WELLS FARGO Wealth & Investment Management

What you need to know about irrevocable trusts

The following information and opinions are provided courtesy of Wells Fargo Bank, N.A.

An irrevocable trust can be a beneficial estate planning strategy for individuals and families who wish to enhance their basic estate plan. Irrevocable trusts can be used for tax planning, generational estate planning, creditor protection, providing for spendthrift or special needs beneficiaries, and allow for professional management of complex trust assets when needed. Generally, an irrevocable trust cannot be amended, modified, or revoked absent a court order, judicial settlement, reformation to align to tax laws, or by consent of the grantor and beneficiaries.

What are the advantages of an irrevocable trust?

There are many reasons for creating an irrevocable trust, including:

- Planning for income, gift, estate, and generation-skipping tax efficiency
- Establishing trust distribution plans including incentive provisions for educational and entrepreneurial endeavors
- Managing complex investment types
- Helping provide a potential layer of protection from creditors or from financially unprepared beneficiaries
- Caring for the needs of children or dependent adults living with special needs or planning for any period of incapacity
- Avoiding probate (an expensive and public process)

Gifting

Using an irrevocable trust as a vehicle for completing a gift is also a popular planning strategy. Instead of an outright transfer of property from grantor to beneficiary, this approach may provide transfer (estate/gift) tax savings once the gift is deemed completed and there are no "strings attached." The potential tax savings may arise in a number of different ways:

- Trust corpus (the "body" or principal property of the trust) is irrevocably given away and is no longer owned by the grantor. Although the value of the gift at the time of transfer is subject to gift tax, any appreciation and income after the date of transfer will not be subject to transfer tax at the grantor's death. The trust can be structured so that either the trust or the grantor is responsible for payment of tax due on the trust's income. This can result in further tax savings.
- Irrevocable trusts are also flexible vehicles for making annual exclusion gifts if drafted properly. Such gifts are excluded from the imposition of a gift tax at the time of transfer, and the removal of the donated property from the grantor's estate eliminates the imposition of the estate tax on the value of such property at the grantor's death.
- If gift taxes are paid upon the creation of an irrevocable trust, the amount of gift tax paid is excluded from the grantor's estate at death unless a grantor dies within three years after the payment of the tax. In many situations, assets that will appreciate during the grantor's life that are transferred to an irrevocable trust will effectively transfer at a "lower" or "discounted" value for transfer tax purposes, thereby using less of the grantor's estate and gift tax exemption. However, gifts made during the life of the grantor transfer with the existing cost basis, so in some circumstances, it may be beneficial to hold low-cost basis assets until death in order to benefit from the step-up in cost basis on the grantor's death.[1]

Asset management and the potential for greater wealth protection

Irrevocable trusts afford other nontax benefits such as protecting the assets subject to a beneficiary's interest in the event of a divorce, malpractice or liability claims that may surface in high-risk professions, or bankruptcy. In particular, an irrevocable trust can provide protection from creditor claims through a provision known as a "spendthrift" clause which prevents a beneficiary from disposing of his or her interests held in trust by way of assignment to creditors or to alimony claims, as an example.

Grantors may also consider establishing an irrevocable trust and appointing a professional trustee when the assets require a high amount of care, attention, and subject matter expertise. For example, incapacitated or special needs beneficiaries may have long-term needs for medical services, transportation, care facilities, and education. In this case, a grantor can establish a special needs trust for a loved one to attend to these unique needs. Such a trust may be structured so that the trust assets and distributions do not prevent a beneficiary from receiving certain forms of government assistance.[2]

Likewise, a trust established during lifetime with incapacity provisions—where the trust may become irrevocable upon incapacity—may help protect the grantor's objectives, goals, and desired outcomes as stated in the trust documents if he or she should become incapacitated by allowing the trustee to manage the trust assets during the period of incapacity.

1. irs.gov; Frequently Asked Questions on Gift Taxes
2. ssa.gov; Social Security Act, Title XIX, Section 1917: Liens, adjustments and recoveries, and transfers of assets

Types of irrevocable trusts

The Tax Cut and Jobs Act of 2017 created an opportunity to transfer wealth in a tax-efficient fashion by effectively doubling the gift and estate tax exclusion and the generation-skipping transfer (GST) tax exclusion from the limits in 2017, adjusted for inflation on an annual basis. While this exclusion is set to expire on December 31, 2025, given the current higher lifetime exclusions, this may be an opportune time to consider strategies involving irrevocable trusts. These may include:

- **Crummey or gifting trust.** Typically used for children or grandchildren to provide for educational expenses. May contain incentive provisions, allow for the purchase of a first home, investment in a business, or overall support. Gifts to this type of trust are intended to qualify for the annual exclusion from gift tax as long as the beneficiary has a period of time to withdraw the gift after the contribution.
- **Dynasty trust.** Designed to help preserve family wealth and provide benefits across multiple generations while minimizing the impact of state, estate, and generation-skipping transfer (GST) taxes. The situs or principal place of administration is specifically selected to take advantage of states with laws abolishing the rule against perpetuities and/or trust income tax.
- **Intentionally defective grantor trust (IDGT).** This type of irrevocable trust is drafted — in accordance with Internal Revenue Code — to include language with enough "defects" (provisions) so that the trust is taxed as a revocable trust for income tax purposes, but an irrevocable trust when it comes to estate tax purposes. The payment of the income tax by the grantor is akin to an additional gift to the trust but not treated as a gift for gift tax purposes.
- **Grantor retained annuity trust (GRAT).** Affords donors with the potential to reduce a taxable estate while retaining an income stream and building a tax-advantaged gift. This can be a particularly attractive option when an IRS-mandated rate is used to discount the gifted property. This rate is 120 percent of the applicable federal midterm rate (compounded annually) for the month in which the valuation is made (also known as the 7520 rate). If this IRS rate is relatively low and gifted assets are expected to appreciate in value based on the investment strategy during the GRAT term, the growth beyond the IRS interest rate will be passed on to beneficiaries free of estate tax.[3]
- **Spousal access lifetime trust (SLAT).** Funded during grantor's lifetime using annual exclusion gifts, applicable exclusion gifts, or taxable gifts. Distributions of income and principal from SLATs may be made to a trust beneficiary (spouse, children, or other heirs) during the grantor's lifetime. SLATs can be an attractive option for grantors who can afford to make a large gift but could potentially access funds if needed in the future, via a distribution to the spousal beneficiary (typically the non-grantor spouse).
- **Irrevocable life insurance trust (ILIT).** Designed to own life insurance on the insured person's life where the proceeds will not be taxed in the insured person's estate but can be held for the benefit of the insured person's designated beneficiaries (typically a surviving spouse and children).
- **Qualified personal interest trust (QPRT).** Designed to transfer the grantor's personal residence to an irrevocable trust which gives the grantor the right to reside in/use the property, and receive whatever income it produces for a specified term. The remainder interest is given to others, such as the grantor's children. If grantor survives the term, the principal is excluded from his or her estate for death tax purposes. After the term, if the grantor continues to reside or use the residence, the grantor must begin paying rent to the trust, but the rent paid to the trust is not treated as an additional gift to the trust for gift tax purposes.

3. irs.gov; Section 7520 Interest Rates

Consult with your advisors

Strategies that employ irrevocable trusts have evolved to help address goals beyond simply restricting access to funds. Now they can be designed with provisions to help inspire and reward beneficiaries, whether it's pursuing higher education, becoming financially independent, or starting a business. A professional trustee can be selected to play a critical role as a steward, guide, and protector of a well-drafted irrevocable trust instrument. How these trusts are created can help reinforce your financial needs, goals, and desires — for today and tomorrow.

To learn more about whether an irrevocable trust may make sense for your goals and particular situation, consult with your legal, tax, and financial advisors.

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