

## WHAT IS A TRUST?

A trust is a legal arrangement under which you, as the grantor, transfer money or other property to a trustee. The trustee will hold and eventually distribute the property for the benefit of one or more beneficiaries.

A trust agreement is used to create the trust. It names a person or institution as trustee to manage the property placed in the trust. It gives the trustee instructions concerning the management and distribution of the property.

Trusts can be broadly categorized as either *testamentary trusts* or *living (inter vivos) trusts*. A testamentary trust is created within a will and takes effect only at death. A living trust is a trust that you put in place during your lifetime.

## REVOCABLE LIVING TRUST

Most revocable living trusts provide for the grantor of the trust (and, perhaps, the grantor's spouse) to receive the trust income for life or for a term of years. On expiration of the trust term, the assets may be distributed to other named beneficiaries.

Revocable living trusts do not generally provide income or estate tax benefits. Yet these trusts have become quite popular in recent years--for a variety of reasons.

The most common reasons for using a revocable living trust are: (1) it can provide uninterrupted management of your assets by your trustee if you become incapacitated (this is especially important if quick action regarding your assets may be needed) and (2) at your death, the trust assets may be administered and distributed according to the terms of the trust, without the procedures and fees of probate.

**Protection from Incapacity.**--If illness or injury ever makes you incapable of managing your financial affairs the trust can spare you and your family the potential publicity and expense of a court-appointed guardianship. Without the trust (or other contingency planning device, such a durable power of attorney), there is no one with authority to manage your property. A court must judge you to be incompetent and appoint a conservator or guardian to manage your affairs. That guardian could be a stranger to your family or be a family member who would normally be unacceptable to

you. With a revocable living trust, your trustee will continue, or take over from you, the management of your assets without elaborate court proceedings.

**Distribution of Assets at Death.**--A living trust may be set up to continue after your death. In the trust agreement, you can provide how the trust property should be distributed at your death. As with a will, you can provide for many special situations. You may provide that your trustee hold and manage property to be distributed to your children until they reach the age of majority--or until a later age if you believe they need longer-term protection. You may also provide that your trustee hold the property and distribute any income to your spouse during his or her life with the property passing to your children--or other beneficiaries--at your spouse's death.

Because your assets pass according to the trust instrument, they do not pass through your estate and, therefore, they are not subject to the fees and public proceedings of probate.

**Practical Considerations.**--There are many other practical considerations in using a revocable living trust.

- A revocable living trust does not eliminate the need for a will. A will is necessary to pass on those assets you have not transferred to the trust. Many people chose to have all their assets managed through the trust. To do so, you must have a will with a pour-over provision. This directs any assets not already in the trust to be transferred into the trust at your death, where they will be managed and distributed as your trust instrument directs. Without a pour-over provision, these additional assets will pass according to your last unrevoked will or the state intestacy law, if there is no will.
- A revocable living trust can involve significant planning. Together with your lawyer, you must carefully develop a plan for the ultimate disposition of your property. Then your lawyer will use that plan to draw the trust instrument which provides how your trustee should manage your assets and how and when your trustee should make distributions. You must arrange for your assets--including real estate, bank accounts, and securities--to be transferred to the trust. While a living trust can save probate fees and estate taxes, the cost of establishing and maintaining the trust must be considered.
- At your death, the property in a revocable trust is included in your estate for estate tax purposes. The tax laws consider you as still owning the property since you still, in effect, control the property. Also,

income from the trust assets maybe considered earned by you for income tax purposes.

## IRREVOCABLE LIVING TRUST

Irrevocable trusts are most often used because they may provide tax advantages. If properly arranged, a gift of assets to an irrevocable trust can result in estate tax savings, and possible income tax savings. As with the revocable trust, you may also save probate fees. If you are committed to a final plan of distribution of your property and you are prepared to make a present irrevocable transfer of property, you might consider using an irrevocable trust.

As with the revocable trust, you must carefully consider how the trustee should manage and distribute the trust property. Your lawyer will use your plan of distribution and asset management to draw the trust instrument. Remember that the difference from the revocable trust is that this plan of distribution and your surrender of control over the assets are permanent.

Because the transfer of assets to the trust is irrevocable, the transfer generally is considered a complete gift. Therefore, the transferred assets are no longer part of your gross estate for federal estate tax purposes unless you retain certain "strings" to the property, such as the right to income from the trust or the power to control the enjoyment of trust income or principal by the trust beneficiaries. Greater estate tax savings may be obtained by transferring appreciating assets to the trust, since the future appreciation also will avoid federal estate taxes. Because transfers to the trust are considered completed gifts, careful planning for possible federal gift tax consequences is important.

In addition to the typical estate tax saving irrevocable living trusts, there are irrevocable living trusts that provide special benefits or serve special purposes. Among those are the irrevocable life insurance trust, the "minor's" trust, the charitable trust, and trusts that protect assets from government aid programs.

**Irrevocable Life Insurance Trusts.**--A popular type of irrevocable trust for saving estate tax is the irrevocable life insurance trust. It works this way: You transfer ownership of your life insurance policy to an irrevocable trust for the benefit of your spouse and children. When you die, the life insurance proceeds are paid to the life insurance trust. The

trustee then manages and distributes the proceeds according to the trust instrument. If you die more than three years after the transfer, the proceeds will not be included in the calculation of the estate tax. If you die within the three year period, the proceeds will be included in your gross estate. This three year draw back rule for life insurance transfers may be avoided by special arrangements.

The irrevocable life insurance trust is especially attractive because it does not require giving away your assets other than what may be necessary to arrange for payment of annual premiums. Careful planning should be undertaken to ensure that all tax law requirements are met.

**“Minor’s Trusts” for Income Tax Savings.**--This irrevocable trust is set up to hold assets for the benefit of a minor. Usually, the income and principal are intended for the minor’s higher education. The trust can provide income tax savings that add to the higher education funds. In a minor’s trust, income will be taxed to the trust entity itself or, if the income is distributed, to the minor--and, therefore, may be taxed at a lower rate than the grantor’s rate. The tax savings must be considered against the costs of establishing and maintaining the trust.

In the terms of the trust agreement, you can keep the trust’s income and principal out of the beneficiary’s reach until he or she reaches age 21. The trust may last longer if provided for in the document.

Because you give up control over the trust property and the power to change the trust agreement, the trust’s assets will not generally be considered part of your taxable estate if you die during the existence of the trust.

**Charitable Trust.**--A charitable trust may provide substantial income tax savings for those who have identified a charity to which they want to leave a significant part of their estate and who are prepared to make the commitment now. There are two major types of charitable trusts. With a *charitable remainder trust*, you transfer assets to an irrevocable trust that will pay income to you for life and then leave the principal remaining at your death to the charity. The tax laws may allow you to take a substantial charitable deduction on the present value of the principal that will pass at your death. If substantially appreciated property is used to fund the trust, additional income tax savings may be realized. A *charitable income (or lead) trust*

provides for the charity to receive trust income for a term of years, with the remainder to pass to a non-charitable beneficiary. Again, a substantial income tax benefit may be realized.

## CHOOSING YOUR TRUSTEE

When setting up any trust, one of your most important decisions is choosing a trustee. For a revocable trust, you generally will choose yourself as trustee so that you may keep control of the trust’s assets. Of course, you must choose someone to take over as trustee at your death or incapacity. For an irrevocable trust, you should not be the trustee because the tax advantage of the irrevocable trust may be lost when the creator of the trust is the trustee. For both revocable and irrevocable trusts, you should select alternate trustees to take over in the event the primary trustee can not continue. To assure that a person of your choice will always be the trustee, you should consider the age and health of trustee candidates and possibly nominate more than one alternate trustee.

Many people setting up trusts with a large principal amount prefer to use a professional trustee, such as a trust company. The institutional trustee can provide professional management and assurance of continuity without interruption. But, because the professional trustee may be detached from the special needs and circumstances of the grantor’s family, it may be wise to select a qualified family member, friend, or advisor as a co-trustee.

## CONCLUSION

Living trusts may seem complicated, but the protection and possible tax benefits they can provide make them valuable estate and financial planning tools. When planning for the security of your family, consider how a living trust can fulfill your needs and objectives.

*This brochure is provided for informational purposes only. While every effort has been made to ensure accuracy, it cannot be relied upon as legal advice. Applicability of the legal principles discussed may differ substantially in individual situations, and you should consult with your legal advisor.*

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## PLANNING WITH TRUSTS

