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Estate Planning Matters

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Understanding Trusts

Trusts are estate-planning tools that can replace or augment wills, as well as help manage property during life. A trust manages the distribution of a person's property by transferring its benefits and obligations to different people. There are many reasons to create a trust, making this technique for distributing property a popular choice for many.

The basic concepts of trust creation are fairly simple. To create a trust, the property owner (the *trustor, grantor, or settlor*) transfers legal ownership to a person or institution (the *trustee*) to manage that property for the benefit of another person (the *beneficiary*). The trustee often receives compensation for his or her management role. Trusts create a *fiduciary relationship* running from the trustee to the beneficiary, meaning that the trustee must act solely in the best interests of the beneficiary when dealing with the trust property. If a trustee does not live up to this duty, then the trustee is legally accountable to the beneficiary for any damage to his or her interests. The grantor may act as the trustee himself or herself and retain ownership instead of transferring the property, but he or she still must act in a fiduciary capacity. A grantor may also name himself or herself as one of the beneficiaries of the trust. In any trust arrangement, however, the trust cannot become effective until the grantor transfers the property to the trustee.

> *Example:* A grantor transfers money to a bank as trustee for the grantor's children, with the bank instructed to pay the children's college expenses as needed; the bank carefully manages the money to ensure there are funds available for this purpose. The children do not have control of the funds and cannot use the funds for any other purposes.

Trusts fall into two broad categories: testamentary trusts and living trusts (also known as *inter vivos* trusts).

A *testamentary trust* transfers property into the trust only after the death of the grantor. Because a trust allows the grantor to specify conditions for receipt of benefits, as well as to spread payment of benefits over a period of time instead of making a single gift, many people prefer to include a trust in their wills to reinforce their preferences and goals after death. The testamentary trust is not automatically created at death.

The terms of a testamentary trust are contained in the will of a decedent. Therefore, the transfer of property to the trust is made either during or at the end of the administration of the decedent's estate, instead of by a direct transfer during life. For the purposes of supervision by the probate court, a testamentary trust is considered to be an extension of the estate. As a result, testamentary trusts often require formal registration and accountings to the probate court. While testamentary trusts are often used in conjunction with tax planning, most frequently they are used to control the disposition of property beyond the normal time for probate administration.

> *Example:* A parent specifies in her will that upon her death her assets should be transferred to a trustee. The trustee manages the assets for the benefit of her children until they reach an age when the parent believes they will be ready to control the assets on their own.

A *living trust*, or *inter vivos trust*, starts during the life of the grantor, but may be designed to continue after his or her death. This type of trust may help avoid probate if all assets subject to probate are transferred into the trust prior to death. A living trust may be revocable or irrevocable. The grantor of a *revocable* living trust can change or revoke the terms of the trust any time after the trust commences. The grantor of an *irrevocable* trust, on the other hand, permanently relinquishes the right to make changes after the trust is created. A revocable trust typically acts as a supplement to a will, or as a way to name a person to manage the grantor's affairs should he or she become incapacitated. Even a revocable living trust usually specifies that it is irrevocable at the death of the grantor.

Irrevocable trusts transfer assets before death and thus avoid probate. However, revocable trusts are more popular as a means to avoid the probate process. If a person transfers all of his assets to a revocable trust, he owns no assets at his death. Therefore, his assets do not have to be transferred through the probate process. Even though the grantor of the trust died, the trust did not die, so the trust assets do not have to be probated. However, trusts avoid probate only if all or most of the deceased person's assets had been transferred to the trust while the person was alive. To allow for the possibility that some assets were not transferred, most revocable living trusts are accompanied by a "pour-over" will, which specifies that at death, all assets not owned by the trustee should be transferred to the trustee of the trust.

> *Example*: A person sets up a revocable trust, which states that on his death, his assets should be distributed to his children in equal shares. He transfers his house to the trust, but he does not transfer some rental real estate, which he owns. At his death, the trust can distribute the house outside of the probate process, but the rental real estate will have to be probated. Based on the will, the probate court will order the rental real estate be transferred to the trustee, who will then distribute it according to the terms of the trust.

Although a grantor may name himself as trustee of a living trust during his lifetime, he should name a successor trustee to act when he is disabled or deceased. At the grantor's death, the successor trustee must distribute the assets of the trust in accordance with the directions in the trust document. In many states, certain people must be notified at the death of the grantor.

While the basic concepts of the trusts discussed above are fairly simple, there are a variety of different types of trusts available for specific estate planning situations, some of which can be quite complex. Therefore, an experienced estate planning attorney should be consulted in order to determine the proper estate planning tools for you. While a lengthy discussion of the many different trusts available is beyond the scope of this article, two of these--the A-B trust and the QTIP trust--are mentioned below.

An A-B trust, is also referred to as a "credit shelter trust," A-B bypass trust," "bypass trust," or "Federal credit trust". It is often used to eliminate or reduce federal estate taxes. Generally, this type of trust is used by married couples whose estates exceed the federal estate tax exemption. It is a tool that can minimize estate taxes by taking full advantage of the combined value of the marital deduction and the unified credit.

A QTIP (Qualified Terminable Interest Property) trust is a trust for the life of a surviving spouse that provides the spouse with a qualifying income interest. It is designed to provide management and control of assets for a surviving spouse after the first spouse dies. This type of trust qualifies for the marital deduction, provided the executor of the decedent's estate makes the necessary election on the estate tax return. One of the advantages of the QTIP trust over other trusts qualifying for the marital deduction, is that the testator determines the disposition of the property in the QTIP trust after the death of his/her surviving spouse. It may be particularly useful when the testator has children from a prior marriage.

Because trusts have important tax, governmental assistance, probate, and personal ramifications, an experienced estate-planning lawyer should be consulted.

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