

## Chapter 4

### TRUSTS

Like a will, a trust is a very useful instrument in the estate-planning arsenal. Estates can be as diverse as people, and the flexibility of a trust makes it useful for many different needs. A trust can do a number of things a will can't do as well, including

- manage assets efficiently if you should die and your beneficiaries are minor children or others not up to the responsibility of handling the estate;
- protect your privacy (unlike a will, a trust is confidential);
- depending on how it is written, and on state law, a trust can protect your assets by reducing taxes;
- if it is a living trust, the trustee can manage property for you while you're alive, providing a way to care for you if you should become disabled. A living trust also avoids probate, lowers estate administration costs, and speeds transfer of your assets to beneficiaries after your death.

Should you have a trust? It depends on the size of your estate and the purpose of the trust. For example, if you mainly want a living trust to protect assets from taxes and probate, but your estate is under the current federal tax floor and small enough to qualify for quick and inexpensive probate in your state, some lawyers would tell you it isn't worth the cost. If, however, you want to avoid a court hearing if you become incompetent or unable to provide for yourself or you want to provide for grandchildren, minor children, or relatives with a disability that makes it difficult for them to manage money, a trust has many advantages.

This chapter discusses general principles of trusts and their common uses (to learn about

amending or revoking a trust, see chapter nine, Changing Your Mind). It should help you determine if one is suitable for you. The next chapter covers the most popular trust--the revocable living trust.

## WHAT IS A TRUST?

A trust is a legal relationship in which one person (or qualified trust company) (**trustee**) holds property for the benefit of another (**beneficiary**). The property can be any kind of real or personal property--money, real estate, stocks, bonds, collections, business interests, personal possessions and automobiles. It is often established by one person for the benefit himself or of another. In those cases, it generally involves at least three people: the **grantor** (the person who creates the trust, also known as the **settlor** or **donor**), the **trustee** (who holds and manages the property for the benefit of the grantor and others), and one or more **beneficiaries** (who are entitled to the benefits).

It may be helpful to think of a trust as a contract between the grantor and the trustee. The grantor makes certain property available to the trustee, for certain purposes. The trustee (who often receives a fee) agrees to manage the property in the way specified.

Putting property in trust transfers it from your personal ownership to the trustee who holds the property for you. The trustee has **legal title** to the trust property. For most purposes, the law looks at these assets as if they were now owned by the trustee. For example, many trusts have separate taxpayer identification numbers. But trustees are not the full owners of the property. Trustees have a legal duty to use the property as provided in the trust agreement and permitted by law. The beneficiaries retain what is known as **equitable title**, the right to benefit from the property as specified in the trust.

The donor may retain control of the property. If you set up a revocable living trust with yourself as trustee, you retain the rights of ownership you'd have if the assets were still in your name. You can buy

anything and add it to the trust, sell anything out of the trust, and give trust property to whomever you wish.

If you set up the trust by your will to take effect at your death--a **testamentary trust**--you retain the title to the property during your lifetime, and on your death it passes to the trustee to be distributed to your beneficiaries as you designate.

We speak of putting assets "in" a trust, but they don't actually change location. Think of a trust instead as an imaginary container. It's not a geographical place that protects your car, but a form of ownership that holds it for your benefit. On your car title, the owner blank would simply read "the Richard Petty trust." It's common to put whole bank and brokerage accounts, as well as homes and other real estate, into a trust.

After your trust comes into being, your assets will probably still be in the same place they were before you set it up--the car in the garage, the money in the bank, the land where it always was--but it will have a different owner: the Richard Petty trust, not Richard Petty.

This may sound abstract, but as this and the next chapter show, the benefits are concrete.

## **HOW DO TRUSTS OPERATE?**

There is no such thing as a standard trust, just as there's no standard will. You can include any provision you want, as long as it doesn't conflict with state law. The provisions of a written trust instrument govern how the trustee holds and manages the property. That varies greatly depending on why the trust was set up in the first place.

In a living trust, the grantor may be the trustee and the beneficiary. In trusts set up in your will, the trustee is often one or more persons or, for larger estates where investment expertise is required, a corporate trust company or bank.

Trusts can be revocable (that is, you can legally change the terms and end the trust) or irrevocable. Later chapters, particularly chapter five, discuss the practical effects of each. Here it's enough to say that a revocable trust gives the donor great flexibility but no tax advantages. If the trust is revocable and you are the trustee, you will have to report the income from the trust on your personal income tax return, instead of on a separate income tax statement for the trust. The theory is that by retaining the right to terminate the trust, you have kept enough control of the property in it to treat it for tax purposes as if you owned it in your name.

Irrevocable trusts are the other side of the coin--far less flexibility but possible tax benefits. The trustee must file a separate tax return.

Trusts can be very simple, intended for limited purposes, or they can be quite complex, spanning two or more generations, providing tax benefits and protection from creditors of the beneficiary, and displacing a will as the primary estate planning vehicle.

## **WHO NEEDS A TRUST?**

### Parents with young children

If you have young children, want to assure a good education for them, and will have enough assets to do so after death (including life insurance proceeds), you should consider setting up a trust. The trustee manages the property in the trust for the benefit of your children during their lifetime or until they reach the ages that you designate. Then any remaining property in the trust may be divided among the children. This type of arrangement has an obvious advantage over an inflexible division of property among children of different ages without regard to their respective ages or needs. Trusts are more flexible than giving outright gifts to minors in your will (which requires a guardian) or a gift under the Uniform Transfer to Minors Act,

which requires appointment of a custodian and transfers of property to the child at age 18. Issues to consider when setting up a trust for the benefit of your children:

- **One trust or many?** Most people will set up one trust that all the children can draw on, until they've completed their educations (or reached an age by which they should have done so). Then the remaining principal is divided among them equally. This permits the trustee greater flexibility to distribute ("sprinkle") the money unequally according to need; for example, one child may choose to pursue an advanced degree at an expensive private university, while another may drop out of community college after a semester. Obviously, they will have different educational expenses.

Where very young children are involved, it's especially important to build in some flexibility; who knows if a two-year-old may turn out to need special counseling or education by the time he turns five or six?

There are two philosophies about what to do if there's a disparity in ages among the children. One theory is that the older children have already received the benefit of the parents' spending before they died, so the trustee should have authority to make unequal distributions in favor of the younger children to compensate. The other camp, by contrast, thinks it better to establish separate trusts, so that the older children don't have to wait until they're well into adulthood before the trust assets are distributed (which usually happens when the youngest child reaches majority age). You'll have to decide which course is best for your family's circumstances.

Generally speaking, the less money you have to distribute, the more likely you would put it all in one trust. Since there is a limited amount of money, you want to pool it to be sure that it goes for the greatest need. On the other hand, if equality is your primary consideration and there's plenty of money available to take care of each child's likely needs, then you may want to set up separate trusts for each

child, to assure that each gets an equal share.

- **What should the assets be used for?** You can specify that the trust pay for education, health care, food, rent, and other basic support. Given life's unpredictability, however, it's often better to write a vague standard (e.g., "for the support of my children") into the document and allow the trustee the discretion to decide if an expenditure is legitimate. Such a provision also gives the trustee flexibility. For example, if one of your children has an unanticipated expenditure, like a serious illness, the trustee could give him more money that year than the other children.
- **When should the assets be distributed?** Some parents pick the age of majority (18) or the age when a child will be out of college (22 or so). If all the assets are in one trust that serves several children, you would usually have the assets distributed when the youngest child reaches the target age. If you have separate trusts and a pretty good idea about each child's level of maturity, you can pick the age that seems appropriate for each one to receive his or her windfall.

If you don't know when each child will be capable of handling money, you can leave the age of distribution up to the trustee (and risk friction between the trustee and the children), have the trustee distribute the assets at different times (say, half when the first child turns 25 and the rest when the youngest does so), or just pick an age for each child, such as 30.

Like any trust, a children's trust costs money to set up: lawyers' fees for creating the trust, fees for preparing and filing the separate tax returns required, and so on. For families of limited assets, it might be best to give the money via a custodial account under the Uniform Gift to Minors Act or the Uniform Transfers to Minors Act. ([See chapter six.](#))

People with beneficiaries who need help

Trusts are especially popular among people with beneficiaries who aren't able to manage property well. This includes elderly beneficiaries with special needs or a relative who may be untrustworthy with money. For example, if you have a granddaughter who has been in a juvenile detention center, it may be a good idea to require her to obtain the money at intervals from a trustee instead of giving her a gift outright in your will. A **discretionary trust** gives the trustee leeway to give the beneficiary as much or as little he or she thinks appropriate.

Another type of trust is for improvident beneficiaries a **spendthrift trust**. It's simply a trust in which your instructions to the trustee carefully control how much money is released from the trust and at what intervals, so you can keep an irresponsible beneficiary from the temptation of getting thousands of dollars in one stroke. You can stipulate that the trustee will pay only certain expenses for the beneficiary--those you (or the trustee) consider legitimate, such as rent and utility bills. In a spendthrift trust the beneficiary cannot assign his or her interest in the trust, and creditors of the beneficiary can't get at the principal in a trust, but can make a claim (if it's otherwise legal) on whatever income the beneficiary receives. Spendthrift provisions raise a number of tricky questions and should be used cautiously--your lawyer can tell you whether such a trust is right for your situation.

#### People who own property that is hard to divide

Trusts help you transfer property that's not easy to divide evenly among several beneficiaries. Suppose you have a little vacation cottage on the Cape, and four children who each want to use it. You can pass it to them in a trust that sets out each child's right to use the property, establishes procedures to prevent conflicts, requires that when the property is sold the trustee divide the proceeds evenly (or unevenly, if some children aren't as well off as others), and sets up a procedure by which any child may buy out another's interest in the cottage.

People who want to control their property because of family dynamics

Through a trust, you can maintain more control over a gift than you can through a will. Some people use trusts to pass money to a relative when they have doubts about that person's spouse. For example, you love your son, but don't trust his wife, Livia. You're afraid she'll spend the money you give him on astrologers and shoes. Leave the money in trust for your son instead of making a direct gift to him, and you can direct that he get only the income, so neither he nor his wife can squander the principal. In many states, if you leave money in trust to your son, Livia can't get at the assets if they divorce. Moreover, he can choose how much, if any, of the trust income or principal to leave Livia; if she hasn't been a good and faithful companion, he can leave the whole thing to whomever he desires.

People who want to provide for administration of their estates if they become physically or mentally unable to do so

People concerned about estate taxes

Trusts are very useful to people with substantial assets, because they can help avoid or reduce estate taxes. For example, by establishing a trust for their benefit, you can make tax-free gifts (up to the limit allowed by law) each year to your children or grandchildren during your lifetime, even if they're minors. This will reduce your taxable estate and save taxes upon your death. A properly drawn trust may also reduce estate taxes by utilizing the marital deduction or avoiding the generation skipping tax. (See [chapter eight](#).)

**SETTING UP A TRUST**



If you establish one in your will, the trust provisions are contained in that document. If you create a trust during your lifetime, its provisions are contained in the **trust agreement** or **trust declaration**. The provisions of that trust document (not your will or state law) will determine what happens to the property in the trust upon your death.

With any type of trust, one of the most important issues is choosing the trustee. See chapter ten for a discussion of this issue.

### Funding the trust

A testamentary trust is funded after your death, with assets that you've specified in your will and through beneficiary designations of your life insurance, IRA, and so on. Such trusts generally receive most of the estate assets, such as the proceeds from the sale of a house. Or you could set up an "unfunded" standby trust. This is a trust that could be called "minimally" funded to avoid confusion. It may have a nominal sum of money in it--\$100 or so--to get it started while you're alive (and thus make it a living trust), but it only receives substantial assets when you die. Your pourover will would direct that many or all of your assets be transferred from your estate to the trust at your death. Life insurance payable to the trust, as well as designating the trust as the beneficiary of IRAs, profit-sharing plans, and so on, will pass these assets directly to the trust outside of probate. However, other assets not already owned by the trust when you die will have to go through probate. This is why many lawyers shy away from unfunded trusts, unless probate avoidance isn't the primary goal (see chapter eleven for some reasons why you might not want to avoid probate).

If your estate--with life insurance benefits included--will add up to more than \$1 million, you can save taxes by removing the life insurance proceeds from your estate and establishing an irrevocable life insurance trust that owns the policy; all incidents of ownership in the policy belong to the trust. When you

die, the proceeds are paid into the trust, escaping estate taxation and creditors in so far as the insurance policy is concerned.

### Trusts and taxes

Chapter eight discusses death and taxes, and trusts are a major part of that discussion. However, there are a few basic principles worth mentioning here. While gifts under the \$1 million level (in a trust or in a will) escape federal estate taxation, the recipients of the trust income will still have to pay income tax when they receive income from the trust. They would not have to pay tax on the principal in the trust when they collected it (unless their state has an inheritance tax).

The trustee pays, out of the principal, the taxes on income from the trust that's reinvested or put back into the principal. Capital gains from the sale of stock, real estate, and the like are generally added to the principal unless you specify otherwise.

The choice of trustee can affect the tax the trust owes. If the beneficiary is made the only trustee, some of the tax advantages of the trust can be lost. Similarly, the more powers the grantor retains, the more likely the assets in the trust will be taxable, either during the grantor's life as income tax or after death as estate tax. Consult your attorney or a tax advisor before setting up any trust for tax purposes.

### Terminating a trust

Only charitable trusts can last indefinitely. Since trusts of this sort are established to accomplish a substantial benefit to the public, it is entirely appropriate that Rhodes scholarships, Pulitzer and Nobel prizes, and thousands of other awards and grants be funded by trusts that are expected to endure.

Private trusts--set up to benefit private beneficiaries--cannot last forever. The **rule against perpetuities**, which is embodied in state law and may vary somewhat from state to state, is designed to

limit the time a trust may be operative. Usually it specifies that a trust can last no longer than the life of a person alive at the time the trust is created, plus 21 years. So if you set up a trust to benefit your infant granddaughter and any children she may eventually have, and she has a long life, your trust may extend 100 years, but not much more.

Your trust agreement should contain a clause that provides how it can be terminated. A good trust drawn up by a lawyer will certainly have such a clause.

A trust often terminates when the principal is distributed to the beneficiaries, at the time stated in the trust agreement. For example, you might provide that a trust for the benefit of your children would end when the youngest child reaches a certain age. At that time, the trustee would distribute the assets to the beneficiaries according to your instructions. The law generally allows a "windup phase" to complete administration of trust duties (e.g., filing tax returns) after the trust has officially terminated.

You can also give your trustees the discretion to distribute the trust assets and terminate the trust when they think it's a good idea, or place some restrictions on their ability to do so. For example, you could allow the trustees to terminate the trust in their discretion, provided that your daughter has completed her education.

Your trust should have a termination provision even if it is an irrevocable trust. "Irrevocability" means that you, the donor, can't change your mind about how you want the trust to terminate. It doesn't mean that you can't set up termination procedures in the first place.

If you have an irrevocable trust and don't have a termination provision, it can usually terminate only if all beneficiaries consent and no material purpose of the trust is defeated. However, an irrevocable trust can also be terminated if there was fraud, duress, undue influence or other problems when the trust was set up; if the trustee and the beneficiary become the same person; if the operation of the trust becomes impracticable or illegal; or if the period of time specified in state law expires. We're obviously into technical territory here, so the basic rule is, don't

set up an irrevocable trust unless you're prepared to live--and die--by its terms.

## Sidebar

### CONSUMER TIP

When you approach a lawyer to help you set up a trust, make sure he or she is willing to work with you to tailor the trust to your particular needs; otherwise the primary benefit of trusts--their flexibility--is wasted. It's another reason to avoid those prefabricated, all-purpose trusts you see in self-help books and at seminars.

A good lawyer will provide you with a financial analysis to show how much you might save over time by structuring your trust in certain ways. You, in return, can help by providing comprehensive lists of assets as determined by the form in Appendix A.

Make sure you choose a lawyer who's familiar with estate planning, trusts, and, if your trust is used for saving taxes, tax law. IRS regulations governing trusts change often, and the agency has always given trusts special scrutiny.

## **Sidebar**

### **WHAT IF I SET UP A TRUST AND THEN MOVE TO ANOTHER STATE?**

#### **WHICH LAW APPLIES?**

State law governs trusts. If the trust involves real estate, the law of the state where the property is located applies. If it's personal property, like a car or money, or most other things, the law of the state where the grantor created the trust will probably control. If you have residences in more than one state, you can provide in your trust which of those states' laws will control the disposition of your real property.

## Sidebar

### KINDS OF TRUSTS

**Charitable trusts** are created to support some charitable purpose. Often these trusts will make an annual gift to a worthy cause of your choosing, simultaneously helping good causes and reducing the taxes on your estate.

**Discretionary trusts** permit the trustee to distribute income and principal among various beneficiaries or to control the disbursements to a single beneficiary, as he or she sees fit.

**Insurance trusts** are tax-saving trusts in which trust assets are used to buy a life insurance policy whose proceeds benefit the settlor's beneficiaries. (See chapter eight.)

**Living trusts** (see chapter five) enable you to put your assets in a trust while still alive. You can wear all the hats--donor, trustee, and beneficiary--or have someone else be trustee and have other beneficiaries.

**Medicaid qualifying trusts** are trusts that may help you qualify for federal Medicaid benefits by placing certain property in a trust, sometimes limiting your assets for Medicaid purposes. This device is mostly used when family members are concerned with paying the costs of nursing home care. It is dealt with in chapter twelve.

**Revocable trusts** are simply ones that can be changed, or even terminated, at any time by the donor. (Though most living trusts are revocable, a living trust and a revocable trust are not synonymous).

**Irrevocable trusts** cannot be changed or terminated before the time specified in the trust, but the loss of flexibility may be offset by savings in taxes.

**Spendthrift trusts** can be set up for people whom the grantor believes wouldn't be able to manage their own affairs--like an extravagant relative, or someone who's mentally incompetent. They may also be useful for beneficiaries who need protection from creditors.

**Support trusts** direct the trustee to spend only as much income and principal as may be needed for the education and support of the beneficiary.

**Testamentary trusts** are set up in wills.

**Totten trusts** are not really trusts at all. They're simply bank accounts that pass to a beneficiary immediately upon your death.

**Wealth trusts** are tax-saving trusts that benefit several generations of your descendants.



## Sidebar

### FIVE OTHER REASONS TO HAVE A TRUST

1. Trusts are generally more difficult to contest than wills.
2. Trusts can be flexible; you can authorize that payments fluctuate with the cost of living, allow extra withdrawals in case of emergency, or even set a standard figure for payment each year; if the income doesn't meet that amount, the difference can be made up out of the principal.
3. Or you can use them to impose discipline on the beneficiary. You could require the beneficiary to live within a set figure, getting a certain amount of income each year, regardless of inflation, need, or the stock market's effect on the principal.
4. Trusts are sometimes set up in divorce, for example to provide for the education of the couple's children.
5. Trusts can also be helpful if you want to make a major charitable gift but wish to retain some use of the property.

[Click here to go to Chapter 5](#)