

# Types of Trusts and Their Tax Treatment

Type of Trust	Income Tax	Estate Tax <sup>1</sup>	Gift Tax <sup>2</sup>
<b>Testamentary trust:</b> Created in the trustor's will and takes effect only at his death. Can be used to avoid tax on a portion of the first spouse's share of the estate; e.g., the credit shelter trust.	Income which is distributed is taxed to the beneficiary; if income is accumulated, it is taxed to the trust until later distributed to the beneficiary.	Trust assets are included in decedent's estate.	No gift tax.
<b>Revocable living trust:</b> Created while the trustor is still living but can be revoked or amended during his or her lifetime. Assets in the trust will avoid probate expenses, delay and publicity.	No income tax savings while trustor lives. After death, same as testamentary trust for income tax purposes.	Trust assets are included in decedent's gross estate.	No gift tax. Trust is revocable.
<b>Irrevocable life insurance trust:</b> Created while the trustor is still living and cannot be revoked by the trustor. Used to reduce the size of the estate. Works best for removing insurance from the estates of both spouses. Some are "funded," and others are "unfunded" or just own a life insurance policy. <sup>3</sup>	Same as testamentary trust above, except if income from a funded trust is accumulated, it is taxable to the trustor.	Usually excluded unless gift of policy was within three years prior to insured's death.	There may be a gift tax liability, but gifts to the trust can usually be made to qualify for the \$12,000 <sup>4</sup> annual gift tax exclusion.
<b>Sec. 2503(c) minor's trust:</b> A type of irrevocable trust for minors which qualifies for the annual gift tax exclusion even though the gifts to it are "future interest." <sup>5</sup>	Same as testamentary trust above.	Usually excluded unless transfer was within three years prior to death.	There may be a gift tax liability, but gifts to the trust can usually be made to qualify for the \$12,000 <sup>4</sup> annual gift tax exclusion.

**Note:** If children under 14 receive unearned income in excess of \$1,700 for 2006 (adjusted annually for inflation), the excess will be taxed at the parents' top income tax bracket.

<sup>1</sup> The Tax Act of 2001 has increased the estate tax exemption to \$3.5 million by 2009 and repeals the tax for one year in 2010. In 2011, the rates (55% top rate) and exemptions (\$1 million) in force in 2001 will return. Beginning in 2002, the top estate tax rates begin a slow decline from 50% in 2002 to 45% in 2009.

<sup>2</sup> Effective in 2010, Tax Act of 2001 imposes a tax on gifts in excess of a lifetime \$1 million. The tax will be at the top individual income tax rate at that time.

<sup>3</sup> Cash contributions may be made to the trust, to be used by the trustee to make premium payments on the life insurance policy. Careful drafting of the trust document is required to qualify the cash gifts for the annual gift tax exclusion.

<sup>4</sup> The annual gift tax exclusion (\$12,000 in 2006) is indexed for inflation in increments of \$1,000.

<sup>5</sup> At age 21, the minor becomes the owner of the assets.