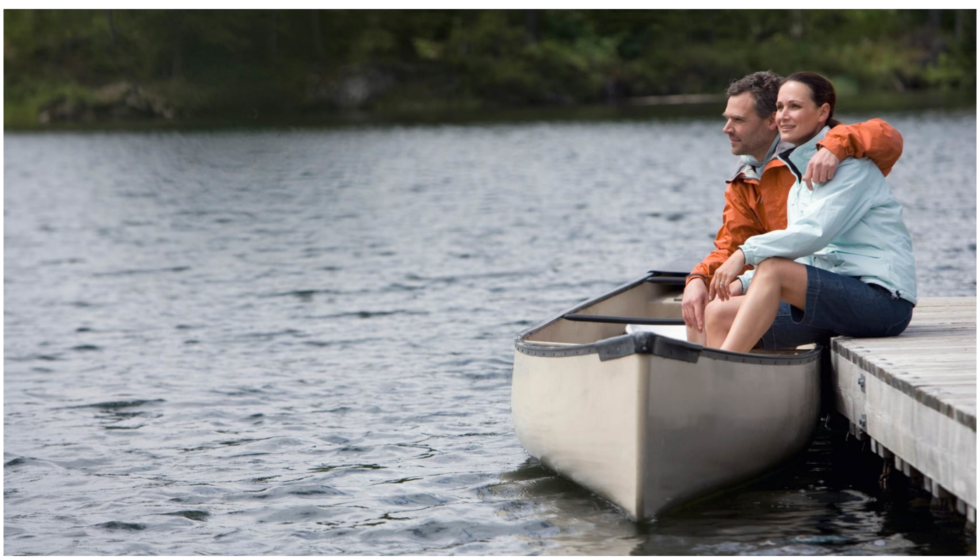
ESTATE PLANNING

The (Only) 3 Reasons You Should Have an Irrevocable Trust

Should you really agree to give up control of your assets? There are some good reasons to get this type of trust, but there are some major drawbacks as well.

by: **Daniel A. Timins, Esq., CFP®** - July 27, 2020



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Despite what you may have heard, you probably do not need (or want) an *irrevocable* trust. When you create an irrevocable trust you are creating a document you cannot change easily, and the property you transfer to the trust is no longer in your control.

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So why would anyone part with power over his or her own assets and rely on someone else to manage their money? The only three times you might want to consider creating an irrevocable trust is when you want to (1) minimize estate taxes,

(2) become eligible for government programs, or (3) protect your assets from your creditors. If none of these applies, you should not have one.

General Information About Trusts

Whether they are revocable or irrevocable, all trusts have three parties:

- The Creator, who creates the trust document and transfers property or assets to the trust,
- The Trustee, who follows the trust's instructions, invests trust funds, uses trust property for the beneficiary's needs, and pays the trust's administrative expenses, and
- The Beneficiary, who sits back and enjoys the benefits from the trust's assets and/or income.

You can act as all three parties, in which case you have a true *revocable* trust, which you can change and revoke at any time. With revocable trusts, however, you only receive limited creditor protection, minimal estate tax savings, and do not qualify to receive any government program benefits.

If, however, you take away your ability to change the trust and name a Trustee who is unrelated to the Beneficiary, you have given up a substantial amount of control over unrelated to the Beneficiary, you have given up a substantial amount of control over the trust. Under these circumstances the government acknowledges you have divested yourself of enough power to grant the Beneficiaries of the trust certain benefits.

The Only Benefits of Irrevocable Trusts

1. Minimizing Estate Taxes: People who are willing to gift money every year can use these funds to purchase life insurance in an “irrevocable life insurance trust” that may avoid paying estate taxes when they die. Another is a “grantor retained annuity trust” that gives the Creator a set income stream for several years and may allow some of the principal to go to family members estate tax free. They may also create a “charitable remainder unitrust” that pays income to family now and leaves the remaining trust funds to a charity at their death. Only in rare instances may the Trustee and the Beneficiary be the same person in estate tax savings trusts, and you must at a minimum have a disinterested party serving as a Co-Trustee who has the power to overrule your directions.

2. Becoming Eligible for Government Programs: Disabled beneficiaries on Medicaid and Supplemental Security Income have stringent income and asset limitations — if they own or receive too much money they can lose these government benefits. Irrevocable trusts can shelter income and assets, so these limits are not exceeded. The Trustee of these “Medicaid trusts” can never be the Creator. Just like estate tax savings trusts, the Beneficiary has been divested of substantial control over the trust, so the government benefits continue to be provided, because the trust funds are not included as the Beneficiary’s own assets and income.

3. Protecting Your Assets. Protecting your assets from your creditors usually requires a trust to be irrevocable, and the Trustee and Beneficiary must be unrelated parties (or, at most, the same party with limited power over trust funds). These are commonly referred to as "asset protection trusts" and are usually only created in states that have favorable trust laws, such as Delaware, Nevada and North Dakota. For people who frequently face lawsuits (such as surgeons, architects and real estate developers) these protections are incredibly meaningful.

The Many Negatives of Irrevocable Trusts

If you are not wealthy, there is no good reason to fund an irrevocable trust with life insurance, create charitable remainder trusts, or gift substantial property to avoid estate taxes prior to your death. Since there is no federal estate tax below $11.58 million per spouse, few people currently need an irrevocable trust for estate tax savings. (Note: **State estate tax limits** can be much lower than federal.) So these actions only make sense if your estate will be sizable.

If you do not plan on qualifying for Medicaid (Medicaid benefits are not particularly lavish) there is no reason to have the majority of your assets transferred to an irrevocable trust and controlled by a Trustee who may deny you use of the funds in the trust. Plus, you are usually limited to receiving income from Medicaid trusts and cannot withdraw principal, so if you do not end up receiving Medicaid your principal is nonetheless locked up.

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An irrevocable trust *may* protect your assets, but a court can reclaim these assets when it feels you unjustly transferred funds to the trust in contemplation of a lawsuit. Most states require that funds be owned by the trust for one or two years prior to their being protected, so assets placed in an asset protection trust may not qualify for protection from recent accidents. And you don't need an irrevocable trust to protect your beneficiaries from their creditors, since a carefully drafted revocable trust protects every beneficiary except you and your spouse (and even then, in certain circumstances your spouse may be protected by a revocable trust). Plus, these trusts usually require an independent individual located in the administering state to manage trust assets. If you sense there is little chance of you being sued, or that the person you would name as trustee is less responsible than you, asset protection trusts may not be a good option.

If you're thinking about an irrevocable trust to avoid probate and protect your privacy, you could probably be just as well-served with a revocable trust instead. Since trusts act as a substitute to wills, all trusts avoid probate unless the will "pours-over" to the trust, since the court needs to know who the ultimate recipient is under the will. So almost all revocable trusts avoid probate. Ditto regarding privacy: Revocable trusts are just as private as irrevocable trusts.

Irrevocable trusts often have worse income tax treatment than revocable trusts if income is not distributed to the beneficiaries. Irrevocable trusts usually have to pay an accountant to file a separate income tax return for the trust. Plus, you often need a third party to act as Trustee of an irrevocable trust, so while you would serve as your own Trustee of your revocable trust for free (since the trust's money is your money

Never forget that you lose control of property transferred to an irrevocable trust.

Has your youngest child ticked you off? Too bad, he is permanently a Beneficiary.

Estate tax exemptions have increased, and your estate is no longer estate taxable? Sorry, you can't reclaim the asset.

Want to receive more trust income, or want your Trustee to sell your current house and upgrade to a larger one? Hope you're on good terms with them: You are not the Trustee, and he or she is the person who gets to decide what happens to trust property.

And worst of all, there are very specific rules you must follow to qualify for the benefits of an irrevocable trust, and if your trust breaches too many of these rules you may end up with an irrevocable trust that locks up your money but does not provide you with any of the advantages of the trust.

Lastly, just because you have an irrevocable trust does not mean you qualify for all three benefits of an irrevocable trust. Quite the opposite: A trust that protects you from estate taxes is usually not Medicaid-compliant, and was most likely not set up with a permissible trustee to allow the creditor protection an asset protection trust affords. So the real question is not whether or not you want an irrevocable trust, but which irrevocable trust would you want now knowing that it may not be the one you want in the future.

Consider Your Trustee Carefully: It Makes a Difference

Yes, you can retain some powers that give you limited control over the trust and the Trustee, and third parties can take some actions to modify irrevocable trusts. A court can be petitioned to change the trust, a trustee or trust protector may have powers to make modifications to the trust, or every beneficiary can agree to change the trust (though this latter strategy is usually not available when there are minor beneficiaries). But these modifications require other people (or worse, courts) to agree with your point of view, because you are powerless to legally change the trust.

The Bottom Line: Be Sure Before You Go This Route

The lesson should be clear: Do not create an irrevocable trust unless you need estate tax savings, government benefits, or creditor protection, and make sure you will want to continue this benefit for the rest of your life.

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