The Irrevocable Trust

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A trust is a legal way of holding, managing, and distributing property. A trust may be either *irrevocable* or *revocable*. State law and the trust instrument itself usually set out whether the trust is revocable. When using a trust for wealth preservation planning, a revocable trust usually is not very helpful.

Setting up and administering a trust is a five-step process:

1. Creation of the trust
2. Tax recognition of the trust
3. Funding of the trust
4. Administration of the trust
5. Distributions from the trust

We'll discuss each of these five steps below and conclude with a brief discussion about trust taxation.

1. Creation

The steps in creating a trust are:

1. Identifying the person who establishes and funds the trust. This person is usually called the "Grantor."
2. Identifying an appropriate trustee. A Trustee is the person who holds, invests, manages, and distributes the money for the "Beneficiary" or the person or persons for whom the trust is established.
3. Drafting the trust to meet any specifics for the trust that the law requires, such as to avoid the trust assets being counted as a resource to the trust beneficiary.
   Because with the *irrevocable income-only trust* we do not want the trust assets to be counted by Medicaid (TennCare) as a resource to the Grantor-Beneficiary, the Grantor-Beneficiary is entitled to receive *income only* distributions from the trust—in other words, the interest income from the trust assets.
   If the Grantor is also the Beneficiary of the trust, the U. S. Department of Veterans Affairs will count the assets in the trust as a resource, even in an income-only trust. So with the *irrevocable asset protection trust*, the Grantor is not a Beneficiary at all—a third party is. For that reason, sometimes we call the irrevocable asset protection trust an *irrevocable third-party trust*.
4. Other persons ("third parties") are entitled to receive distributions from trust *principal* (this is the legal term to describe the assets that have been transferred by the Grantor to the Trustee) and sometimes income as well.

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Example: Mildred owns a $200,000 CD. She wishes to protect the trust principal ($200,000) from the cost of long-term care but still continue to receive the interest on the CD.

Mildred creates and funds a trust of which she is the Grantor of the trust and also the Beneficiary of the *income* from the trust assets. Mildred designates her children as Beneficiaries of the trust *principal*. She transfers title of the CD to her daughter Barbara, who Mildred named the trustee of her trust. As Trustee, Barbara holds the trust assets for the benefit of the trust's beneficiaries.

2. Tax Recognition

Once the trust has been created, a federal employees identification number (a tax ID or "EIN") is obtained from the Internal Revenue Service's web site (www.irs.gov). Trust funds are invested under a tax ID number, not a Social Security number.

Getting a tax ID number doesn't automatically mean the trust must pay income taxes. The trust is or could be a taxpaying entity. In practice, however, any income the trust earns is usually taxed to the beneficiary, who would pay the taxes on that income. The trust may have to file a federal income tax return but usually would not have to pay any income taxes.

We recommend that the trustee retain professional help for guidance on trust accounting and trust taxation.

3. Funding

Needless to say, if there is no money, there is nothing to manage or distribute. After the trust has been created, the trust is *funded*. Typically, there are two substeps to the funding process:

Sub step 1: The Grantor transfers his or her assets to the Trustee;

Sub step 2: The Trustee accepts title to the assets.

In most instances all this means is that the trustee goes to the bank or brokerage company with a copy of the trust agreement, the federal tax ID number, and a check made out by the Grantor to the Trustee to open up a trustee account. Instead of a social security number, the tax ID number is used.

4. Administration

Understanding Fiduciary Obligations

The trustee is a fiduciary. A fiduciary is someone who acts solely for the benefit of trust beneficiaries.

Unless the trust agreement says otherwise, local law limits the kinds of investments that a trustee may make. It is wise for a trustee to discuss trust investments with an investment adviser to help the trustee determine what investments of the trust assets should be made that further the intent of the trust.

A fiduciary is any person who:

- Exercises any discretionary control or authority over the management of the trust or the disposition of its assets;
- Offers investment advice regarding plan assets and derives compensation for it, either direct or indirect; or
- Has any discretionary authority or responsibility regarding trust administration.

The fiduciaries involved in a trust are therefore the trustee, the trust administrator, and the investment adviser.

Back-End Duties of a Fiduciary

We divide the duties of a fiduciary into two functions: back-end duties and front-end services. The fiduciary's back-end services

can themselves be split into two functions: trust administration and investment management. Both relate to the establishment, monitoring, and daily management of a trust fund. (Front-end services pertain to distributions for the beneficiary's special needs, the trustee's role that will be considered in the next section.)

A fiduciary's responsibilities as administrator of the trust are as follows:

- Open the trust account in accordance with a written trust agreement;
- Operate the trust in accordance with the trust document and other operating procedures;
- Operate the trust solely in the best interests of the trust beneficiary; and
- Ensure that the trust remains in compliance with all legal and regulatory requirements.

For large trusts, most trustees work with a record keeper, service provider, or consultant to ensure that these administrative duties are properly handled. It is also the fiduciary's responsibility to select the service provider and to monitor the service provider's performance to ensure that the trust is being administered correctly. For small "family" trusts, the trustee may do most or all of this work.

The responsibilities for a fiduciary acting in an investment management capacity include the following:

- Ensure FDIC coverage limits
- Establish policy outlining how investment decisions are to be made and monitored;
- Ensure diversification of assets in accordance with risk and reward objectives;
- Monitor trust investment options to ensure that established objectives are met;
- Utilize prudent experts to make investment decisions;
- Control and account for all investment expenses;
- Monitor money manager and service provider activities; and
- Avoid conflicts of interest.

How to Stay Compliant

The trustee should monitor investments closely. Look for a financial services firm that not only can relieve the burdens of recordkeeping, compliance, and administration, but one that can assist with investment advisory services too. Choose an investment adviser who understands the conservative approach that must be taken toward the trust funds. Document the file as to the investment advice given to the trustee.

The Foundation for Fiduciary Studies (now called "fi360") has made available for free download a handbook on prudent investment practices. The primary purpose of *Prudent Investment Practices: A Handbook for Investment Fiduciaries* is to outline uniform fiduciary standards of care and practices that are intended to define a prudent investment process. The handbook covers 27 practices culled from federal and state legislation, regulatory opinion letters, and relevant case law. The handbook states: "Fiduciary liability is not determined by investment performance, but rather on whether prudent investment practices were followed. It's not whether you win or lose, it's how you play the game."[1]

Establish a regular schedule for accounting

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[1]fi360.com, formerly Foundation for Fiduciary Studies (May 2003), available for free download at http://www.sec.gov/nb/comments/akendal033105-hand1.pdf.

to the beneficiary or the beneficiary's representative of investments and distributions from the trust sub-account.

Trustees must have a thorough understanding of their own fiduciary responsibility—and potential liability. It is not a privilege or an honor to be a trustee, it is a job.

Property and Casualty Insurance

The trustee, not the individual grantor, is the owner of the trust assets. The trustee therefore should notify any insurance company that insures those assets, such as the homeowners insurance company, the title to the insured assets has changed to the trustee of the trust.

Failure to notify the insurance company of the change in title to the trustee of the trust could result in a denial of a claim should a loss occur.

5. Distribution

Income-Only Trust/Grantor Trust

The trustee of the *irrevocable income-only trust* is prohibited under the terms of the trust from distributing anything to the grantor-beneficiary other than income earned on the trust principal. If the trustee makes a mistake and distributes trust principal to the grantor-beneficiary, the trustee risks that the State Medicaid agency will count the trust principal as a resource to the grantor-beneficiary, if and when the grantor-beneficiary applies for Medicaid nursing home benefits. Distributions to the grantor-beneficiary that are disqualifying may render the trustee liable to the grantor-beneficiary for a loss or diminution of these Medicaid benefits.

Asset Protection/Third-Party Trust/Complex Trust

The trustee of the *irrevocable asset protection trust* or *irrevocable third-party trust* is prohibited under the terms of the trust from distributing anything to the grantor-beneficiary. If the trustee makes a mistake and distributes trust income or principal to the grantor-beneficiary, the trustee risks that the State Medicaid agency will count the trust principal as a resource to the grantor-beneficiary, if and when the grantor-beneficiary applies for Medicaid nursing home benefits, VA pension benefits, or makes application for HUD (Section 8) housing. Distributions to the grantor-beneficiary that are disqualifying may render the trustee liable to the grantor-beneficiary for a loss or diminution of these public benefits.

Principal Distributions

The trustee may but need not distribute trust principal to other beneficiaries. These beneficiaries—the "third parties"—will be identified in the trust document itself and may be children or grandchildren.

Example: Mildred created an irrevocable income-only trust in which she is the income-only beneficiary and her children are beneficiaries of the principal. She transferred $200,000 of her money to the trustee of the trust (her daughter Barbara). Last year, the trust earned $6,500 in interest income; and Barbara, the trustee, distributed all of the trust income last year to Mildred.

Because Mildred wanted some more money to pay toward her living expenses, Barbara as trustee distributed $10,000 in trust principal to Mildred's son Mark, who elected to use that money to help pay for Mildred's expenses.

Taxation of Trusts, in General

Income Tax

It is important to know who will be taxed on the income generated by the trust. Income earned from trust assets will be taxed to

the grantor, the beneficiary, or the trust itself. Income that is taxed to the trust is taxed at much steeper rates than income taxed to individuals. Because trust income reaches the highest tax bracket much more quickly than individual income, it is desirable to structure the trust so that income is taxed, instead, to either the grantor or the beneficiary.

Please read this section carefully because you will want to share this information with your tax accountant or other tax preparer.

For tax purposes an irrevocable trust can be treated as a *simple*, *complex*, or *grantor* trust, depending on the powers over the trust assets retained by the grantor or given to the trustee as set forth in the trust instrument.

A "grantor trust" is a term used in the Internal Revenue Code to describe any trust in which the grantor retains certain powers over or benefits in the trust. If a trust is a grantor trust, then the grantor is treated as the owner of the assets, the trust is disregarded as a separate tax entity, and all income is taxed to the grantor. A revocable trust, for example, is a grantor trust.

A trust subject to Internal Revenue Code §§ 651 and 652 is known as a "simple trust." A "simple trust" is not a grantor trust nor is it required to be treated as a grantor trust. It is required to distribute all income annually and may not distribute the corpus of the trust or make charitable contributions.

A trust that is not a simple trust is known as a "complex trust" and is subject to the provisions of §§ 661-663.

The irrevocable income-only trust is a grantor trust.

The irrevocable asset protection trust is not a grantor trust.

Depending upon the conditions for distribution of trust income and corpus, *the irrevocable asset protection trust will be either a complex trust or a simple trust.*

Taxable income generated by assets held in the irrevocable trust is taxable to the trust (at trust tax rates) unless the income is taxable to the grantor (at the grantor's rates) under the grantor trust rules. Because the irrevocable income-only trust is a grantor trust, the income the trust earns is taxable to the grantor-beneficiary even if not distributed to the grantor-beneficiary.

If the trust is not a grantor trust, the income the trust earns will be taxed to the beneficiary only if it is distributed to the beneficiary. Otherwise, it would be taxed to the trust.

Gift Tax

Whether the transfer of property into the trust is a taxable gift depends upon whether the gift is complete. For gift tax purposes, a gift is complete to the extent the donor (the person making the gift) has irrevocably parted with dominion and control over all or part of the transferred property, whether directly or indirectly, leaving the donor without the power to change its disposition, whether for the benefit of the donor or for the benefit of others.

A completed gift qualifies for the annual federal gift tax exclusion. A transfer to an irrevocable trust usually will constitute a taxable gift by the grantor unless the grantor retains a *limited power of appointment* or other right to determine who receives trust distributions. For example, the grantor may reserve the right to appoint the trust assets (that is, to remove trust assets out of the trustee's hands) and give them to someone else. Reservation of that power to appoint renders the transfer to the trust an incomplete gift.

Because the trust document reserves to the Grantor a limited power of appoint-

ment, the transfer of trust assets by the Grantor to the irrevocable income-only trust is *not* a completed gift and therefore not subject to federal gift tax. (Tennessee has no estate or gift tax.)

Filing Income Tax Returns

A trustee of a grantor trust will issue a Form 1099-MISC to the grantor of the grantor's share of the trust's income.

A trustee of a non-grantor trust will issue a Form K-1 to the beneficiary of the trust of the beneficiary's share of the trust's income.

Trusts must file Form 1041, U.S. Income Tax Return for Estates and Trusts, for each taxable year in which the trust has $600 in income or the trust has a non-resident alien as a beneficiary.

If the trust is classified as a grantor trust, however, it is not required to file Form 1041, provided that the individual grantor-beneficiary reports all items of income and allowable expenses on his or her own Form 1040, U.S. Individual Income Tax Return.

Example: Mildred created an irrevocable income-only trust in which she is the income-only beneficiary and her children are beneficiaries of the principal. She transferred $200,000 of her money to the trustee of the trust (her daughter Barbara). Last year, the trust earned $6,500 in interest income; and Barbara, the trustee, distributed all of the trust income last year to Mildred. The trust is a grantor trust. Barbara as trustee issues a Form 1099-MISC to Mildred showing that Mildred received $6,500 in trust income. Mildred files a federal income tax return reporting the trust income. The trustee is not required to file a federal income tax return.

Last year, Barbara as trustee distributed $10,000 of trust principal to Mildred's son Mark. Distribution of trust principal to Mark completed a $10,000 gift by Mildred to Mark. Because the $10,000 gift is less than the annual gift tax exclusion amount for federal gift tax purposes, no gift tax is owed on the distribution to Mark.

Example: Frances created an irrevocable trust in which her son Jason is beneficiary of the income only and her four other children are beneficiaries of the principal. She transferred $200,000 of her money to the trustee of the trust (her friend George). Last year, the trust earned $6,500 in interest income; and George, the trustee, distributed all of the trust income last year to Jason. The trust is a simple trust. George as trustee issues a Form K-1 to Jason showing that Jason received $6,500 in trust income. Jason files a federal income tax return reporting the trust income. The trustee is required to file a federal income tax return, but will pay no federal income tax.

We do not file tax returns for our clients and cannot hold ourselves out as a "tax preparer." We will not give you advice on how to prepare a tax return for the trust.

We recommend strongly that you engage a competent accounting and tax professional to assist you in setting up the books and records of your trust and to advise you on whether and how to file a tax return for the trust.