

# CHAPTER 4



## TRUSTS

### *Introduction*

In general terms, a trust is the creation of a right to property that is held by one person for the use and enjoyment of another. The person who holds the property is referred to as the “trustee” and the person who will benefit from the property is the “beneficiary.” A trustee is a fiduciary under the law and is obligated to manage the property of the trust for the benefit of the beneficiary (and not for his or her own benefit) and to follow the directions of the trust and applicable law. No higher duty of one person to another exists in the law than that of a fiduciary.



In any given trust there can be one or more beneficiaries. The rights of those beneficiaries to distributions from the trust are defined by the trust document as well as applicable law. Some beneficiaries (referred to as the primary beneficiaries) have the current right to benefit from the trust property. Other beneficiaries (referred to as secondary beneficiaries) only benefit after the rights of the primary beneficiaries have terminated under the terms of the trust.

For example, a wife may create a trust that will hold her assets after she has died for the lifetime benefit of her husband if he survives. During his life, the husband is entitled to receive the income of the trust and may receive the trust principal if necessary for his health and general welfare. After the husband dies, the children of the wife receive the assets of the trust. In this case the husband is the primary beneficiary—receiving the current benefit of the trust for his lifetime, and the children are the secondary beneficiaries—receiving the assets only after the husband’s death.

There are many types of trusts, some of which will be explored in this chapter and some in other chapters.

Trusts generally fall into two categories: living (or what the law refers to as *inter vivos*) and testamentary. Living trusts, as the name implies, are trusts that are created during the trust creator’s lifetime. The creator of a living trust is called the trustor, settler or grantor. Testamentary trusts are established at death under the terms of the decedent’s will or as part of a living trust described above. Living trusts can be revocable—that is, the trustor can revoke or change the

trust at any time—or irrevocable, meaning that the trust, once executed, is not subject to change or revocation.

Trusts are very flexible and can provide many different benefits based on the client's objectives. For example, certain irrevocable trusts can be used to reduce estate taxes, provide for deferred gifts to charities, protect assets from creditors, or shelter assets in the event the beneficiary requires long-term care or is receiving government benefits. Other irrevocable trusts are used to allow the intended beneficiary more time to develop the necessary level of maturity to properly manage the assets of the trust or for those individuals who may never achieve the necessary level of financial capability. Such trusts may last for the lifetime of the trust beneficiary.

## *Living trusts*

As stated above, living trusts are established during the life of the trustor. Living trusts fall into two categories: revocable and irrevocable.

### **REVOCABLE LIVING TRUSTS**

The revocable living trust has become a bit of a phenomenon in the estate planning world over the last thirty years. Revocable living trusts are often referred to as “will substitutes” but they offer many other benefits in addition to the distribution of your estate at death. They are flexible estate planning tools and include the following common benefits:

- The trustor may be his or her own trustee and, therefore, may have complete control over the assets of the trust.
- The revocable living trust allows the trustor to benefit from the trust by receiving all of the trust income and access to the principal of the trust during life.
- The trustor may name his or her own successor trustees; that is, who will become the trustee when the trustor dies or becomes incapacitated.
- If the trustor becomes incapacitated, the revocable living trust can be used to provide for the efficient management of the trustor's assets during the incapacity.
- The trustor may control when and how the trust assets are distributed after the trustor's death.
- Finally, the trust assets will be distributed to the secondary beneficiaries of the trust without the necessity of a probate of the assets.

Many of these benefits may be important in your personal situation. However, the advice of a qualified estate planning attorney is essential to help you reach this decision. The proper implementation of a revocable living trust is difficult and should not be undertaken without considering these difficulties and the available alternatives.

It is also important to remember that no matter how well-drafted a revocable living trust is, it cannot be fully effective if your assets are not contributed to the trust. If you establish a revocable living trust but do not transfer your assets to the trust, it will not work efficiently. For example, if you become incapacitated, a guardianship or conservatorship may still be necessary; and at your death a probate may be necessary for any assets that you own and did not contribute to your revocable living trust.

Depending on your state of residence, there may be some disadvantages to having a revocable living trust. For example, in some states your estate may not take advantage of the notice to creditors procedure that is available in a probate proceeding.

## **IRREVOCABLE LIVING TRUSTS**

The irrevocable living trust is used less often and for different purposes than a revocable living trust. Generally, the irrevocable living trust is used where the purpose of the trust would fail if the trustor retained the power to amend or revoke the trust.

In using an irrevocable living trust, the trustor creates the trust and transfers certain property to the trust with the intent that the assets of the trust will be used for the trustor's benefit or for the benefit of another person or persons. As with other trusts, the terms of the irrevocable living trust control the distributions that are made to the beneficiaries.

Frequently, an irrevocable living trust is used as part of a plan to save estate and/or gift tax. For example, the trustor may transfer assets to a trust that includes the appropriate provisions required under the Internal Revenue Code so that the transfer to the trust will have minimal, if any, gift tax consequences but will transfer the trust assets to the trustor's heirs without estate tax. If the trustor wishes to make a gift to a combination of charities and individuals (including the trustor), certain types of charitable trusts may be used. See Chapters 6, 7 and 8 for further discussion of these planning strategies.

An irrevocable living trust may also be used in circumstances where the trustor lacks the ability to properly manage assets due to mental impairment or poor judgment. These trusts may be established where the trustor is competent or by a third party (such as a court). In these circumstances, the outright ownership of the assets would reduce or eliminate the benefits that the trustor would otherwise be entitled to receive from one or more governmental programs such as Medicaid and Supplemental Security Income. An irrevocable living trust may be used under the proper circumstances to allow the trustor to continue to benefit from the assets of the trust without losing these important benefits. See Chapter 11 for a further discussion regarding these benefits and the use of trusts to preserve them.

## *Testamentary trusts*

In contrast to living trusts, a testamentary trust is not created until the time of death, usually as a result of the provisions of a person's will or living trust. A testamentary trust is irrevocable although it may contain many flexible provisions to allow for appropriate management of the trust assets and distributions for the benefit of the beneficiaries.

Typical provisions of a testamentary trust include the trustee's authority to distribute the income and the principal of the trust based on certain standards and conditions that are set forth in the trust instrument. Although there is no requirement that a trust distribute its income or principal, it is generally a good idea to provide for some mechanism for distributions to or for the benefit of the trust beneficiaries, even for very limited purposes.

The trust may provide for either the accumulation of income or the distribution of part or all of the income earned by the trust assets on a periodic basis. This decision is based on the needs of the beneficiaries and the objectives of the trustor or testator. For example, if the trust is being established for the benefit of a minor or young adult who may lack the proper level of maturity to make sound financial decisions, the trust instrument will likely provide for accumulation of income with the power on the part of the trustee to distribute the income for the beneficiary's health, education and welfare. Such an approach will allow the trustee to make a distribution for almost any prudent purpose without subjecting the trust income to the whims of the beneficiary.

Likewise, the trust instrument may allow distributions of the trust principal for the needs of the beneficiaries. In the example above, trust principal may be distributed for the benefit of the beneficiary for his or her health, education and welfare. As the beneficiary becomes older (and presumably more financially capable), the trustee may be authorized to make additional distributions from the income and the principal of the trust for a broad range of purposes. These might include the down payment on a personal residence, starting a business, travel opportunities and other prudent expenditures.

However, some testamentary trusts must include specific provisions in order to achieve the objectives of the trustor or testator. Some of the trusts that require specific provisions include the following:

### **TAX-PLANNING TRUSTS**

A tax-planning trust is a testamentary trust that is established to take advantage of tax savings opportunities in the federal and state tax law. For example, a credit shelter trust established at the death of one spouse for the benefit of the surviving spouse is a form of a testamentary trust.

Frequently, the surviving spouse is designated in the deceased spouse's will (or living trust) to serve as the trustee of the credit shelter trust. If so,

certain restrictions must be imposed on the surviving spouse's right to remove principal from the trust. As a general rule, the surviving spouse, as the trustee of the credit shelter trust, may remove principal for his or her health, education, support and maintenance. See Chapter 6 for a thorough overview of tax planning for the married couple.

## **TRUSTS TO PROTECT GOVERNMENT BENEFITS**

Often referred to as a "Special Needs Trust," this type of testamentary trust is designed to preserve the beneficiary's right to receive certain government benefits that are need-based. These benefits include Medicaid and Supplemental Security Income (known as "SSI").

A person who owns assets exceeding certain limitations is not eligible to receive certain government benefits, so a special needs trust is often used to shelter the assets that would have otherwise been distributed to the beneficiary. Assets held in a special needs trust are not counted for the purpose of determining the beneficiary's eligibility for the government benefits otherwise available to the beneficiary.

If the special needs trust is not used, the beneficiary will lose his or her government benefits and will be required to spend (or otherwise dispose of) the assets before reacquiring eligibility for the benefits.

## **ASSET PROTECTION**

Asset protection is a growing area of the law and estate planning in particular. The term asset protection refers to engaging in certain planning steps during lifetime that will have the effect of protecting your assets from the claims of creditors in the future. Asset protection planning is discussed in further detail in Chapter 10.

In the testamentary trust context, asset protection involves the use of long-term trusts that will allow the beneficiaries of the estate (such as your children) the ability to benefit from the trust assets without subjecting the assets to the claims of the beneficiaries' creditors. Creditors include the typical debts that a beneficiary may incur such as consumer credit, as well as less common ones like those arising from divorce, lawsuits and bankruptcy.

This form of trust is typically established to last for the lifetime of the beneficiary, although a shorter duration may be appropriate in some circumstances (for example, divorce rates decline with age). Distributions of income and principal may be made available to the beneficiary under conditions similar to that which is outlined above.

Many clients desire that the beneficiary also serve as the trustee of the trust. This should be done with great caution as the purpose of the trust (protection from creditors) can be undermined if the beneficiary—as

trustee—fails to abide by the terms of the trust. If the trustee ignores the formalities of the trust, a court (bankruptcy, divorce, etc.) may ignore it as well.

If a beneficiary is to serve as a trustee, he or she should have administrative powers only (such as the power to participate in the trust investment decisions) and not the power to make distributions to himself or herself from the trust. This power should be held by a person (or financial institution) that is independent of the influence of the beneficiary.

## *Conclusion*

The use of trusts, both living trusts and testamentary trusts, are an important part of any complete estate plan. Certain trusts, such as the credit shelter trust, may be established to achieve tax objectives. Trusts may also be used to achieve non-tax objectives such as efficient management and distribution of your assets, asset protection, and to preserve government benefits (including SSI and Medicaid). The proper design of any trust is an important part of leaving a legacy.