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Are Trusts Still Necessary?

Trusts are often viewed as estate planning tools that are used to reduce estate taxes. But with the gradual elimination of the estate tax, does that mean that trusts are no longer needed for estate planning purposes? The long phase-out period means that estate taxes still need to be dealt with during this time. Also, trusts are established for many purposes, not just to reduce estate taxes. Some commonly used trusts and their status under current tax law include:

- **Revocable living trusts.** These trusts are established for reasons other than the reduction of estate taxes, so their use should not change. With a revocable living trust, ownership of assets is transferred to the trust while you are alive. You can keep any or all of the income, act as trustee, change the trust's provisions, or terminate the trust. You can provide for a successor trustee to take over if you become mentally or physically disabled. Assets in the trust are controlled by the trust agreement and are not subject to probate proceedings.

- **Bypass or credit shelter trust.** This trust is generally used to ensure that both spouses take advantage of their estate tax applicable exclusion amount, without directly transferring assets to other heirs until both spouses have died. Generally, assets equal to the estate tax exclusion amount are placed in trust after your death. Your spouse may then use the income, and in certain circumstances, some of the trust's principal, with the remaining assets transferred to your other heirs after your spouse's death. The use of this trust is likely to continue, since the estate tax won't be repealed until 2010. However, make sure to review the amounts that will be placed in the trust. With the applicable exclusion amount increasing significantly, those amounts may be higher than you originally intended.

- **Qualified terminable interest property (QTIP) trust.** This trust is typically used when a spouse has remarried and wants to financially protect children from a previous marriage. It provides that assets in excess of those placed in the credit shelter trust be placed in the QTIP trust. Income from the trust is distributed to the surviving spouse during his/her lifetime. This qualifies for the unlimited marital deduction, so that estate taxes will not be paid after the first spouse's death. After the surviving spouse's death, the principal is distributed to the first spouse's heirs. Since the purpose of this trust encompasses more than estate tax reduction, its use is likely to continue.

- **Irrevocable life insurance trust.** This trust is used to ensure that the proceeds from a life insurance policy are not subject to estate taxes. Annually, you can make gifts to the trust, possibly using your annual gift tax exclusion, so the trustee can pay the policy premium. After your death, the trust receives the insurance proceeds, distributing them in accordance with the trust's terms. Due to the irrevocable nature of this trust, its future use is uncertain. It probably makes sense to continue any existing trusts, since the estate tax will not be fully repealed until 2010. Even if the proceeds are not needed for estate tax purposes, you may have other uses for the proceeds. Deciding whether to set up a new irrevocable life insurance trust is a tougher call, requiring a careful analysis of all factors.

- **Charitable remainder trust.** This trust is typically used to provide a large charitable contribution while avoiding a large capital gains tax bill. You transfer an asset to the trust, typically one with a low basis that has appreciated significantly. Since the trust is a tax-exempt organization, it can then sell the asset without paying any capital gains taxes and reinvest the proceeds. You receive an immediate charitable contribution deduction equal to the present value of the property the charity will receive. You also receive the income from the trust, with the remaining principal going to the charity after the trust terminates. Since this type of trust is established for income and estate tax purposes, its use should not change under the new law.

- **Qualified personal residence trust.** With this trust, you place your home or vacation home in an irrevocable trust, retaining the right to live in the home for a specified number of years.

When the trust terminates, ownership passes to your beneficiaries. The gift tax value is determined on the date the house is placed in trust, by calculating the present value discounted over the trust's term. If you die before the trust ends, the home is included in your estate at its fair market value. Although this trust is typically used to remove assets from your taxable estate, that may still remain a valid objective for the next several years. Additionally, since present value calculations are used to determine the gift's value, this trust allows you to leverage the use of your $1,000,000 lifetime gift exemption.