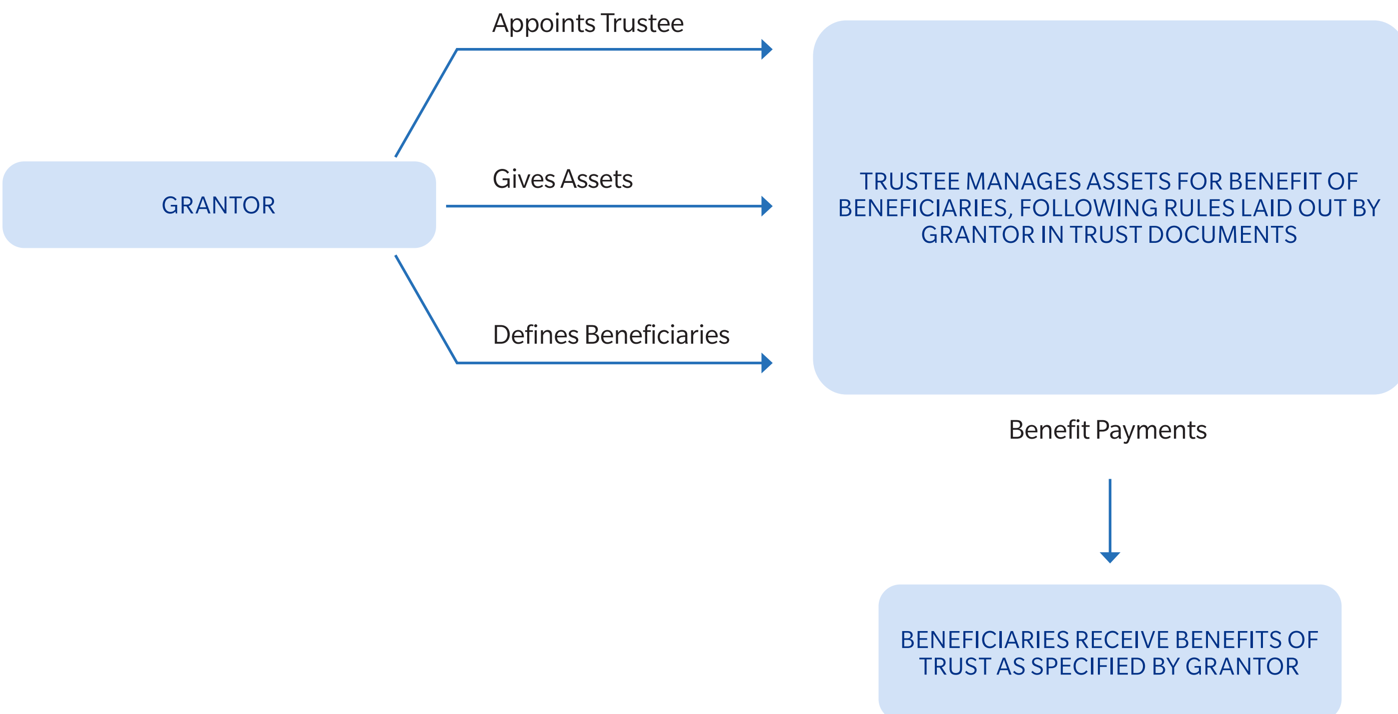
A trust is a legal entity that owns and manages property for the benefit of another.

The person creating the trust, called the grantor, establishes the trust by transferring assets to the trust and nominating a person, the trustee, to manage the trust.

The trustee agrees to manage the trust according to the rules the grantor sets out in the document creating the trust. The trust document also defines the beneficiaries of the trust — the individuals or organizations to whom the trust will provide benefits.

In order for assets to be managed by a trust, they must be titled in the name of the trust, rather than in the name of the grantor. This can involve establishing separate bank accounts, re-titling real property, or re-registering securities. This is an important step in protecting the assets, yet it is occasionally overlooked, leaving the trust a paper entity with no assets to manage.

Establishing a trust



These different roles are not always filled by different people. A grantor may also be the trustee or beneficiary of a trust, or the grantor may appoint the beneficiary of a trust as its trustee. The choice of trustee and beneficiaries can have important tax and legal implications that should be discussed with your attorney.

A husband and wife may create a trust together and transfer property into that trust, with each spouse being a grantor, trustee and beneficiary of the trust. Upon the death of the last surviving spouse, the remainder of the trust's assets could then pass to contingent beneficiaries such as children or a charitable organization.

Why create a trust?

A trust allows its grantor to set up separate legal management of the assets in the trust.

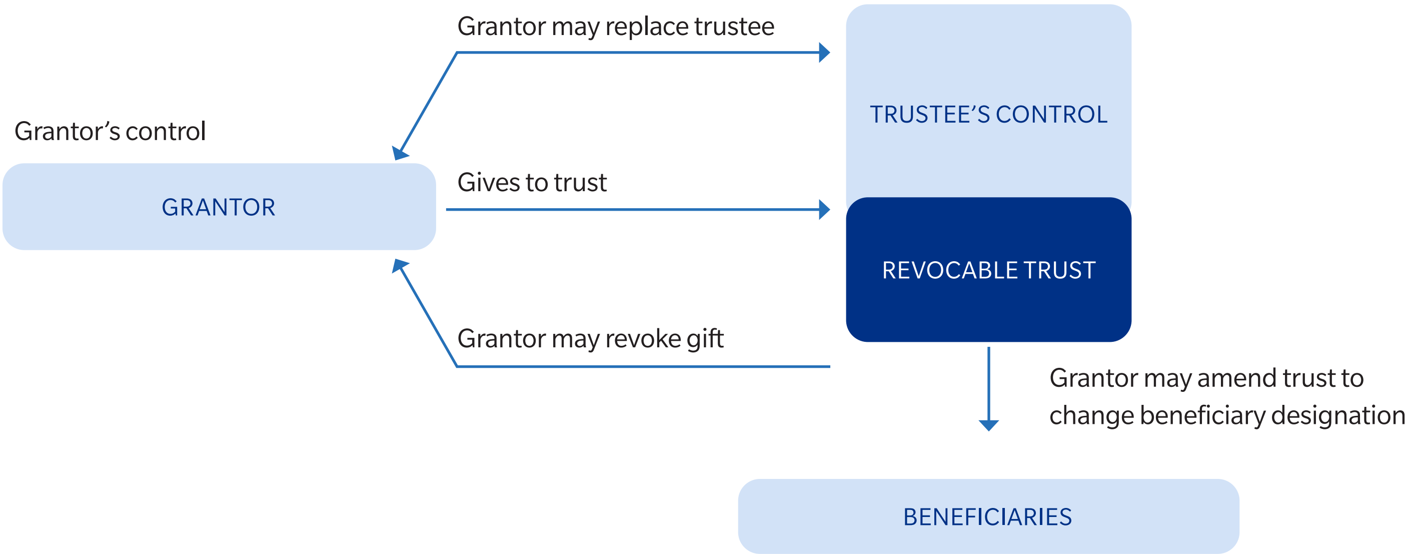
This can have many benefits in estate planning, including helping to:

- Avoid probate
- Remove assets from the taxable estate
- Protect assets from creditors and liability
- Establish trusted management of assets
- Provide ongoing support to beneficiaries
- Promote personal values
- Create a charitable legacy

Revocable vs. Irrevocable Trusts

There are many types of trusts. One of the key distinctions is whether a trust is revocable or irrevocable. A revocable trust is one the grantor can revoke or change — the grantor may remove assets from the trust, replace the trustee, change the beneficiaries of the trust, or change the instructions on which the trust operates. Because the grantor retains control over the trust and its assets, those assets are still treated as the property of the grantor for many tax and legal purposes.

Inside grantor's control and taxable estate

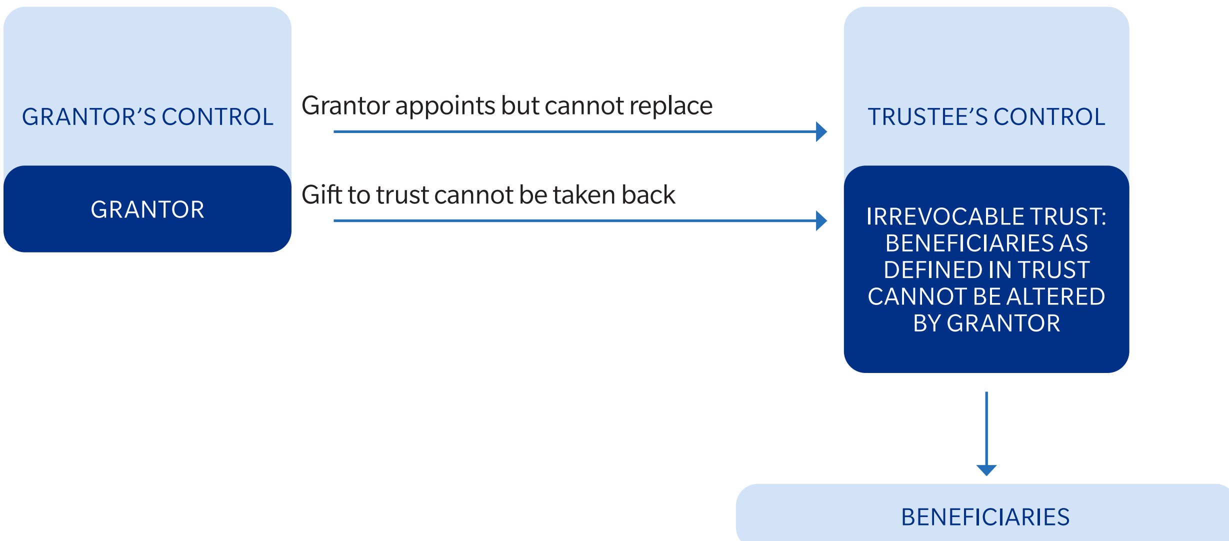


Irrevocable Trusts

By contrast, putting assets into an irrevocable trust is generally a permanent decision. The grantor generally cannot take back assets from an irrevocable trust, alter the trust document or change the beneficiaries of the trust. The grantor generally has given up all rights to the assets placed in an irrevocable trust, and these assets are no longer part of the grantor's taxable estate, or available to pay income taxes, creditors or other liabilities of the grantor.

The permanence of an irrevocable trust makes careful planning extremely important. The design of the trust should allow for the uncertainty of the future — how will the trust adapt to the death of a beneficiary? When a trust is created to benefit the grantor's spouse, what will happen in the event their marriage is dissolved? How much flexibility does the trustee have in dealing with unanticipated tax law changes or other events beyond the trustee's control? An experienced estate planner can help you consider the many contingencies your trust agreement should include.

Irrevocable trust out of grantor's control and taxable estate



Lifetime vs. Testamentary Trusts

Commonly, a trust is created while the grantor is alive. This can provide protection and management of trust assets for the benefit of the grantor as well as other beneficiaries. A trust created during the grantor's life is commonly referred to as a lifetime trust. A lifetime trust may be revocable or irrevocable, depending on the grantor's needs and desires.

Trusts can also be drafted in advance, and spring into being at a triggering event. The most common triggering event is the death of the grantor, though trusts can also be triggered by disability or other events. A trust drafted to begin at the grantor's death is known as a testamentary trust. This can place specified assets into a pre-defined trust during probate, which can reduce but not eliminate the expense and uncertainty of probate court proceedings.

Placing assets into a trust for the benefit of an individual can also provide more protection and control for those assets than the outright distribution to the individual through a will. Assets left outright to a minor, for example, could be mismanaged by that minor's parents or guardian, or spent recklessly when the child is old enough to access the assets directly. Instead, these assets could be placed in a trust, with a trustee selected by the grantor to reliably manage the assets on behalf of the child. The trust might provide only its income to the beneficiary until an age when the grantor expects the child to have grown into a financially experienced adult.

Whether to create a lifetime or testamentary trust depends on the purposes of the trust, the situation of the grantor and beneficiaries, and the amount of control the grantor wishes to retain while living. These are all issues to be discussed with your tax advisor and/or estate-planning attorney.

Trusts and taxes

There are many specific details that you will need to discuss with your attorney and/or tax advisor, but, in general, the less control you have over an asset, the less likely you are to be taxed on it. Putting assets into a revocable trust leaves you control, but also leaves the assets in your taxable estate, while establishing an irrevocable trust removes your control and also removes the assets from your taxable estate. The IRS is aware that some people would like to avoid the taxes they owe by setting up irrevocable trusts that actually remain in the grantor's control, even though on paper the trustee is separate from the grantor.

To preserve the tax status of a trust, it is important to understand what its particular requirements are. Is your choice of trustee someone the IRS will recognize as independent, or will the IRS deem the trust to be within your control? Can the grantor receive any benefit from the trust? If the grantor's spouse receives benefits from the trust, is separate bookkeeping required to document that those benefits really went to the spouse instead of the grantor?

Another consideration is the taxability of contributions to the trust. If the trust is revocable, the assets you place in the trust remain in your control and within your taxable estate. If the trust is irrevocable, however, then a contribution to the trust is treated as a gift at the time it is made, subject to the usual gift tax rules. (Without such a provision, estate taxation would be largely toothless, as a wealthy individual could transfer assets to trusts in anticipation of death. Taxing contributions that exceed gift tax limits ensures that the government gets a share of the wealth no matter when or how the wealth is transferred.)

In addition, you must consider the tax on any income generated by a trust. Generally, if a trust is revocable, its income is treated as the grantor's income. If a trust is irrevocable, it is generally treated as a separate entity for income tax purposes. Unlike a natural person, a trust has no personal exemptions to income taxes. Trusts also face a very compressed schedule of tax rates compared to individuals, facing relatively high tax levels on low levels of income. If a trust is expected to earn significant income, your attorney may include language that qualifies it as a "grantor trust" under the internal revenue code, allowing its income to be treated as income to the grantor, which becomes a de facto gift to the beneficiary.

Estate planning trusts

Common types of trusts

Beyond the basic form of trust, revocable or irrevocable, and the timing of the trust, lifetime or testamentary, there are many trust details that can be customized to suit individual needs. Following are brief descriptions of some of the most common types of trusts that you may encounter in your estate planning.

Grantor trust

A grantor trust is a trust whose income is treated as income of the grantor. With suitable language, a grantor trust can exclude assets from your taxable estate without creating the overhead and expense of a separate taxable entity. This can make administration of the trust much simpler, since its income is reported on the grantor's personal income tax return.

Totten trust

This is a very simple form of trust commonly used for bank or brokerage accounts. The account registration at the bank or securities firm can specify that, upon the death of the account holder, all assets in the account will automatically transfer to a beneficiary named by the account holder. In effect, the account holder is grantor, trustee, and sole beneficiary of a revocable trust. Upon the death of the account holder, the beneficiary named in the registration paperwork receives the balance of the account.

While the account holder lives, the arrangement can be revoked, a new beneficiary can be named, or the account holder may simply withdraw funds from the account. The beneficiary has no rights to the account until the death of the account holder. At the account holder's death, the account transfers outside of probate, allowing the beneficiary immediate access to the account.

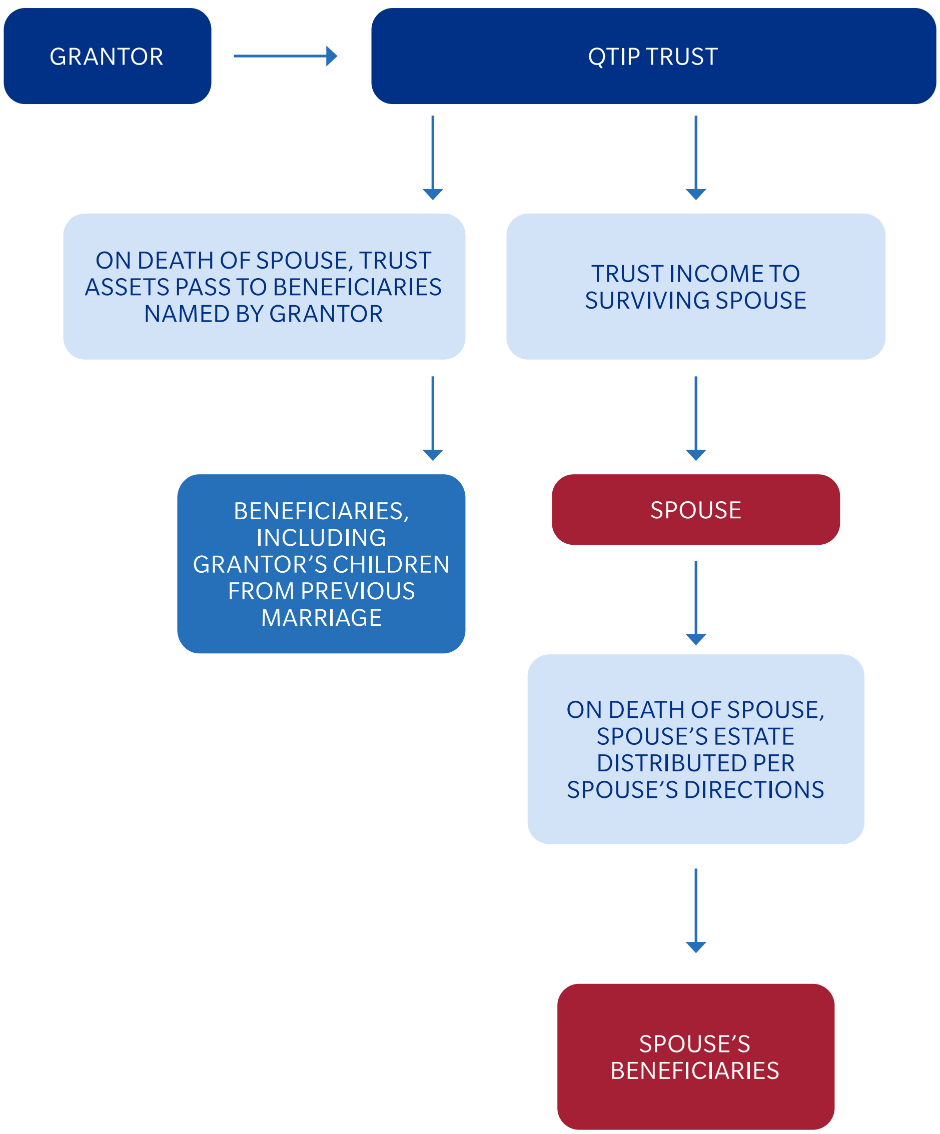
One alternative to the Totten trust is to establish the account as a joint account with the beneficiary. While this may seem simpler, it also gives the beneficiary an immediate interest in the account. The assets may be withdrawn by the joint account holder, and may be attached to satisfy the joint account holder's creditors or other liabilities. The Totten trust can provide much greater protection to the account holder and the assets in the account.

Qualified Terminable Interest Property (QTIP) trust

This trust arrangement is designed to provide for the management and protection of assets left for the benefit of a surviving spouse. The trust is designed so that assets placed into the trust are included in the deceased spouse's unlimited marital deduction, avoiding estate taxes on the death of the first spouse, just as if the assets had been left outright to the surviving spouse.

Unlike an outright bequest to the surviving spouse, the QTIP trust appoints an independent trustee to manage the assets in the trust. The trustee is often required to make the assets of the trust productive. This can help isolate the assets from mismanagement by a financially naïve surviving spouse, and protect the assets from potentially becoming community property should the surviving spouse remarry. A QTIP trust also allows the grantor to specify contingent beneficiaries. This is especially useful when the grantor wishes to ensure that assets pass to children from a prior marriage, rather than to the surviving spouse's own children or other beneficiaries.

QTIP trust

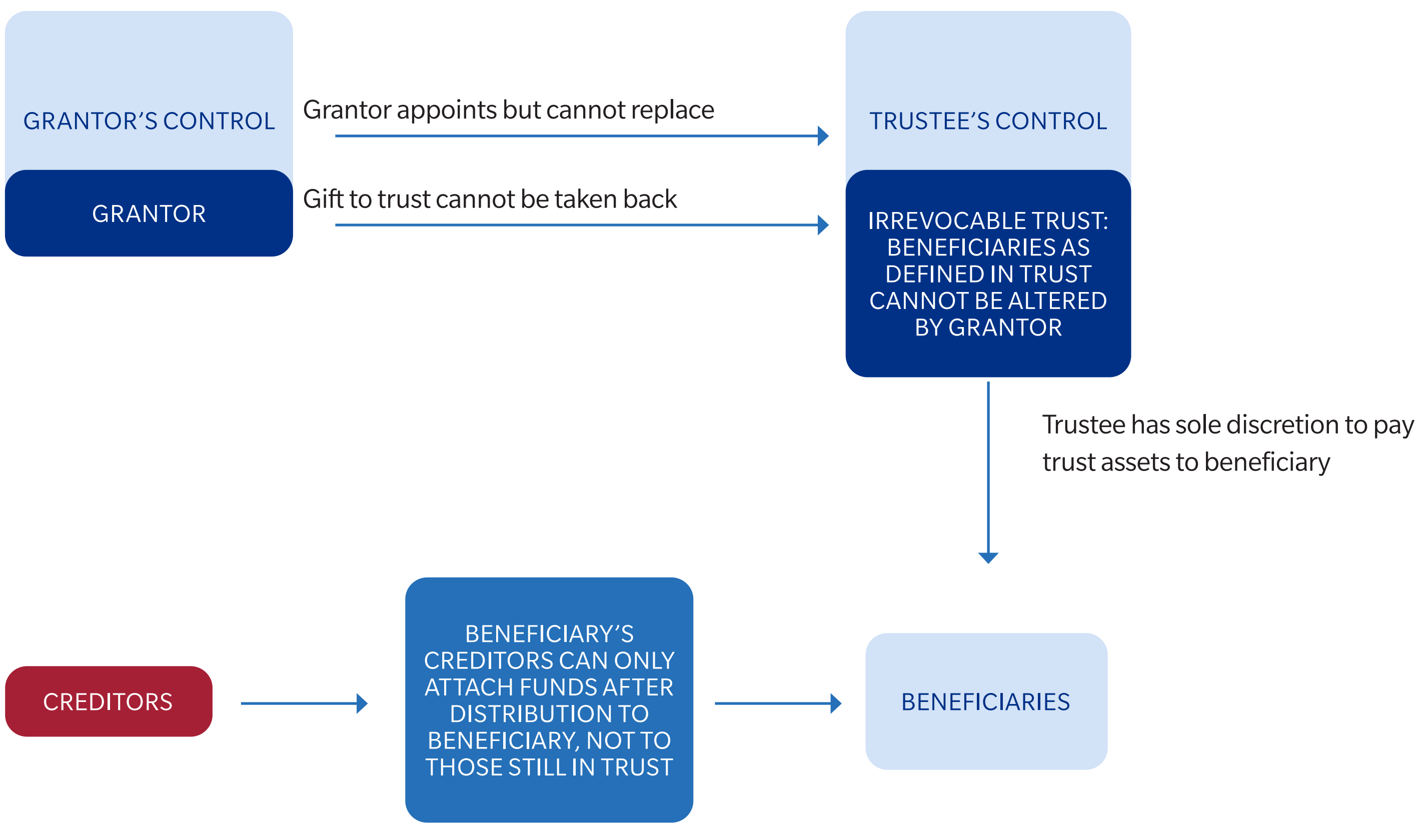


Spendthrift trust

A spendthrift[1] trust is generally designed to preserve assets for a beneficiary who cannot be trusted to manage those assets responsibly. The trust gives an independent trustee the full authority to decide how trust funds may be spent or distributed for the benefit of the beneficiary. The trust document often does not establish any required schedule of payments, leaving that to the discretion of the trustee. The beneficiary cannot force the trust to make any benefit payments unless they are required by the trust document, and cannot give away the right to receive payments in the future. A beneficiary who is unable or unwilling to control spending habits can squander any payments already received, but cannot access trust assets unless the independent trustee approves payment.

Because the payment of trust funds to the beneficiary is entirely at the trustee's discretion, creditors of the beneficiary generally cannot attach trust assets to force payment, except for certain necessities of the beneficiary such as food and shelter, or claims of child support or alimony against the beneficiary. Because future payments are at the discretion of the trustee, creditors generally cannot attach any unscheduled future payments either, and the beneficiary cannot give away the right to these payments, or use future payments as collateral for loans. All other creditors must wait to attach money as it is distributed to the beneficiary.

Spendthrift trust



Estate planning trusts using life insurance

Trusts and life insurance

Life insurance policies and life insurance proceeds can be among the assets owned and managed by a trust. Trusts can offer multiple advantages for life insurance. The policy itself can be removed from the owner's taxable estate and protected from claims for taxes or liability. Ownership by a trust allows the grantor to select a trusted individual to oversee the policy in case of disability or mental incompetence, allowing continued payment of premiums or access to policy cash value[2] as financial circumstances require.

Ownership of life insurance by an irrevocable trust removes that life insurance from the taxable estate of the grantor. While life insurance proceeds are generally received free of federal income tax by the policy beneficiary, the face amount of a policy owned by a deceased individual is included in the value of that person's estate for purposes of estate taxes. A policy owned by an irrevocable trust is outside the insured's taxable estate, and does not generate additional estate tax liability.

When contemplating the use of an irrevocable trust to own a life insurance policy insuring your life, it is important to consider the possibility that you may not qualify for life insurance. If there is any doubt as to your insurability, you may wish to hold off funding the trust until your life insurance application is approved — gifts to an irrevocable trust are permanent and cannot be revoked should you not qualify for life insurance.

Trusts and charitable giving

A common dilemma is the desire to contribute to charitable organizations balanced against the need to provide for one's own family. Creation of a trust can remove assets from the grantor's taxable estate and from the uncertainties of probate proceedings, and allow the grantor to specify support for loved ones as well as charitable causes. Because a trust can allow the grantor to express a very generous intent towards a charity while still allowing for the possible needs of family beneficiaries, it can bring planned giving within the reach of middle-class families who do not have the wealth to make large, no-strings-attached contributions.

Irrevocable Life Insurance Trust (ILIT)

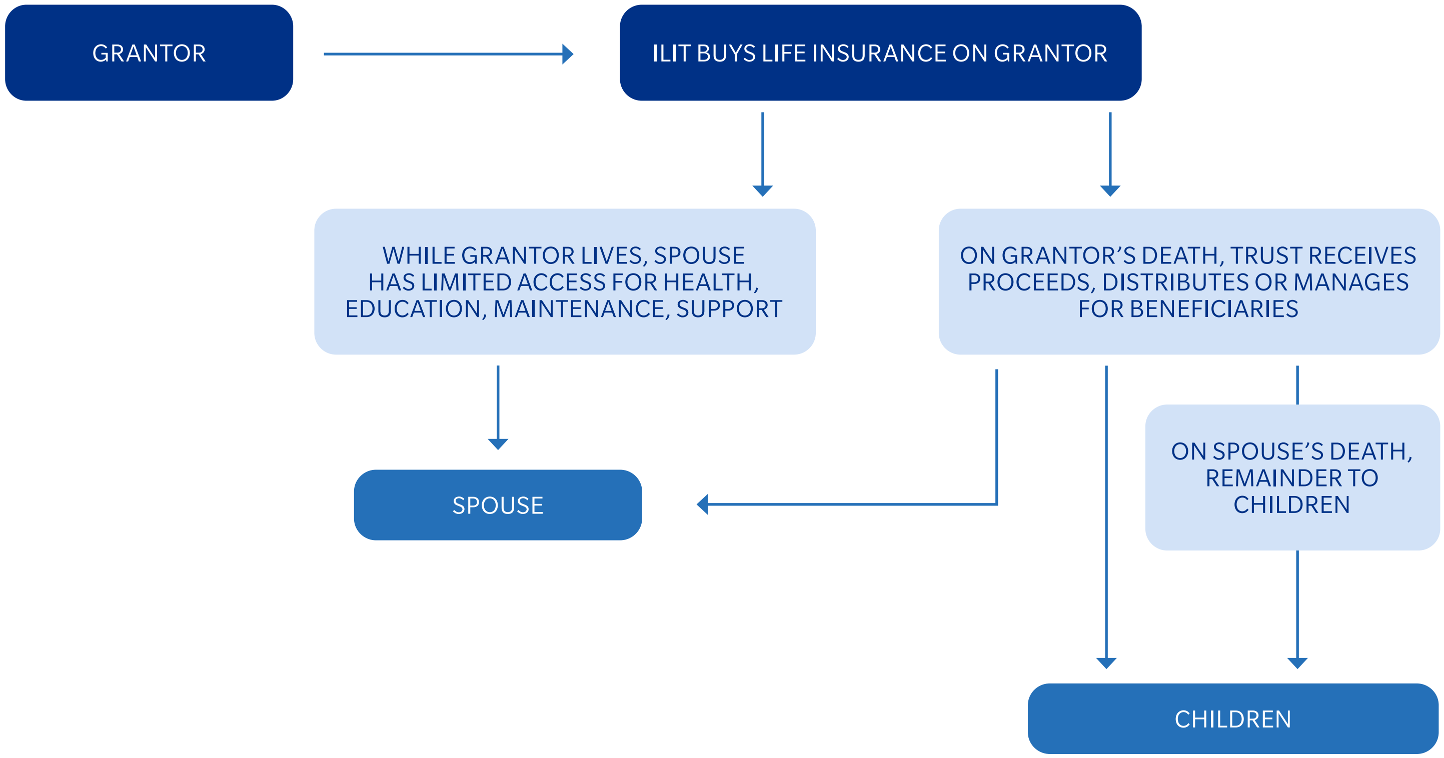
When you die, life insurance proceeds on a policy owned by you are included in your taxable estate. To avoid this, you may consider setting up an Irrevocable Life Insurance Trust (ILIT) as the owner of your life insurance policies. You may give money to the trust so that it can purchase a life insurance policy on you, or you may transfer ownership of an existing policy to the trust. A life insurance policy owned by an ILIT is outside your taxable estate, but is also beyond your control — you no longer control any policy cash value, and cannot change the beneficiary designations of the policy. Since this is an irrevocable trust, transferring either money or an existing policy to the trust is treated as a gift for tax purposes. If your existing policy has a large cash value, or if the policy you wish to purchase will have a premium higher than the annual gift tax exemption, this arrangement may create annual gift tax issues. These issues may still be more manageable than a large estate tax burden at the time death benefits are paid. As always, consult with your attorney and/or tax advisor for advice on your particular situation.

Spousal Lifetime Access Trust (SLAT)

A SLAT is a form of ILIT designed to allow access to the cash value of life insurance policies owned by the trust, while excluding the death benefit of those policies from the grantor's taxable estate. A person who wants to purchase life insurance while excluding the insurance and its proceeds from their taxable estate establishes an irrevocable trust, listing as beneficiaries the grantor's spouse and, typically, children and grandchildren. The grantor makes gifts to the trust — allowing the trust to purchase life insurance on the grantor, outside the grantor's taxable estate. The trust document allows an independent trustee to make distributions to the grantor's spouse from the trust's assets for specific expenses such as health, education, maintenance and support. This can include loans and withdrawals from the life insurance policy, though the trustee should keep in mind that policy loans or withdrawals can reduce the eventual death benefit and increase the risk of policy lapse.

As long as the grantor's spouse is careful not to commingle trust benefits with the grantor's assets, or spend the benefits on behalf of the grantor, the trust remains outside the grantor's taxable estate. On the grantor's eventual death, the policy proceeds, net of any outstanding policy loans and interest, will be paid to the trust, which may then distribute the proceeds or manage them on behalf of the trust's beneficiaries.

Spousal lifetime access trust



Dynasty trust

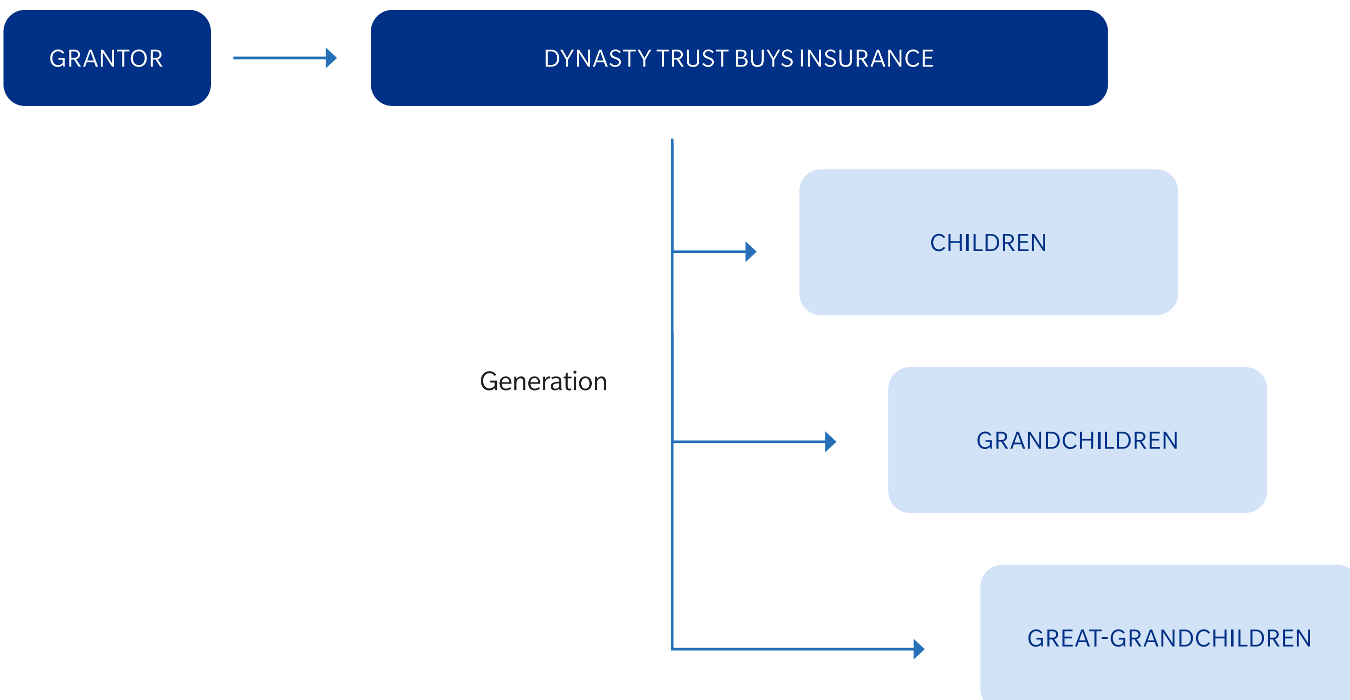
The Internal Revenue Code attempts to tax the inherited wealth of every generation. If your child takes good care of the assets you pass on, and can pass them on in turn to your grandchild, both of those transfers may be subject to estate or gift taxes. If you attempt to bypass this by leaving assets directly to a grandchild, the bequest may be subject to an additional generation-skipping transfer tax designed to recapture the second generation of estate tax.

A dynasty trust is a long-term arrangement designed to reduce the impact of estate and generation-skipping transfer taxes. Established as a form of irrevocable life insurance trust, the dynasty trust receives gifts from you that fund a life insurance policy. At the time of your death, the trust receives life insurance proceeds outside your taxable estate, and manages those proceeds for multiple generations of descendants that you designate as beneficiaries of the trust.

In general, state statutes (some limiting trust existence to 99 years) or rules against perpetuities may limit the length of a dynasty trust's operations, but those limits are still long — typically 21 years beyond the death of the last beneficiary who was alive at the time you created the trust. Depending on the state of creation, if you name a young grandchild or great-grandchild as a beneficiary, your dynasty trust could continue supporting your descendants for over a century.

You may subject trust benefit payments to conditions that promote your personal values. For example, some dynasty trusts will make payments only to descendants who stay in school, who start businesses, who refrain from smoking, or who meet certain social obligations. Using life insurance to fund a dynasty trust allows even people of modest means to help shape their families' attitudes and behavior for generations.

Dynasty trust



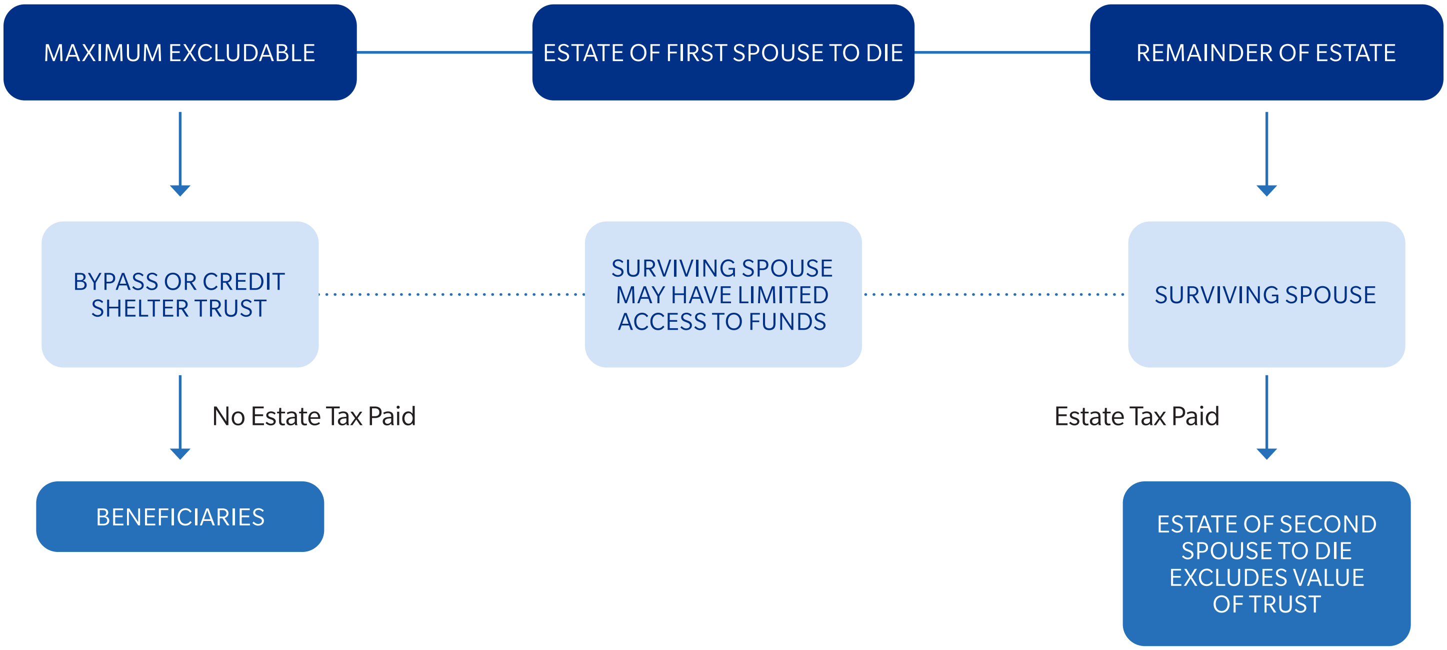
Bypass, or credit shelter, trust

This arrangement is used by married couples whose combined estate exceeds the federal estate tax exclusion amount, the amount of an estate that may be excluded from estate taxes.

At death, a married person may leave an unlimited amount of assets to a spouse, free from gift and estate taxes. But leaving assets directly to a spouse places those assets within the taxable estate of the surviving spouse, which can increase the estate tax burden when the surviving spouse passes away.

Instead of leaving the entire estate of the first spouse to the surviving spouse, a bypass trust arrangement takes an amount equal to the deceased spouse's applicable exclusion amount and places those assets into an irrevocable trust, whose beneficiary is the surviving spouse. The surviving spouse is given limited access to the assets in the trust, so that the trust is not considered to be in the surviving spouse's taxable estate. This ensures that assets placed into the trust will be available for the needs of the surviving spouse, but will not be subject to estate tax after the death of the second spouse.

Bypass trust



Special needs trust

A special needs trust is designed to provide ongoing support for a beneficiary with a physical or mental disability. Leaving assets to a disabled beneficiary outright may open the door for mismanagement or abuse, and may also have significant impact on eligibility for benefits such as Medicaid.

For most people, Medicaid is the only government-funded benefit program that can cover life-long nursing care. To qualify for Medicaid, an applicant must meet certain requirements established by the Social Security Income (SSI) system.

This system limits an individual to owning no more than a few thousand dollars in "countable" assets. Any significant inheritance can disqualify a disabled person from Medicaid-funded nursing care. The inheritance would generally be dissipated quickly with nursing care expenses and the transition from Medicaid to private care and back again can be very disruptive to the individual.

A special needs trust is designed so that the trust assets do not qualify as "countable" assets for SSI/Medicare. As with a spendthrift trust, payments are discretionary for improvement of the life of the Special Needs beneficiary, such as a tablet or a lap pool, but not for basic needs such as food, clothing, and shelter. The beneficiary cannot compel the trustee to make unscheduled payments. Drafted and administered properly, a special needs trust can hold assets for the benefit of a disabled person without impairing Medicaid eligibility. Such trusts can be established while the grantor is alive, or through the grantor's will. They may also be used as vehicles to hold the proceeds of life insurance policies in trust for the needs of a disabled beneficiary.

Because of the variations in state laws, it is important to have the assistance of a local, licensed attorney with experience in preparing special needs trusts.

Don't forget

Trusts involve many legal and tax considerations that may vary significantly depending on your state, your current family situation, and legislative changes. Before adopting any trust arrangement, you should evaluate it thoroughly with your tax and legal advisors.

Contact your Farmers® agent to discuss your options.

[1] All states have adopted the Uniform Model Trust Act, which includes this provision. However, states are free to adopt their own provisions. Clients should always work with local counsel in determining the applicability of the general information given here in their particular situation.

[2] Cash values may be accessible through policy loans. Policy loans that are not repaid and partial surrenders will reduce cash surrender value and death benefit. Policy loans are subject to interest charges. If your policy is a modified endowment contract, loans and surrenders may incur taxes and penalties.

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