The Basics of Trusts

What is a trust?

A **trust** is a legal entity that holds property or assets for the person who created it—known as the **grantor, settlor, trust creator,** or **trustor** – for the eventual benefit of someone else: the **beneficiary(ies)**.

Trusts and **wills** are the main means of estate planning in America. Large estates are subject to estate taxes. Trusts can reduce that liability by getting assets out of the grantor's estate. In general, the purpose of trusts and wills -- of all estate planning -- is to defer federal and state income tax liability for as long as possible, while allowing the assets to grow as much as possible.

Reasons for Establishing Trusts

In recent times, the main reason for establishing trusts has been to minimize taxes: federal and state income, inheritance/estate, gift, generation-skipping transfer, and fiduciary income taxes. Most specific types of trusts, then, are defined, initially, by their tax benefits.

However, trusts are created for other reasons as well:

- To control/direct/distribute wealth, and protect it from creditors and irresponsible beneficiaries,
- To maintain privacy, and
- To avoid probate.
- Estate and gift taxes

Each American citizen taxpayer has an exemption of $5.34 million for taxable gifts and his estate. Gifts and estates below the exemption limit are generally exempt from transfer taxes—estate, gift, and generation-skipping. If the taxpayer makes taxable gifts during his lifetime, they reduce the exemption. The reason for gift tax is that, otherwise, taxpayers could forestall estate taxes entirely merely by giving away their assets within their lifetimes.

Spouses can combine and shift their exemptions, so that they can exempt a total $10.6 million between their estates. Amounts in excess of these limits are taxable at up to 40% upon death, but a married taxpayer can give his/her US citizen spouse any amount, exempt from tax.

Flexibility vs Control

The goal is to structure the trust document tightly enough to make sure the grantor's intentions will be carried out, while also providing enough flexibility to be able to adapt to changes that the grantor may never have envisaged.

At the other end of the continuum is **dead-hand control,** sometimes called control from the grave. When a trust incorporates dead-hand control, imposing rigid conditions on the trustee and/or beneficiaries, matters can often wind up in court. If that happens, everybody loses: It's the worst-case scenario.

Many trusts established 30 years ago or more provided exceptions specifically only for payment of taxes. These days, most newly formed trusts explicitly make exceptions for "medical emergencies." But that only raises the question: What constitutes an emergency? Surely open-heart surgery does—but what about rhinoplasty?

In the end, such considerations often boil down to giving cover to the trustee--especially a corporate trustee, who seeks to avoid liability at all costs--to make decisions without feeling a judge's blessing is needed.

In designing a trust, the grantor's intent is pivotal, but conveying it in a trust document can be daunting. It involves more than a mere expression of the grantor's wishes. Often the tax implications get paramount consideration--and sometimes, lawyers forget about other things. Taxes should not be allowed to override other important goals.

The grantor and his attorney must consider options for fulfilling his intention, the specific language of the document, how others will interpret it, and the limitations it places on the trustee, who is responsible for implementing it. As we've said, this raises constant tension between flexibility and control.

Grantor vs Non-Grantor Trusts

Grantor and non-grantor trusts are the two primary types of funded trusts, and the relationship of the grantor to the other individuals in the trust determines whether it is a grantor or non-grantor trust. A third type of trust, the intentionally defective grantor trust, contains elements of both the grantor and non-grantor trusts.

In a **grantor trust,** the trustor retains certain powers over the trust and, because of this, the trust's income remains taxable to him. After the grantor dies, a grantor trust loses that status. If the trust continues to operate, the trustee must begin filing income tax returns for it, as a distinct entity.

In non-grantor trusts, the grantor has given up all right and interest in the principal, and only the trustee may terminate the trust. In a non-grantor trust, the grantor cannot be named as a trustee, beneficiary or remainderman. Grantor trusts and intentionally defective grantor trusts become non-grantor trusts at the grantor's death.

In an intentionally defective grantor trust (IDGT), the grantor makes an irrevocable gift of property into a trust, names someone else as trustee and retains the right to substitute other assets of equivalent worth for the property initially put into the trust. Unlike grantor trust tax requirements, the property is effectively moved from the grantor's estate and into the trust. Gift tax is paid on the assets when moved into the trust. No estate tax is due when the grantor dies.

Grantor Trust Tax Implications

Some of the tax consequences of the grantor trust structure are:

Income tax - A grantor trust is a disregarded entity for income tax purposes. This means that any taxable income or deduction earned by the trust will flow onto the grantor's individual income tax return.

Gift tax – A grantor often makes a gift when funding the trust. For tax purposes, this is treated as a gift to the beneficiary(ies). No gift tax return need be filed if the amount is less than federal exclusions, and beneficiaries are notified of the right to withdraw each time a transfer is made, under a provision known as a **Crummey Withdrawal Right** (see page 21). But if the cumulative lifetime amount of the donor's gift(s) exceeds the $5.43 million gift tax threshold, the grantor must file a gift tax return (IRS Form 709). There is one common exception: each taxpayer may give any number of recipients up to $14,000 per year in gifts, which are disregarded for gift tax purposes.

Estate tax – If the grantor **r**etains the power to revoke the trust, its assets will be included in the grantor's gross estate for federal estate tax purposes.

Generation-skipping transfer tax (GSTT) – The grantor's generation determines when the "skip" happens. See page 17 for more on this.

Revocable, Irrevocable, or Somewhere in Between?

Another important feature of trusts is whether they are revocable or irrevocable. Both types of trust are set up while the grantor is alive. The basic distinction is whether you can change your mind about assets you put in the trust.

While the grantor is alive, he can change the terms of a revocable trust or dissolve it entirely. He is considered the taxpayer, and uses his Social Security number to report taxable events. So, revocable grantor trusts ordinarily have no tax advantage; their purpose instead is to enable the estate to avoid probate. They can be a substitute for wills. Putting the grantor's assets in a revocable trust can help protect his privacy. That's because assets that are governed by wills are generally subject to probate, which is public record.

The concept of irrevocable trusts is that once property is put into the trust, it cannot be taken out. These days, almost no rule is iron clad, and we will get into detail on those maneuvers later. (See page xx) Quite commonly, revocable trusts are written such that they become irrevocable upon the grantor's death.

Beneficiaries

Beneficiaries In General

Many trusts have only one beneficiary, or one category of beneficiaries. More complicated trusts may involve both **income beneficiary(ies),** who are entitled to income generated by assets held in the trust, and a **remainder beneficiary(ies),** also called **remaindermen.**

A remainder beneficiary(ies) is entitled to receive the assets of the trust, once the interests of the income beneficiaries have been fulfilled. Having both types of beneficiaries is a way to give greater flexibility and control to the grantor. Even after the primary beneficiary(ies) no longer needs the assets, the grantor dead or alive still controls what ultimately happens to them.

If the trust document says, "I leave the remainder of my estate to my trustee, to hold in trust for my wife for life, remainder to my children equally," the wife is the current/income beneficiary; the children are the future/remainder beneficiaries.

This arrangement can give rise to conflicts because current beneficiaries tend to want maximum current benefits, while remainder persons want to make sure assets are preserved or grown.

Vested and Contingent Interests

A **vested interest** is a current right that cannot be taken away, unless some “condition subsequent” comes into effect. An example is: “Child A shall receive the balance of the remaining trust principal upon reaching age 45.” At age 45, Child A’s interest is vested.

A **contingent interest** is a right in the trust that *could* come into force in the future, if a “condition precedent” is met. Suppose the trustor leaves $100,000 to his grandson, provided that the grandson gets a bachelor's degree. Attainment of the degree is a **condition precedent**: it must happen before the $100,000 becomes vested. Once the grandson gets his degree, it converts from a contingent interest to a vested interest.

If the trustee shall pay the income of the trust to child C at least quarterly for her lifetime, with the reminder to child D if he survives her, that’s a combined vested and contingent interest. Child C's income interest is vested, and D's remainder interest is contingent upon his surviving C.

By contrast, if the trust stipulated that the remainder goes to D no matter what, D’s estate would receive C’s interest even if C outlives D. Then both would be vested interests.

The distinction between vested and contingent beneficiaries determines their standing with the trustee. A vested beneficiary can discuss all trust administration matters with the trustee. But a contingent beneficiary has no immediate right to involve herself in the administration of the trust.

Another type of interest is **vested, but subject to forfeiture by condition subsequent**. An example: My husband shall receive all the trust income until he remarries.

Beneficiaries’ Rights

Beneficiary rights begin with those specified in the trust instrument itself. They might include:

- Income for life
- Certain amounts at stated ages
- The remainder of the assets upon some event (e.g., death of a prior interest holder)

- The right to occupy certain real property
- The right to make trust property productive of income (in a QTIP Marital Trust, this right is mandatory, to preserve the estate tax marital deduction. See page 15).
- Other beneficiary rights are bestowed by state or trust law. The first is the right to be informed about the status of the trust. This includes receiving annual trust accounting reports. Estate law rules specify when trustees must obtain beneficiaries' consent. Also, consent may be required or advisable for major events, such as changes in investment allocation, sale of significant assets such as a family business, and "decanting" (see page 13).

For trustees, the practical need is proof that they have informed the beneficiaries. The best proof is to get a receipt or acknowledgement.