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TO TRUST OR NOT TO TRUST?

Is A Trust Right For You?

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To Trust or Not To Trust?

That is the question we will explore today. There is a certain degree of mystique associated with the idea of having a trust. This makes perfect sense because trust documents are private, so the public never gets a glimpse at what is inside. The first thought I have when I think of a trust is the Rockefeller family. The top 1% have the resources to incorporate trusts to handle most of their important financial resources. The good news is that trusts are not just reserved for the ultra-wealthy. Trusts can provide solutions that match what many families are looking to accomplish (which we will address later in this paper). My goal here is to explain what trusts are, why so many families use them, and why you may want to consider incorporating them into your estate plan.

1. WHAT IS A TRUST

A trust is an agreement that describes how assets will be managed and held for the beneficiary(ies).

A TRUST TYPICALLY INCLUDES THREE PARTIES:

1. First, you have the **creator** of the trust. In the legal world, they call this person the settlor/grantor/trustor (just to make life a little more confusing).
2. The second party is the **trustee**, who is responsible for administering and following the terms of the trust. The trustee can be a person or a corporation (i.e. a professional trustee). If the trustee is a person, it is often the creator of the trust.
3. The third and final party are the **beneficiaries** of the trust. This can be anyone or anything (i.e. charities/organizations/corporations). Oftentimes, the first beneficiary is the creator and the trustee, while the second beneficiary is a spouse or child.

Depending upon the type of trust being created and the goals of the creator, he/she will transfer assets into the trust by changing the ownership of the assets from him/her to the trust. This is referred to as **funding** the trust **inter vivos** (during the creator's lifetime). Sometimes, the trust document is created but remains **unfunded** until the creator passes away, at which time assets are transferred into the trust. Some trusts are created after the creator passes away with instructions typically found within the creator's will. These are referred to as **testamentary trusts**.

By far the most popular type of trust is a **revocable living trust** (more on this in a second). In this case, the creator, the trustee, and the beneficiary are usually the same person. Secondary trustees and beneficiaries are usually identified in the event that the creator either passes away or becomes ill and can no longer fulfill their duty as trustee.

THREE PRIMARY REASONS WHY SOMEONE CREATES A TRUST:

- To avoid probate.
- To identify a secondary trustee who can step in to manage the assets in the trust if the trustee becomes ill.
- At their attorney's recommendation (okay, I know this is not a primary reason, but it is a popular response I receive from clients).

2. REVOCABLE LIVING TRUST VS. IRREVOCABLE TRUST

REVOCABLE LIVING TRUST:

A revocable living trust is by far the most popular type of trust. It helps avoid probate and handles incapacitation issues very well. The terms of the trust are private, so no unauthorized persons can find out the creator's wishes or what they owned. Families also like the fact that since it is revocable, any of the terms within the trust can be changed at any time during the creator's lifetime.

In most instances, the creator reports all taxable income right on their own personal tax return. This helps keep things simple because there are no additional tax forms that need to be filed.

The biggest hurdle for most families is funding the trust with all of the assets that would normally pass through probate. It requires time and energy to retitle accounts/assets from the creator's name to that of the revocable living trust. It is not an overly complex task but may require patience. At our firm, we always start by looking at a family's balance sheet to identify which assets need to be retitled. We then, slowly but surely, check them off as we proceed through the funding process.

IRREVOCABLE TRUST:

Unlike revocable living trusts, which the creator can modify, an irrevocable trust cannot be modified (in most but not all instances). This can be intimidating for families and is one of the reasons that families opt for revocable living trusts instead. That being said, there are situations where an irrevocable trust is a better fit to match the creator's objectives. This is particularly true if the creator is interested in asset protection strategies.

Unless specified within the trust document, assets in an irrevocable trust are not accessible to the creator. For this reason, irrevocable trusts are a valuable tool for families who want to protect assets from creditors or nursing homes. **Revocable living trusts do not offer asset protection from creditors or nursing homes**. This is an important statement because many creators who have a revocable living trust are under the impression that their trust does offer creditor or nursing home protection. The best advice I can offer is to call the attorney who helped create the trust and ask him/her whether your trust offers this protection.

When the creator passes away, a revocable living trust automatically becomes **irrevocable**. The trustee will refer to the trust document to determine whether the trust assets should be paid out immediately to the beneficiaries or whether assets should remain in the trust until some future date. For example, trust documents typically have provisions that delay the distribution of trust assets to minor children until they reach a certain age, when they will hopefully be more mature and better prepared to inherit assets.

Irrevocable trusts are often but not always considered a separate tax-paying entity. Think of them as a living and breathing person. Irrevocable trusts usually file their own tax return and pay their own taxes (exceptions apply). Handling taxes for irrevocable trusts can be rather complex because oftentimes the assets in the trust generate income like interest, dividends, and capital gains. This income can either be retained by the trust or paid out to income beneficiaries, such as a surviving spouse. If the income remains in the trust, then the trust is responsible for paying the tax. If the income is paid out to the income beneficiary, then the beneficiary is responsible for paying the tax.

Below, I have included a table[1] that shows tax rates for married couples, single and irrevocable trusts (2024).

[1] Cass, B. (2024, January 3). Key tax figures for 2024. Retrieved February 6th, 2024, from https://www.putnam.com/advisor/content/wealthManagement/7596-key-tax-figures-for-2024

Income tax

	If taxable income is over	But not over	The tax is	Of the amount over
Married/Filing jointly and qualifying widow(er)s	$0	$23,200	$0 + 10%	$0
	$23,200	$94,300	$2,320 + 12%	$23,200
	$94,300	$201,050	$10,852 + 22%	$94,300
	$201,050	$383,900	$34,337 + 24%	$201,050
	$383,900	$487,450	$78,221 +32%	$383,900
	$487,450	$731,200	$111,357 + 35%	$487,450
	$731,200		$196,669.50 + 37%	$731,200
Single	$0	$11,600	$0 + 10%	$0
	$11,600	$47,150	$1,160 + 12%	$11,600
	$47,150	$100,525	$5,426 + 22%	$47,150
	$100,525	$191,950	$17,168.50 + 24%	$100,525
	$191,950	$243,725	$39,110.50 + 32%	$191,950
	$243,725	$609,350	$55,678.50 + 35%	$243,725
	$609,350		$183,647.25 + 37%	$609,350
Estates and trusts	$0	$3,100	$0 + 10%	$0
	$3,100	$11,150	$310 + 24%	$3,100
	$11,150	$15,200	$2,242 + 35%	$11,150
	$15,200		$3,659.50 + 37%	$15,200

As you can see, irrevocable trusts reach the top tax bracket of 37% (prior to the 2017 Tax Reform, the rate was 39.6%), when their income exceeds only $15,200, versus $731,200 for a married couple. For this reason, it is easy to see why it makes sense to have the income beneficiary pick up the tax liability on his/her own personal tax return when possible.

Below is a quick summary comparing the differences between a revocable trust and an irrevocable trust:

Revocable Living Trust

- "Will Substitute"
- Right to change or cancel at any time before death
- Retain control of assets in trust
- You are the grantor, trustee, and beneficiary
  - Trust is not a legal entity so harder to shield assets from creditors and lawsuits
- Income appears on your tax returns
- At your death, trust has instructions on how to manage and distribute assets in trust

Irrevocable Trust

- Trust cannot be changed until the terms completed
- Legal entity
  - Independent trustee (pay management fee about 0.75% to 1.25% of assets managed)
- All property in trust is transferred out of your taxable estate
  - Reduces estate tax liability
  - Use to avoid Medicaid spend-down provisions
- Better protection from creditors and lawsuits
- Trust files its own tax returns
  - Income does not appear on your tax return
- Lose control over assets in trust

3. WHEN YOU SHOULD CONSIDER CREATING A TRUST

- If you want to avoid probate or plan for the management of your assets in the event you become incapacitated.
- If you want to control your assets from the grave.
- If you want privacy. When someone passes away the terms of their trust remain under wraps. Probate is a public process, and your will is accessible to anyone who cares to take the time to look it up.
- If you have property in more than one state, you run the risk of having your estate probated in each state. One way around this is to put your properties into a revocable living trust (also known as a realty trust when dealing with real estate). It is hard enough dealing with the probate process in one state, let alone two of them.
- If you have a more colorful family dynamic, then a trust might help ensure that assets flow where you want them to. For example, if you have children from a previous marriage that you want to leave assets to, but only after your current spouse has access to them during their lifetime. This type of trust is called a qualified terminable interest property trust (QTIP).
- If you have minor children and you want to delay their access to their inheritance beyond the age of majority (18-21 depending upon which state, they reside in). If you feel that this is too young, then a trust (revocable living trust or testamentary trust) can help. This trust can be managed by someone reliable until your child reaches an age that you feel is more appropriate. This is something that my wife and I have done within our revocable living trusts for our two minor children. We don't want to take the chance that an early-age inheritance could lead to poor decision-making. Maybe a new Ferrari? However, we still gave the trustee discretion to pay for their education and welfare at any age.
- If you plan to leave any of your accounts/assets to someone with special needs, then you should consider a trust called a special needs trust (SNT). Assets that are owned by an SNT are *NOT* considered assets of the beneficiary and will preserve their ability to maintain government benefits now or in the future (if applicable).

4. ESTATE TAXES

A handful of states charge estate taxes when assets pass to a non-spouse beneficiary. Our home state of Massachusetts is one of those states. If you pass away in Massachusetts and leave over $2 million to a non-spouse beneficiary, then the state of Massachusetts will tax your estate (tax rates range from 0%-16%). This tax will only apply to funds over $2 million[2]. One option to eliminate this exposure is

[2] Benham Nygren, Mary, Sally Dabrowski, and Sarah Richards. "Massachusetts Estate Tax Exemption $2,000,000 as of January 1, 2023." Nixon Peabody LLP, October 4, 2023.

to move north to New Hampshire. If that doesn't work for you, then you might want to consider incorporating estate tax-sensitive trusts into your estate plan. You should give these trusts consideration if you are married and your estate, including life insurance, exceeds $2 million.

The federal government also charges estate taxes. Fortunately, the exemption at the federal level is $13,610,000 per person (2024). If your estate is greater than $13,610,000, including life insurance proceeds, and you are married, then you should consider estate tax-sensitive trusts. These trusts can potentially double your exemption, allowing you and your spouse to pass on up to $27,220,000 to non-spouse beneficiaries without triggering a federal estate tax.

WHEN SHOULD YOU PASS ON CREATING A TRUST?

Trusts are not appropriate for everyone. Let's look at some of the more common reasons why you might want to pass on creating a trust.

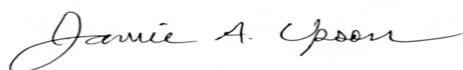
- For starters, if you don't own assets then a trust is likely not worth pursuing.
- You don't want to spend the money to create a trust.
- You are okay if your estate is probated.
- Privacy is not important to you.
- You already have a durable power of attorney document that gives someone the authority to handle your financial affairs if/when you become incapacitated and you have a will appointing a personal representative to handle your estate.
- You are not concerned if your estate needs to pay estate taxes.
- You prefer to keep your estate plan simple.
- Most of your assets are jointly owned and/or have a listed beneficiary (which both avoid probate).

SUMMARY

To trust or not to trust is a personal question that can only be answered by you. Hopefully now you feel better informed to make the right decision for you and your family. Please remember that nothing referenced in this paper should be construed as legal advice. Legal advice should only come from a qualified attorney.

If you would like to discuss your personal financial situation, please do not hesitate to give our office a call at (978) 624-3000. We would be happy to talk to you.

Sincerely,



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www.nixonpeabody.com/insights/articles/2023/10/04/massachusetts-estate-tax-exemption-2000000-as-of-january-1-2023

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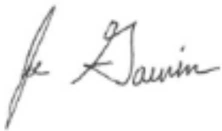

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