

Put Your Trust in Money or Put Your Money in Trust?

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The chapter on trusts in my book of Wills, Estates & Trusts begins with the proverb, “*Put not your trust in money but put your money in trust.*” It is truly fascinating to observe how many people will readily accept the wisdom of this proverb, while at the same time having little or no understanding of what a trust is and how it might work. Nevertheless, just about everyone seems to be pretty sure that trusts can do just about everything from avoiding probate to educating children to protecting assets to saving huge amounts of taxes, and so it seems they are ready to put their money in any trust that comes along.

The fact is that while trusts may be able to do all these things, they are typically not done through a single trust. There are many different types of trusts and each different trust contains different provisions to satisfy the different objectives. This discussion will explain to you in basic terms what is a trust and how it works, and then will offer an overview of some of the more popular trusts used in today’s financial and estate plans.

In a certain sense, understanding trusts can be mastered very quickly, since every trust, from the simplest to the most complicated, contains the same basic four elements, always having the same relationship to each other. First, there is the person creating the trust, called the *settlor* (also called the grantor, donor, and trustor). Then there is the person whose responsibility it is to manage the trust, called the *trustee* (a bank or trust company can also be a trustee). Next there is the property (e.g., cash, securities, real estate) which the settlor transfers to the trustee to hold and manage “in trust,” (called the trust property or corpus), and finally there are the individuals who are to benefit from the trust arrangement, called the beneficiaries.

Today almost all trusts are in a writing made by the settlor, spelling out in detail the terms of the trust, sort of a legend and road map for the trustee (and successor trustees) to follow. The beauty of the trust, and one of the reasons for its unequalled popularity in financial and estate planning, is its almost infinite flexibility. About the only restrictions on what a trust cannot do are that it cannot be created to do anything that is illegal or against public policy. (An example of a trust violating public policy would be one that encouraged divorce or dropping out of school.) A trust can be revocable (changeable) by the settlor or irrevocable. Some trusts that are “irrevocable” can nevertheless contain terms that allow modification of certain terms of the trust.

All trusts must have all of the four required elements or you won't have a trust. And when all the elements are present, they all work the same way: once assets are transferred to the trustee, she begins to manage and administer these assets for the beneficiaries according to the terms of the trust. For instance, say the trust is an educational trust (specifying that the trust assets and income are to be used for college education) and at present the beneficiaries are ages 10 and 12. The trustee would simply invest the trust assets until a beneficiary entered college, at which time tuition (and possibly other expenses, depending on the terms of the trust) would be paid out of the trust for the education of the beneficiaries.

One final (for this brief discussion) and important point to understand is that in some trusts the positions explained above may be filled by the same person and the trust will still be valid. For example, Andy as settlor can transfer assets to Oscar as trustee to hold for Andy as beneficiary. Or Andy can transfer assets to himself (by stating he is taking the assets *as trustee*) for the benefit of Oscar. Or Andy as settlor can transfer assets to himself, as trustee, for his *own* (Andy's) benefit. In this last case, the trust *must* provide for a named beneficiary after Andy's death, otherwise you may not have a valid trust. Note also that in a number of special types of trusts, including some of those discussed below, it may be a bad idea to fill different positions with the same person, because although the trust may still be valid, the desired purpose will fail.

Employing all of these elements as a base, the minds of creative trust lawyers, working around constantly changing tax and other laws, have developed numerous special types of trusts. Following is an overview of some of the more common and useful of these trusts, with the admonition that it is just an overview, and you must not proceed with any of these (and *please*, especially not through some form book!), without the advice of a competent professional who specializes in this field.

Living Trust. This is actually not a special type of trust at all. The term tells us only one thing and absolutely nothing more – that the trust was created during the settlor’s lifetime, as opposed to a “testamentary trust,” which is one created on the settlor’s death, through her last will. One reason the living trust is so widely known is that it can cause assets to avoid the probate process on the death or disability of the settlor. *BUT*, what many people fail to understand is that this will *only* be the case for assets that are transferred to the trust during the settlor’s lifetime, and *only* where the trust provides for beneficiaries after the settlor’s death. The other common misconception in this regard is that avoiding probate means avoiding taxes. One has nothing to do with the other.

Life Insurance Trust. This trust takes advantage of one of the few remaining loopholes in the estate tax law, which provides that life insurance proceeds will not be taxed in the estate of the insured person if he had no rights of ownership in the policy (e.g., the right to borrow cash value or change the beneficiary). The typical life insurance trust is irrevocable, designed to *own* one or more policies on the settlor’s life, (although it can certainly own other assets as well). The trust (or the trustee) is also named as the beneficiary of those policies, so that on the insured settlor’s death, the proceeds are paid directly to the trustee of the trust, to be managed for the beneficiaries, typically the settlor’s spouse and children. Since the settlor has no ownership rights in the policies and no control over the trust, the proceeds are estate tax free to the trust on the settlor’s death. But note that if the policies were transferred to the trust by the settlor within three years of her death, tax savings will be lost, as the proceeds will be fully included in the settlor’s estate for tax purposes. If the policies are instead applied for and purchased by the

trustee, then there would be no transfer to be concerned about and the three year rule would not apply.

Medicaid Trust. Many elderly individuals and couples are terrified at the thought of having to enter a nursing home and losing their life savings as well as their homes. Here in the U.S. we have a program called Medicaid that will pay for nursing home costs, but only after the individual or couple has practically no assets or has become impoverished as a result of the costs of care, since unlike Medicare, the Medicaid program is a welfare program. As a result, over the past two decades a specialty has developed among advisors called Medicaid planning, which is designed to arrange a person's assets so they are not "counted" for Medicaid purposes. The objective is to qualify for Medicaid assistance without losing everything. One of the most popular vehicles used in this regard is the Medicaid trust.

For practical purposes, there are two types of Medicaid trusts. One is a trust established for a person who is under the age of 65. This type of trust may be established with that person's assets but, because of a hastily written, poorly thought out law, it may only be established by the person's parents, grandparents, legal guardian, or a court, and *not* by the person herself. This irrevocable trust may be established at any time – even after the individual has entered a long term care facility – and unlike the Medicaid trust described below, the person could become immediately eligible for Medicaid benefits, because the transfer to the trust and the assets in the trust are disregarded. This would be the case even though the terms of the trust provided for unlimited discretionary payments to the individual. ("Discretionary payments" means that the trustee has the power to pay out any amounts at any time, in his discretion to the person for whom the trust is established.) The reason the law allows such a liberal arrangement is that in order to qualify as an "under 65 Medicaid trust," the trust must contain a provision that directs the trustee to repay the state, on the beneficiary's death, for all Medicaid benefits paid to or for the beneficiary. Any remainder can go to other beneficiaries, such as family.

The other type of Medicaid trust commonly used is the “income-only” irrevocable trust. In this trust, the settlor may only be paid the income from the trust (i.e., interest or dividends, as opposed to the trust principal) and under no circumstances may principal be paid out to her, although such a trust typically allows for distributions of principal to, for example, the settlor’s children. Since the settlor has no access to the principal, it will not be counted as her asset for Medicaid purposes – thus, she has the use of the income from the funds or investments but will not lose them to long term care costs, and on her death, the remaining principal can be paid out to her beneficiaries named in the trust and not to the state. That’s the good news. The bad news is that, unlike the “under 65 Trust,” the transfer of assets to this type of trust is considered a “disqualifying transfer” for Medicaid purposes and will disqualify the settlor from receiving Medicaid benefits for up to five years after the transfer to the trust. In short, if you are thinking about use this type of trust, be sure you will not enter a nursing home in the succeeding five years or that if you do there is a source of funds to pay for your care during that time.

Charitable Remainder Trust. Another form of tax loophole, provided you are at least somewhat charitably minded. This type of irrevocable trust can allow you to sell highly appreciated assets without paying a capital gains tax, then receive a lifetime income (or income for a specified term) from the full sales proceeds. The catch is, when you’re done receiving the income (you can also add your spouse as an income beneficiary) the remainder in the trust must pass to a qualified charity – hence the term, “charitable remainder trust” (CRT). Here’s how it can work.

Donald has a vacation home he purchased many years ago for \$50,000. Today it is worth \$1 million. Although he would like to use the proceeds as he needs more income, he is reluctant to sell the home because of the large capital gains tax he would have to pay. (Note the same illustration could apply to other assets, such as securities or even a family business.) Donald is advised he could establish a CRT, transfer the vacation home to this trust and then have the trustee immediately put the property up for sale. Once the property is sold, let’s say for \$1 million, Donald can begin to receive an annual income of, say, 8 percent per year, or \$80,000 on the \$1 million. Because the trust is considered

a charitable trust under the tax code, no capital gains tax will be paid on the gain. The 8 percent income is somewhat arbitrary. Under the tax code, the income can be any amount that is not less than 5 percent or more than 50 percent of the trust assets. (Remember, this is just a *brief* explanation.) On Donald's death, the trust could provide a similar income to his wife for her lifetime, and on his wife's death, the remainder would pass (estate tax free) to one or more charities (chosen by Donald).

As an added incentive to the CRT, not only would Donald escape immediate capital gains tax on the sale (though the trust income he receives would be taxable to him), he would also be entitled to a current income tax deduction for the "present value" of the amount that will ultimately pass to the charity. The amount of the deduction is based on the amount contributed to the trust, Donald's age, the income he is to receive, and whether his wife is also to receive income.

As a planning tip, to make up for the loss to the family of the assets placed in the CRT (here, \$1 million), the settlor could use some of the substantial extra income produced by the CRT (and by the cash generated by the income tax deduction allowed when the CRT is funded) to purchase a life insurance policy in a life insurance trust. This way, not only would there be no estate taxes on the CRT on the settlor's death, but the life insurance proceeds would be estate tax free as well, producing a win-win result for the family.

Estate Freeze Trust. This type of trust typically involves a sale of a family asset from a parent to a trust that is established for other members of the family. It works best where the asset to be sold produces income which can be used to pay off the sales price. For instance, say that Dad has a four family home he purchased many years ago for \$60,000, and today it is worth about \$500,000. The property produces about \$40,000 net annual income. Dad creates an irrevocable trust for the benefit of his children. He contributes (or if the children have any funds they contribute) about \$50,000 as "seed money" to the trust. (It is a good idea for the trust to have independent funds of about 10 percent of the purchase price of the asset.) Dad then sells the property to the trust for its fair value (\$500,000) taking back a promissory note and mortgage from the trustee for the sales

price. The note could call for amortized payments (interest plus principal) or it could call for regular payments of interest only, with a “balloon” payment of principal at the end of the term. Present IRS rules call for a pretty low rate of interest on such notes so the income from the property should be more than adequate to cover the payments.

Meanwhile, if the deal is properly done, Dad has “frozen” the value of the property for estate tax purposes, as he has substituted property that is appreciating in return for a note which is fixed in value. If Dad dies several years later when the property is worth, say, \$750,000, only the balance due on the \$500,000 note will be in his estate. In fact, there is even a way to get the value of the note out of his estate by using a self-canceling installment note. This type of note is automatically cancelled on the payee’s death, so there is no value to include in his estate, although any capital gains on the property must be recognized at that time.

Asset Protection Trust. It seems that everyone wants to protect assets and there are several types of trusts that can readily do this, ranging from a simple irrevocable limited benefit trust established in just about any state, to special asset protection trusts (with unlimited benefits for the settlor) established in a state that has adopted special laws for that very purpose (i.e., Alaska, Delaware, Missouri, Nevada, Rhode Island, and Utah), to offshore trusts established in a foreign jurisdiction such as Gibraltar, Liechtenstein, or the Cook Islands.

Although it is a relatively simple matter in every state for one person to set up an asset protection trust for someone else (called a “spendthrift trust”), it is not so simple to set one up for yourself. Except for the six states noted above, the law in this country frowns upon the idea of a person being able to arrange his assets in a way that he can benefit from them but his creditors cannot. Nevertheless, in any of the six states mentioned, a person can transfer assets to a discretionary asset protection trust in the chosen state, with the result that the person’s creditors (with only certain exceptions) cannot reach these assets. The concern of most commentators in this regard is the fact that the assets are still here in the U.S. and subject to the reach of U.S. courts. For this reason the serious asset

protection plans take place outside the U.S. where U.S. courts simply have no jurisdiction. Thus a creditor seeking to enforce a U.S. judgment against a debtor whose assets are in a foreign trust must bring the legal action (often anew) in the foreign jurisdiction, usually at considerable expense and without a great likelihood of success.

It is *very important* to note here that virtually all self-settled (i.e. trusts you create for yourself) asset protection trusts, whether domestic or offshore, are *tax neutral* and *fully reportable*. There is no suggestion of hiding money or avoiding income taxes – the objective is to protect the trust assets without losing the use and enjoyment of them.

Conclusion

As can be seen from this discussion and as observed at the outset, there are dozens of different types of trusts and more are being thought up all the time by trust lawyers and other planners. The trust is perhaps the most flexible document in an estate and financial plan and its concept provides us with virtually unlimited possibilities to structure arrangements to suit a myriad of objectives. But as with anything having so much potential, there are pitfalls as well as opportunities. Thus there is no substitute for the best expert advice to make sure that you “avoid the pitfalls, seize the opportunities, and be home by five o’clock.”*

*(Woody Allen from his article, “Alone Adrift in the Cosmos.”)

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SIDEBAR

Other types of trusts often used in a family plan: **Qualified Personal Residence Trust (QPRT)**. This is an irrevocable trust established for a term of years (chosen by you and your advisor) to which you would transfer a residence (principal or secondary). You would be the beneficiary – usually that means the right to live there – during the chosen term, and at the end of the term the residence would belong to the children. If you wish to continue living in the home the trust may provide that the property could be rented to you (at fair market rent). The idea of this plan is that if you outlive the chosen term the full value of the property will be excluded from your estate for estate tax purposes. The other side of that coin, however, is that the children would take your (probably) low cost basis in the home.

The Minor's Trust. When making gifts to a minor, parents or other relatives often resort to a custodial account, where the gift is given to a custodian to hold for the minor, typically until the minor reaches the age of 18, when she has a right to withdraw the funds. A far better option is a minor's trust. This is a relatively simple inexpensive document which can provide for the minor up to age 21 and beyond. It can also save income taxes and provide a mini-estate plan for the minor, neither of which can be done with a custodial account.

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