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Trusts

Wealth Managed to a Fiduciary Standard

At RDM, we help you coordinate what is often multiple financial goals (wealth accumulation, retirement income, legacy planning, etc.) through a maze of tax, legal and investment possibilities. It is critical to understand, develop and implement effective, long-term strategies that align with your objectives and prepare you for the future.

Trusts

What is a trust?

A trust is a legal entity that is created when you transfer property to a trustee for the benefit of a third person. The trustee manages the property for the beneficiary in accordance with the terms and the instructions in the trust document. In legal terms, the trustee has legal ownership of the property, while the beneficiary has beneficial ownership.

Creator of trust

The person who creates the trust is called the grantor, settlor, donor, or trustor. The grantor usually decides what assets will be transferred to the trust, who the beneficiaries will be, what the terms and conditions of the trust will be, and who will be the trustee. The grantor may also be a trustee and/or a beneficiary. Moreover, a beneficiary can be a trustee. The only arrangement that will not work is if the sole trustee is also the sole beneficiary (the legal and beneficial interests are said to merge and the trust is therefore disregarded as a legal entity).

Trust document

To create a trust, you usually have to have a written document (called a deed or agreement) that provides the terms of the trust. In most cases, an attorney should draft the trust document. Among other things, the trust document names a trustee, directs the trustee about how to manage and invest the assets in the trust, names the beneficiaries of the trust, and instructs the trustee regarding when to pay out income and principal to the beneficiaries. The trust document may give explicit and detailed instructions about these duties. Alternatively, the trust document may give only very broad and simple guidance. Furthermore, the trust document may give instructions for the distribution of principal which differ from instructions for the distribution of the income generated by the trust. For example, it is very common that a trust document will instruct the trustee to distribute the income to one or more beneficiaries and then pay out the principal to completely different beneficiaries at some point in the future.

Trustee

The grantor selects the trustee. There can be one trustee or multiple trustees. The trustee can be an individual or a corporate trustee (such as a bank trust department). Some trusts may have both a corporate trustee and an individual trustee. The trustee assumes responsibility for the management and distribution of the assets in the trust. The trustee's duties include making numerous complex legal, investment, and fiduciary decisions. Therefore, the selection of trustee should not be taken lightly. There are many factors that should be considered before selecting a trustee, such as the size of the trust, the purpose of the trust, the duration of the trust, the location of beneficiaries, and the tax ramifications.

In certain situations, the grantor can name himself or herself as trustee. A family member can be appointed as trustee, as can a friend, the attorney who drafts the trust, or your accountant. Finally, a corporate trustee, such as a bank trust department or an independent trust company can be named. You should probably discuss all of these options with an attorney.

Location of trust

In addition to choosing a trustee, you must also decide where the trust will be located. You have the option of setting up a trust in any state. State law governs how a trust is created and maintained, and these laws vary dramatically from state to state. There are also variations in state gift, estate, and income tax laws, as well as differences from state to state in the rights and obligations of the trustee and the beneficiaries. For example, some states provide better creditor protection to trusts than other states. Therefore, the decision regarding where to set up your trust should be discussed with your attorney.

Trust assets

Another decision you will face in setting up a trust is: Which assets should you transfer to the trust? The type of asset that you may transfer to a trust is almost limitless. You can transfer cash, stocks, bonds, insurance policies, real estate, your personal residence, artwork, and almost any other type of asset. The type of asset that you might transfer to a trust depends on what assets you currently own and what your goals are. For example, if you want to provide the beneficiaries with income, you may want to transfer bonds or high-yield stocks. If your goal is to provide the beneficiaries with liquidity to pay estate taxes, you may want to transfer a life insurance policy.

Types of trusts

There are several different types of trusts that you can create. You can create a trust in your will (this is called a testamentary trust), or you can create a trust during your life (this is called a living trust). You can create a revocable trust (this kind of trust you can amend or revoke), or an irrevocable trust (this kind of trust you cannot amend or revoke).

Testamentary trust

A testamentary trust is one that is created and funded under the terms of your will. It does not come into existence until your death. Assets that are transferred to the trust must pass through probate.

Until your death, you can change the terms of the trust by amending your will. Upon your death, the trust becomes irrevocable.

A testamentary trust can be contingent. That means that it will be created upon your death only if certain conditions are present (e.g., your children are under a certain age).

Living trust

A living trust, also called an inter vivos trust, is created while you are living. A living trust can either end or continue at your death. Property in the trust is distributed according to the terms of the trust, not your will. Living trust assets avoid probate.

Revocable trust

As the name implies, you can revoke or amend the terms of a revocable trust. You can change the beneficiaries or trustee. You can add or remove assets from the trust. You can also change the provisions of the trust. You can even dissolve the trust. Furthermore, at your death, the assets in the revocable trust do not pass by the terms your will (and thus do not pass through probate). Instead, the assets in a revocable trust are distributed in accordance with the terms of the trust. In fact, many people set up a revocable living trust simply to avoid the delay and cost of probate. However, one big disadvantage to a revocable trust is that the assets in trust will be included in your gross estate for estate tax purposes. Thus, a revocable trust is not used to avoid estate taxes.

Caution: *A revocable trust may become an irrevocable trust at the death of the grantor, unless the grantor gives someone else the power to amend the trust. The spouse of the decedent, for example, cannot change the terms of the trust unless he or she is given a special power of appointment.*

Irrevocable trust

Again, as the name implies, an irrevocable trust is one that you cannot revoke or amend once the trust has been established. This means that you cannot dissolve the trust, change the beneficiaries, remove assets from the trust, or change the terms of the trust. The main advantage to setting up an irrevocable trust is that the assets in the trust, including any future appreciation, are not typically included in your gross estate for estate tax purposes. Of course, the transfer to an irrevocable trust may be a taxable gift , and gift taxes may have to be paid at the time of the transfer. A secondary benefit of an irrevocable trust may be that the assets in the trust are beyond the reach of your creditors.

Irrevocable trusts are used primarily as estate planning tools. With careful planning, you may be able to save substantial amounts in estate taxes. There are many different types of irrevocable trusts that can be set up. To name a few, there is an irrevocable life insurance trust (to hold an insurance policy), a qualified personal residence trust (to hold a personal residence), and a grantor retained annuity trust (to provide you with income).

Why use a trust?

There are many different reasons why you may want to use a trust. For example, you may want to: (1) avoid probate, (2) have professional management of your assets, (3) provide for your minor children, (4) avoid estate taxes, and (5) protect your assets from creditors.

Avoid probate

As noted, assets in both a revocable and irrevocable trust do not pass through probate at your death. The assets are distributed in accordance with the terms of the trust, which may even continue past your death. Your estate, therefore, avoids the cost and

delay of probate. A further benefit of using a trust is that you will have increased privacy. A will is a public document (i.e., anyone can go down the probate court and review the contents of your will). However, a trust remains private.

Protect against old age and disability

Another reason to use a trust is to protect yourself in case of a mental or physical disability or other age-related problems. You can set up a trust, name yourself as the beneficiary, and then name yourself and another person as the trustees. If you become infirm or mentally incapacitated, the other trustee can manage your assets for you and distribute those assets in a way that is in your best interest.

Provide for your minor children

You may want to use a trust if you plan to leave your assets to minor children (generally, under age 18). Because you cannot predict when you might die, you may want to set up a contingent trust in your will in case you die when your children are still minors. The assets could then be transferred to the trust, and the trustee could manage the assets and make the necessary distributions when your children reach an older age.

Avoid estate taxes

Assets that have been transferred to an irrevocable trust are typically not included in your gross estate for estate tax purposes. (This result assumes that the creator of the trust is not a beneficiary of the trust. Furthermore, if the creator is also the trustee, then his or her ability to make distributions to the beneficiaries must be limited to ascertainable standards.) It is important to note, however, that gift taxes may have to be paid at the time of the original transfer to the trust. However, any appreciation in the assets after the transfer should avoid both estate and gift taxes.

Caution: *One exception to the general rule that assets transferred to an irrevocable trust are not included your gross estate is a life insurance policy. If you transfer a life insurance policy to an irrevocable trust within three years of your death, then the insurance policy will be pulled back into your gross estate.*

Reduce income taxes

By transferring income-producing assets to certain types of trusts, you may be able to transfer income to those heirs who are in a lower income tax bracket than you. By doing this, you may be able to reduce your own income taxes.

Benefit a charity

There are certain types of trusts where you transfer assets to the trust, receive income from the trust for a period of time, and then leave the assets to a charity upon your death. These types of trusts may provide you with both income and estate tax benefits, and also allow you to give to your favorite charity.

Other benefits

There are numerous other reasons why you may want to transfer your assets using a trust. These other benefits are beyond the scope of this general discussion. Please consult an estate planning attorney or other resources.

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