10 Ways Irrevocable Trusts Can Help You Avoid Death Taxes

An irrevocable living trust is one you create during your lifetime that you cannot revoke. Once you put assets in an irrevocable trust, you can't withdraw them. The grantor cannot change the beneficiaries or terms of the trust and surrenders ownership of the property.

While the beneficiaries can agree to change some of the terms of an irrevocable living trust, the grantor largely gives up control of the assets put into such instruments.

Overview of Trust Types

The term living trust (also called inter vivos trust) simply means any trust enacted during your life. Testamentary trusts are established after the creator passes. The creator's will produces these instruments. Unless technology finds some way to reliably communicate with the dead, testamentary trusts are also irrevocable.

In earlier times, many wealthy families created perpetual trusts that were intended to last long beyond the lifetime of their creator. No U.S. jurisdiction currently allows perpetual trusts. Quite of few of these agreements, however, still remain in effect today protected by grandfather laws.

A trust will allow you to keep assets out of probate, which has two main advantages. First, it lowers your tax burden. Second, a will becomes public record after your death. If you want to maintain the privacy of your heirs, a trust will help accomplish this purpose.

Why Do Estate Planners Recommend Irrevocable Instruments in Some Situations?

Revocable living trusts allow the grantor(s) far more control after creating the agreement. So, why do estate planners ever recommend irrevocable trusts to their clients?

The two big advantages of an irrevocable inter vivos trust are:

1. Removes Assets from Your Estate

Under current U.S. federal tax law, you can exclude up to $11.4 million from estate taxes. The federal government will demand a 40% tax on any amount larger than $11.4 million. If you have more than $11.4 million to pass to your heirs, an irrevocable living trust can save a huge amount of taxes to your beneficiaries.

While the current exemption from estate taxes seems generous at $11.4 million per person, Congress can always change federal tax law. If public opinion turns hostile toward heirs or anyone whom they consider wealthy, the estate tax exemption could become a popular target. This could also happen if the federal government runs into a long-term revenue crunch.

If the caps change, an estate that projects well under the current tax exemption could exceed it. An irrevocable trust can guard against this estate-planning disaster.

2. Protect Your Assets from Lawsuits and Bankruptcy

Since you no longer own the assets you put into an irrevocable inter vivos trust, they can't be awarded as damages in a lawsuit against you. Nor can these assets be attached in bankruptcy proceedings. The simple reason is that you no longer own them.

Irrevocable instruments are also good for the so-called asset protection trust. Protecting assets can be significant for clients in businesses where lawsuits are common, such as doctors, lawyers, and people who own companies that build products vulnerable to class-action lawsuits. Irrevocable instruments are also suitable for clients involved in volatile firms in risky economic sectors. The irrevocable inter vivos trust protects against a crash that can wipe out assets you've spent a lifetime to earn.

Specific Irrevocable Trust Benefits

Aside from the general benefits listed above, irrevocable instruments can:

3. Gift Assets from the Estate While Continuing to Receive Income from the Assets

This feature can enable you to immediately protect assets from creditors while retaining their income during your lifetime. You can enjoy the fruits of your labor while ensuring that you can pass them on to your heirs. This choice can also guard against the problem of giving too much away during your lifetime and finding yourself short of resources in the later stages of your life.

4. Can Remove Some Assets from Your Estate While Retaining Control Over Others

The inability to change the trust after creating it worries many clients. Your estate planner can use a combination of testamentary (related to an agreement intended to pass on assets) instruments to meet your specific desires. For example, you can exempt up to $11.4 million in a revocable trust to retain some ability to control your assets during your life while protecting other assets in an irrevocable vehicle.

5. Will Provide a Step Up in Cost Basis for Assets

The IRS imposes taxes on any gain in value on the sale of property, which is measured by the asset's sale price minus the cost basis (which roughly correlates to the purchase price). While you won't retain control of any property you put into an irrevocable instrument, your beneficiaries will get a step-up in the cost basis to the market value of the asset at the time they receive the benefit.

Since assets like securities and real property tend to increase over time, this step-up can save significant money on capital gains taxes when your beneficiaries sell the asset.

6. Can Remove Life Insurance Benefits From Your Estate

Under normal circumstances, any asset your heirs or beneficiaries receive upon your death will become part of your estate to calculate the estate tax exemption. You can remove death benefits from your estate by placing the life insurance policy in an irrevocable life insurance trust (ILIT).

This is another tool to use in your quest to avoid death taxes.

7. Protect Eligibility for Government Benefits and Entitlements

Trusts aren't just for the wealthy. You can use these vehicles to remove assets from your control, which could cause you or your beneficiaries to exceed the asset caps for federal benefits and entitlement programs like Medicaid and Social Security.

Not only can your assets grow larger than you expect if economic conditions turn in your favor, but the cap limits for federal programs can change at the whim of Congress. If entitlement program trust funds become strained in the future, these caps could go very low. You've spent your life paying into entitlement programs. You should get some return on that investment.

Also, an expensive medical problem at the end of your life could eat a massive hole in the benefits you can pass on. You can guard against such a disaster by removing assets from your estate.

8. Can Pass Principle Residence to Children Under Favorable Tax Rules

You can pass your principal residence as a lifetime gift and count it as part of your estate tax exemption. Using an irrevocable inter vivos trust to achieve this transaction can result in more favorable tax impacts for your beneficiaries.

Irrevocable Inter Vivos Trust Benefits Shared with Other Trust Types

9. Can Prevent Misuse of Assets by Beneficiaries

Trusts can allow assets to pass only if certain conditions are satisfied. You can use this feature to prevent misuse of your assets after your passing and curtail the risk that your beneficiaries squander the assets.

10. Maintain Privacy

Wills become part of the public record as part of the probate process. If you don't want public access to what you have left to your beneficiaries, a trust can avoid this problem. Trusts do not become part of the public record.

Types Of Irrevocable Inter Vivos Trusts

Now that you have a general overview of why you might want to create an irrevocable vehicle and what you can achieve using such an instrument, we'll drill down to some specific types of irrevocable inter
vivos trusts.

Irrevocable Living Insurance Trusts (ILIT)

As mentioned above, you can use an ILIT to remove your life insurance policy from your estate. One major advantage of using this structure is that the proceeds will not pass in a lump sum to your beneficiaries. Instead, the trust will pay out the proceeds in increments. If the policy pays out in a lump sum, this money will become part of the estate of any beneficiary and could be subject to estate taxes.

Another advantage is that you can retain more control over these funds than most assets you put into an irrevocable vehicle. While you can't change the beneficiaries on the policy, you can always stop paying premiums. The policy will then lapse.

Special Needs Trusts

This type of trust is designed to provide for beneficiaries who might be disabled or require other types of long-term care. Suppose you pass enough assets to support them for the remainder of their life. In that case, you will almost assuredly exceed the asset caps for government benefits they'd otherwise be eligible to receive, such as Medicaid, Supplemental Social Security Income (SSI), and housing benefits.

The income from the trust can even pay for education and vacations aside from providing resources for their maintenance.

Intentionally Defective Grantor Trusts (IDGT)

Under IRS rules for grantor trusts, under certain conditions, the IRS will consider the grantor the owner of the assets held in an irrevocable inter vivos trust for tax purposes. Estate planners can use these rules to pass more wealth to your beneficiaries.

Using this strategy, the grantor will be liable for property taxes on assets put into the IDGT. To lower the value of the creator's estate, the creator will sell the asset to the trust in exchange for a promissory note. Typically, you will put assets that you expect to grow more than the interest on the note in the trust. For example, you could place real estate in an ascending market or an index fund in an IDGT.

This trust type lets you pass more wealth to your beneficiaries by gifting an appreciating asset at a locked-in valuation. You also remove those assets from your taxable estate.

QTIP Trusts
The Qualified Terminable Interest Property Trust (QTIP) enables couples to remove assets from one spouse's estate and push back estate taxes until the second spouse passes. Delaying tax events is a key strategy for estate planners to preserve wealth.

Bypass Trusts
Estate planners can use this trust type to lower the estate taxes of the second spouse upon their death. At the first spouse's death, the property is placed in trust. The second spouse can use the trust assets, including any income, but never becomes the legal owner. When the second spouse dies, the assets pass to that spouse's beneficiaries but are not considered part of the estate.

Generation-Skipping Trusts (GST)
The GST is a valuable tool for especially wealthy grantors. This structure allows the grantor to "skip" a generation and typically pass assets to their grandchild or grandchildren. The children can use and receive income from the property but will never own it. However, the IRS imposes an extra GST tax on assets passed in this manner.

Charitable Trusts
Irrevocable Trusts are useful to pass your assets for charitable purposes rather than going to the government in taxes. The three basic types of charitable trusts are:

1. Charitable Remainder Trust
This trust structure allows you to pass assets to a charity upon the death of your beneficiaries. While the beneficiaries won't own this property, they will retain the use and income from these assets.

2. Pooled Income Trust
You can pool assets with other donors and receive an income from the trust for a set time. In this trust structure, the charity is the trustee and will receive the assets after the grantors pass.

3. Charitable Lead Trusts
Instead of leaving assets to a charity, you can mandate that the charity receives an income from the trust assets for a set amount of time. The trust assets pass to another beneficiary when the time limit expires.

Spendthrift Trusts
These trusts can pass assets to beneficiaries who you worry may not be able to handle their own affairs. You fund the trust with assets and appoint a trustee to control disbursements to the beneficiaries. The trust can create terms to govern the circumstances under which the trustee can disburse assets.

The trust prevents the beneficiary from accessing trust assets without trustee approval. Of course, the beneficiaries control any funds conveyed to them under the terms of the trust.

Grantor-Retained Interest Trusts

These trusts can come in multiple flavors (GRAT, GRIT, and QPRT), but the essence of these structures is to pass assets to beneficiaries while retaining some control over the assets for a set period. Once the time limit expires, ownership passes to the beneficiaries whether or not the grantor still lives. You can fund such a trust with the right to live in a home (QPRT), a fixed annuity (GRAT), or an income stream (GRIT). The "flavors" mentioned above are a partial list. You can use any number of financial vehicles with structured payments for this purpose.

Summary

This survey is a brief primer for a complex topic. Irrevocable instruments are a great way to create asset protection trusts that can protect you and your beneficiaries from taxes. Trusts and other testamentary instruments can help achieve a wide variety of purposes. Consult an experienced estates and trusts attorney to get a fuller picture of available options.