MFS®

ESTATE PLANNING

USING TRUSTS AS PART OF YOUR ESTATE PLANNING

One of the most common tools in estate planning is the trust, an arrangement under which you can place assets that are for your or someone else's benefit (the beneficiary) under the control of a trustee. There are advantages and disadvantages to using a trust as an estate planning tool.

While this information sheet provides an overview of several types of trusts and the reasons why they may or may not be beneficial for you, you should meet with a professional advisor to discuss your individual financial situation and to understand all of the consequences of establishing trust arrangements.

Depending on your goals, the use of a trust can be an effective way to achieve your estate planning objectives. Trusts are usually categorized in one of two ways:

1. Inter vivos trust (living trust)

An inter vivos, or living, trust

- is created during your lifetime as a contract between you and a trustee
- may be revocable or irrevocable

Revocable trust

- The trust's assets can be returned to you at any time.
- It is subject to income taxation on the ordinary income and capital gains earned by the trust.
- The trust's assets are included in your taxable estate at the time of death.
- It is generally set up to retain control over assets rather than for estate tax reasons.

Irrevocable trust

- You may enjoy certain estate tax advantages because the assets held by the trust may be considered a gift and not subject to estate tax.

Key points

Trusts could help you

- lower estate taxes
- protect your family's assets
- ensure your wishes are carried out after your death
- avoid probate

Which trust may be right for you will depend on your specific objectives.

Meet with your estate planning professionals to determine if a trust is the best option for you.

This material should be used as helpful hints only. Each person's situation is different. You should consult your investment professional or other relevant professional before making any decisions.

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Potential disadvantages

- Not all items may be easily transferred into an inter vivos trust.
- The federal estate tax allows an estate to use a year other than a calendar year as the "taxable year" used in tax deadlines. Trusts are not allowed the same flexibility.
- Trusts are required to make estimated tax payments, while estates are exempt from this requirement for the first two years.
- Unlike wills, revocable trusts are not automatically revoked or amended on divorce. If you do not amend the trust, an out-of-date beneficiary could receive unintended benefits.

2. Testamentary trust

A testamentary trust

- is created as part of your will
- comes into existence at the time of death
- is always irrevocable
- provides control over how your heirs will receive the assets
- may provide certain tax advantages

In an estate plan, a testamentary trust can serve a variety of purposes, such as

- conserving property for your beneficiaries
- helping you manage your investments
- avoiding guardianship requirements applicable to property transfers to minors and other legally incapacitated persons
- minimizing probate costs by transferring property before death
- reducing or eliminating estate taxes for beneficiaries of your estate
- keeping arrangements private by avoiding the public probate process
- providing creditor protection

Potential disadvantages

- The trust may bind the beneficiaries to an agreement after familial relationships have broken down. If the beneficiaries can no longer agree, a trust may have to be dissolved.
- Individuals feeling unfairly excluded from a share of an inheritance may be motivated to challenge a testamentary trust in court.

Once you have determined what your estate planning objectives are, you may want to consider establishing one or more of the following types of trusts.

Objective

To provide for a surviving spouse during his or her lifetime but ultimately to pass assets on to other beneficiaries

Charitable remainder trust

A charitable remainder trust allows you to provide for your surviving spouse, donate assets to charity and avoid federal transfer taxes. The trust works like this: First, income from trust assets goes to your surviving spouse. After your spouse's death, trust assets are transferred to the charity, and no federal transfer taxes are incurred.

Potential disadvantages

- Because the donor and heirs do not have access to the trust principal during their remaining lifetimes, they cannot make any personal use of the trust's property other than to receive income payments.
- Donors should consider carefully whether they have other capital resources that will be sufficient to meet their future needs.

Bypass trust

A bypass trust (also known as a credit shelter trust) allows you to create a trust upon your death that benefits your spouse and at the same time is shielded from estate tax upon your spouse's death. The bypass trust is funded with an amount equal to your applicable credit — the maximum amount that may be transferred from an estate without payment of federal estate taxes. Your surviving spouse may be the beneficiary of income from the trust and continue to have the economic benefit of the trust assets. Because your spouse does not own the trust assets, the assets are not included in your spouse's estate at the time of death.

For the tax year 2019, the applicable credit (tax-free amount) is $11.4 million and the maximum tax rate is 40%.

Potential disadvantages

- The surviving spouse does not have full access to the deceased spouse's estate, which may be a drawback for a surviving spouse in financial need.
- The trust may be responsible for paying income tax on the amount of trust income that a trustee with discretionary authority over income distributions elects to accumulate.
- The transfer to the trust is irrevocable upon the first spouse's death and cannot be altered to suit changing circumstances.

Qualified terminable interest property (QTIP) trust

A QTIP trust is useful when the objective is to provide income to your surviving spouse while leaving the underlying property to a different beneficiary. Your surviving spouse's income interest in a QTIP is not taxed upon your death because of your marital deduction, but he or she has no control over the ultimate disposition of the property, and upon your spouse's death, the assets are includable in his or her estate. QTIP trusts are frequently used in second marriages when the donor wants to provide for the current spouse but ultimately wants the property to go to children from a prior relationship.

Potential disadvantages

- The executor's election decision is irrevocable.
- A QTIP cannot be amended after the first death to meet changing life circumstances.

Objective

To save on estate taxes

Life insurance trust

A primary estate tax planning objective is ensuring that the proceeds from a life insurance policy are not subject to federal estate taxes. This can be accomplished by arranging for an irrevocable trust to own the policy and serve as its beneficiary.

Potential disadvantages

- The grantor's decision to set up a trust is irrevocable.
- A gift tax could be imposed on the initial transfer.

Grantor retained annuity trust (GRAT)

A GRAT is an estate and gift tax planning tool that allows you to give away an asset at a greatly reduced gift tax cost. To create a GRAT, you transfer the assets to an irrevocable trust and retain an annuity interest for a specified number of years. The retained annuity interest is designated as a percentage of the initial value of the trust assets (a GRAT). The remainder interest is designated as a gift to someone. The advantage of making a gift through a GRAT is that only the value of the remainder interest is taxable as a gift.

If the annuity paid to you is large enough, the value of your gift is zero (known as a zeroed-out GRAT). Any appreciation in the assets held by the GRAT over the IRS' interest rate inure to the benefit of the remainder at no gift tax cost.

Potential disadvantages

- Hard-to-value assets (*i.e.,* real estate, closely held or family-held stock, partnership or limited liability company interests) that are used to make annuity payments must be appraised annually.
- The loss of GRAT status for any reason results in a taxable gift of the entire value of assets deposited in the GRAT.

Qualified personal residence trust (QPRT)

A QPRT is created when you transfer your personal residence to an irrevocable trust for the benefit of your beneficiaries while retaining your right to use the property for a certain amount of time. The benefits of a QPRT are that it enables you to incur gift taxes based only on the value of the remainder interest and to remove future appreciation on the property from your gross estate. You also will be able to live rent free in your home for the fixed term.

Potential disadvantages

- The transfer is irrevocable, and the property is distributed to your beneficiaries, who then have control of your home.
- If the grantor dies before the expiration of the QPRT, the residence's actual value on the day it is contributed to the trust is included in the grantor's estate and thus becomes subject to federal estate tax.

Objective

To save on estate taxes

Crummey trust

A Crummey trust (also known as a demand trust) is set up with the objective of using your annual gift tax exclusion of $15,000 per recipient ($30,000 for a married couple). In this arrangement, you deposit property up to the tax-free gift limit for each year ($15,000 for 2019, $30,000 for a married couple) into the trust. Each year, your beneficiary is given a window of time during which some or all of the property can be withdrawn.

Potential disadvantages

- Because of the involvement of an attorney (in drafting the trust document, for example), the trust could incur high setup and administration costs. The annual waiver must be in writing.
- The trust is treated as an asset of the beneficiary for financial aid purposes (high impact).
- If the donor acts as a trustee, the trust is included in the donor's gross taxable estate. It is best if the trustee is someone other than the donor or the donor's spouse.
- There is a chance that the beneficiary will not cooperate.

Totten trust

The Totten trust is a type of revocable trust through which you deposit funds in a bank account for a beneficiary. Because the transfer into the account is revocable, only amounts that are actually distributed from the account to the beneficiary constitute a completed gift. A Totten trust does not provide any gift or estate tax benefits, but it is effective as a probate avoidance device.

Potential disadvantages

- If the beneficiary dies before the account owner, probate is required.
- The beneficiary cannot have any access to the account while the account owner is alive, even if the account owner is incapacitated and needs the beneficiary's assistance in withdrawing funds to pay medical bills. A guardianship or power of attorney is required in that case.

To be effective, trusts generally need to be carefully created and may need to meet requirements not described here. Individuals should meet with a professional advisor to discuss their individual financial situation and needs, to ensure that the trusts are properly created and to clearly understand all of the consequences of establishing trust arrangements.

Contact your financial advisor for more information or visit mfs.com.

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