Understanding Trusts: Primer for Purpose and Planning with Trusts

Contact us for more information about the types of trusts that may be beneficial based on your estate planning, asset management and long-term health care needs. Schedule an appointment with Elder Law and Estate Planning Attorney Nancy A. Cogar at Samples, Jennings, Clem and Fields, PLLC by calling 423-892-2006 or by email at ncogar@sampleslaw.com

There are all kinds of trusts and even more reasons why you might decide to establish a trust. Trusts are a flexible tool and with the right planning can be established to achieve a wide variety of long-term planning needs or goals as to your personal legacy. Understanding how different types of trusts function can help you decide whether to consider a trust as part of your estate and long-term planning.

Estate Basics: What is an "estate"? Your estate is everything you own – this includes all your property rights – even assets that may have indebtedness secured against them. A decedent cannot own property, so when someone dies ownership of the assets must be assigned to an estate.

Trust Basics: A trust is a legal document that creates a relationship between two parties: A Trustee and the Trustor who is also known as the Settlor or Grantor. The Trustor is the person who establishes the trust and initially funds it (or transfers assets into the trust). The Trustee is the "watchman" of the trust. He/she is the person or entity with a fiduciary responsibility for managing the trust and its assets according to the specific intent of the Trustor. Sometimes a Trustor and Trustee can be the same person as is the case with what is known as a "self-settled trust."

Trust: A trust is a legal entity or a written agreement that allows someone as Trustor or Grantor to transfer property to someone known as the Trustee for the benefit of a third party – known as the beneficiary. The entity is created to set up, hold, safeguard and distribute assets.

Trustee: A Trustee is a fiduciary with specific obligations to manage a trust and its assets. There is a high level of responsibility on a Trustee and for this reason, a Trustor should take care in selecting a Trustee who has a good history with money and financial decisions. Often an individual convicted of a prior felony or someone who has filed bankruptcy is disqualified from serving as a fiduciary.

Benefits of a Trust: A trust can assist with special needs and/or planning and asset management strategies. A trust may also help avoid probate, create a device to manage both personal and/or business assets if you should become incapacitated, set aside assets or monies for care of a family member or other individual with certain special needs or a disability, establish specific rules for beneficiaries to receive a disbursement, preserve assets for minor children or adult

children with challenges in handling finances under the control of a Trustee who can make disbursements for education, health, welfare and other specific needs. A trust may also help reduce estate and/or gift taxes.

Trust Beneficiaries: Like a Last Testament and Will, a Trust normally has beneficiaries. Trusts offer broad flexibility as to who those beneficiaries may be – a spouse, children, grandchildren, other family members, non-profit entities and/or charities, even close friends. The beneficiaries of a trust are entitled to receive assets from the trust based on the directives of the Trustor (or trust creator). The Trustee is charged with administration of the trust, including distribution of assets.

Trust Assets: The types of assets that may be transferred to a trust are varied as well. They may include: real estate, including your home or other real estate – including investment property and real property in other states than the one you reside, bank accounts, investment accounts including stocks, bonds and money market accounts, life insurance policies, business holdings and assets, collectibles, antiques and other personal property.

Funding Trusts: Funding a trust takes place when assets are transferred int the name of the trust. At that time, the Trustee takes over control of the assets.

Revocable versus Irrevocable Trusts:

Revocable Trusts: A revocable trust which is also known as a revocable "living" trust creates an entity which can house assets in the name of the trust and still allow you to maintain individual control over those assets during your lifetime. In more simpler terms, a revocable trust is a flexible creation as it can be "revoked" by the creator Trustor at any time. This provides for greater flexibility over a Trustor's lifetime and requires potential amendments and/or updates to the trust following significant life events, i.e. divorces, additional purchases of property, moves, etc. You can also put assets in and take assets out of a revocable trust. You might picture a box as the trust with a lid that the Trustor can open and shut to put assets in or take them out during his/her lifetime. The disposition of assets into a revocable trust does not become "permanent" until the Trustor dies.

Revocable trusts are also not subject to probate administration. For this reason, assets held in a trust are distributed to beneficiaries without having to request or file any action with a Court. This provides attractive privacy for some individuals who prefer to avoid the public notice requirements that accompany a probate administration. For this reason, it can be more difficult for creditors to make claims against assets held in a revocable trust to satisfy outstanding debts. (Irrevocable Trusts offer greater protection from creditor claims – for more information see the section on Irrevocable Trusts).

Irrevocable Trusts: Just like is sounds, an irrevocable trust cannot be "revoked" by the Trustor. For that reason, it generally offers greater creditor protection and can be effective in managing assets, legacy planning and preparing for long term needs. Irrevocable Trusts can also offer protection from Medicaid/TennCare recovery for government assistance provided towards health care or other special needs. An Irrevocable Trust can also shelter assets from gift and/or estate

taxes. This can be especially appealing if there is a larger estate where strategies to minimize tax liability may be appropriate.

Specialized Trusts:

- Marital Trusts (also known as an "A" Trust): A marital trust may be created by one spouse for the benefit of the other. When the first spouses dies the assets in the trust and any income generated are passed on to the surviving spouse. A marital trust may allow the surviving spouse from paying estate taxes on the assets during her/his lifetime. The surviving spouses' heirs should expect to be responsible for paying any estate tax liability on trust assets that are passed on to them when the surviving spouse dies.

- Bypass Trusts (also known as a "B" Trust or Creditor Shelter Trust: Married couples can also create a bypass or creditor shelter trust which is also known as a "B" trust. These trusts are normally created in instances where there are is a larger estate and there is a desire to reduce the potential estate tax liability for heirs. This type of irrevocable trust transfers assets directly from one spouse to another at the time of the first spouse's death. In a "B" Trust the surviving spouse does not hold the assets directly. A Trustee manages the assets which may allow for them to be excluded from that surviving spouse's estate. When the surviving spouse dies, the objective allows the remaining assets to be distributed to beneficiaries, free of estate tax.

- Charitable Trusts: A charitable trust can be effective to help create a legacy of giving as part of your estate planning. There are two types of charitable trusts you can establish both a charitable lead trust and a charitable remainder trust. A charitable lead trust can allow you to earmark certain assets for specific charities while the remainder of the trust assets go to beneficiaries when the Trustor dies. A charitable remainder trust allows you to receive income from your assets for a specific time and remaining assets and/or income go to a designated charity.

- Generation-skipping trusts: If you would rather designate your assets to go to your grandchildren versus your children, you might consider a generation-skipping trust. A GST allows assets to pass to your grandchildren, in effect "skipping a generation of heirs" which allows children to avoid paying estate taxes on those assets. You can also retain an option to allow your children to access the income that those assets produce before passing to their children, (your grandchildren).

- Special Needs Trust: A special needs trust allows for monies to be set aside for a special needs or disabled dependent including a child, sibling, or even long-term care of a parent. At the same time, a SNT should not compromise the special needs person from being eligible to receive government assistance for their care or needs, i.e. SSI and/or Medicaid. The funds in the SNT allow for certain day-to-day needs to be paid while allowing them to remain eligible for government benefits. The Trust assets cannot be disbursed directly to the beneficiary so that they do not have any control over them.

- Medicaid Asset Protection Trust: A Medicaid Asset Protection Trust or MAPT is an irrevocable trust created during the lifetime of the Trustor. Its purpose is to set aside certain assets from being considered "countable" as assets that may go towards the Trustor's future nursing home costs. For this type of trust to be effective, it is subject to the so-called "5-year Medicaid eligibility look back" which looks at transfers within 5 years of an application for Medicaid/TennCare assistance. If such assistance is needed within 5 years of a such a transfer it may result in a spend-down or period of ineligibility.

- Miller Trusts (Qualified Income Trust): Miller Trusts, also called Qualified Income Trusts, are an effective tool for Medicaid applicants who have income over Medicaid's limit to become eligible for Medicaid long term care including nursing home care. Miller Trusts are called by a variety of names and include the following: Qualifying Income Trusts, QITs, Income Diversion Trusts, Income Cap Trusts, Irrevocable Income Trusts, Income Trusts, d4B trusts, and Income Only Trusts. Miller Trusts / Qualifying Income Trusts are helpful in planning for long term health care or nursing home care in states like Tennessee which are designated as "medically needy" (also called "spend down") states, while others are "categorically needy" (also called "income cap") states. In "spend down" states, Medicaid applicants who are over the income limit can spend "excess" income on medical and care expenses. Once their income is "spent down" to the medically needy income limit, they are eligible for Medicaid for the rest of the spend down period. Upon the death of the Medicaid recipient, the state is named as the beneficiary of the Miller Trust / Qualifying Income Trust. In the event there are any funds remaining in the trust account, the state will receive it as reimbursement for funds paid for the care of the Medicaid recipient. That said, the state will not receive an amount greater than it paid for the deceased Medicaid beneficiary's long term care, although it would be very unlikely for a Miller Trust to have funds in excess of this amount.

  Pooled Trusts: Pooled Income Trusts, a type of special needs trust, are created by non-profit organizations and accomplish the same means as Miller Trusts. They allow applicants with income over the long-term care Medicaid income limit a way to meet the income limit. Pooled Income Trusts are only allowed in a handful of states, two of which are New York and Connecticut (New York and Connecticut do not permit Miller Trusts). In simple terms, with Pooled Income Trusts, one's excess income (the income over the long-term care income limit) is deposited into the trust, no longer counting towards Medicaid's income limit. The term, "pooled", comes from the fact that it is not an individual account. Rather, income from a large number of people is pooled and managed together.

- Income Only Trust: (IIOT) An irrevocable income-only trust is a type of living trust often used for Medicaid planning. It protects assets from being sold to pay for nursing home and other long-term care expenses so that the assets can be passed on to lifetime beneficiaries who are named to receive after the Trustor passes away. IIOT's are subject

to Medicaid's 5-year look back snapshot for purposes which would review transfers relating five years from the date of application for government assistance for long term or nursing home care. After five years the assets in an IIOT should not be considered "countable" for Medicaid qualification purposes. In order for that to be the case, the Trust must be irrevocable, and the Grantor/Trustor may not have access to the principal of the trust.

- Constructive Trust: A constructive trust is put into place by a Court to avoid what is known as unjust enrichment. The Court has the discretion to create a constructive trust to secure assets when it determines that a party is in possession of assets that it should not justly have in its possession. In this sense a trust is "implied" by the Court and the purpose of the constructive trust is to transfer those assets to a place where they can benefit the rightful owner as determined by the Court.

- Qualified Terminable Interest Property Trust (QTIP Trust): A QTIP Trust divides your assets among named beneficiaries at different times. For instance, income from the QTIP may be directed to a surviving spouse upon your passing and then to your children when the surviving spouse passes away. A QTIP also restricts your surviving spouse from accessing the full principal of the Trust assets and limits them to distribution of the income from the trust.

- Spendthrift Trust: A spendthrift trust can provide additional peace of mind to a Trustor who may be concerned about an heir's ability to manage an inheritance. This type of trust allows the creator to specify when, for what purpose and how much money can be accessed by a beneficiary and prevents the money from being misused or squandered. A spendthrift trust can also authorize disbursements for limited purposes to avoid potential mismanagement of an outright disbursement to an heir with creditor or money management issues.

- Testamentary Trust: A testamentary trust, or will trust, is established through an individual's Last Will and Testament. It often allows for a trust to be established if certain conditions exist at the time that a disposition would be made under a Will, i.e. minor beneficiaries or beneficiaries with special needs who may become ineligible for certain care or benefits by an inheritance.

- Totten Trust: This type of trust is none as a payable-on-death account. It allows you to put money into a bank account or other security interest for an individual. When you die the money set aside in a Totten Trust then passes directly to that named beneficiary.

- Irrevocable Life Insurance Trust: An Irrevocable Life Insurance Trust or (ILIT) is a trust that owns a life insurance policy for the purpose of paying a Trustor's estate taxes. It also keeps the value of that insurance policy out of the Trustor's estate. These are not

currently put into practice very often as the federal estate tax exemption limit is currently set at $11.58 million.

- Pet Trusts: You cannot leave money directly to a pet, but you can name pet(s) as beneficiaries of a Pet Trust to pay for their care after you pass away. Pet Trusts can be used as vehicles to house monies to care for Trustor's surviving pets. A Trustee is named to be over the management of the Trust and its assets, and a caretaker is named for the pets (beneficiaries). The same person can serve in both roles.