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EXTENSION

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A Beginner's Guide to Trusts¹

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Introduction

This is the second in a brief three-document series on estate planning. Each is simple and intended only to provide an outline to someone who knows little about the subject. The other two documents are (1) wills and (2) living wills and power of attorney. Creating a trust should be part of your estate planning. While wills unavoidably involve probate, which is time consuming, costly and lacking in privacy, trusts avoid some of these problems. Because trusts are complex and variable, only the basics of trusts will be outlined here.

What Is a Trust?

A "trust" is a legal device designed to hold the property of an individual, the grantor, for the sake of one or more beneficiaries (TIAA-CREF, 2000). Like a will, a trust is a written document that transfers property. However, unlike a will, which is a specific statement of what the beneficiaries receive, a trust is a multipurpose tool. It can be established anytime, by

virtually anyone, to manage property, distribute assets to beneficiaries, avoid probate and reduce taxes. No one trust can accomplish everything, so it may be necessary to establish different trusts to serve different functions or benefit different people (Morris et al., 1995).

Morgan Stanley Dean Witter says this about how trusts serve an investor. Trusts can:

- *Establish control.* Trusts enable you to control the management, distribution and use of assets and keep money in your family for generations.
- *Safeguard Assets.* Trust assets can be protected against family disputes, business reversals and claims from creditors.
- *Avoid Probate.* Assets in most trusts avoid the cost, time delays and publicity of probate.
- *Offer Protection Against Incapacity.* Trusts can be structured so that personal and financial affairs are maintained should you become incapacitated or unable to manage your affairs.

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- *Reduce Tax Liabilities.* Assets in certain irrevocable trusts do not count toward your net estate, thus reducing an estate tax liability.
- *Help with Specific Circumstances.* Trusts are often established or updated to help with life-changing events (Morgan Stanley Dean Witter, 2000).

How a Trust Works

You, as the donor or grantor, set up the trust through a lawyer. You name the beneficiaries and the trustees and transfer property to the trust. The beneficiaries are the individuals or organizations that receive the benefits of the trust. The trustees control the property in the trust, manage the trust's investments and oversee payments. You must retitle the property to show it belongs to the trust. The function of a trust is to earn income, pay taxes and distribute benefits (Morris et al., 2000).

In some states it is legal for the donor to also be both trustee and beneficiary of the trust. However, one person can have two roles in a trust as donor/beneficiary, donor/trustee or trustee/beneficiary in all states. It is not uncommon for a separate person or organization to fill each role (Morris et al., 1995).

Types of Trusts

There are many types of trusts. The most common include revocable living trusts, irrevocable trusts, credit shelter trusts, marital trusts, qualified terminable interest property trusts, grantor retained trusts, charitable remainder and lead trusts, life insurance trusts, qualified personal residence trusts and special needs trusts. Of these the most typical are the revocable living trust and the irrevocable trust. Sample forms of each are shown in Tables 1 and 2. Either allows the donor to transfer property to beneficiaries outside the probate process. However, the revocable trust can be changed, whereas an irrevocable trust generally cannot (Shenkman, 1991).

The revocable living trust plays no role while you, as the donor, are alive. You can transfer as much property as you like to the trust without owing gift tax, and you can change the terms of this trust at

anytime. After your death, the person you selected as the successor trustee takes control of the trust property and transfers it according to the directions you left in the trust documents (Nolo.com, 2000).

Since a revocable living trust does not eliminate estate taxes, it may be advantageous to also create an irrevocable living trust which does reduce estate duties. However, once you put property into an irrevocable living trust, it is difficult to change things. The same situation applies with beneficiaries. The tax advantages occur because the property transferred to the trust is no longer your property. The trust, not the donor, pays income taxes on what the assets earn. When you die, the trust property is not included in the estate and is therefore excluded from the death tax (Morris et al., 1995).

There are advantages and disadvantages to each type of trust and these depend largely on the individual's situation. Consequently it is usually useful to consult a professional specializing in estate planning to help you decide which trust(s) best suits your financial situation and estate distribution desires.

References

Morgan Stanley Dean Witter. *Preserving and Transferring Wealth with a Name You Can Trust*. Morgan Stanley Dean Witter Trust FSB. 2000.

Morris, K.M., A.M. Siegel and V.B. Morris. *The Wall Street Journal Guide to Planning Your Financial Future*. New York, NY: Lightbulb Press, Inc. 1995.

Shenkman, Martin M. *The Estate Planning Guide*. New York, NY: John Wiley and Sons, Inc. 1991.

TIAA-CREF. *Taxes and Estate Planning*. New York, NY: TIAA-CREF Library Series. 1999.

Table 1. Sample Irrevocable Trust (The 'Lectric Law Library — <http://www.lectlaw.com>).

<p>IRREVOCABLE TRUST (CANNOT BE REVOKED OR CHANGED)</p>	
<p>This Irrevocable Trust Agreement is made this [day] day of [month], 20__ [year], between [Name], of [address], City of [city], State of [State], herein referred to as Grantor, and [name], of [address], City of [city], State of [state], herein referred to as Trustee.</p>	
<p>In consideration of the mutual covenants and promises set forth herein, Grantor and Trustee agree as follows:</p>	
<ol style="list-style-type: none"> 1. Transfer of Trust. Grantor herewith assigns, transfers and conveys to Trustee the property described in Exhibit A attached hereto and made a part hereof by this reference, and receipt of such property is hereby acknowledged by Trustee. Such property, hereafter designated the Trust Estate, shall be held by Trustee in Trust for the uses and purposes and on the terms and conditions set forth herein. 2. Disposition of Principal and Income. Trustee shall administer and manage the Trust Estate, collect the income therefrom and, after payment of all taxes and assessments thereon and all charges incident to the management thereof, apply and dispose of the net income and the principal of the Trust Estate as follows: [names and addresses of beneficiaries] 3. Additions to Trust. Grantor and any other person shall have the right at any time to add property acceptable to Trustee to the this Trust. Such property, when received and accepted by Trustee, shall become part of the Trust Estate. 4. Irrevocability of Trust. This trust shall be irrevocable and shall not be revoked or terminated by Grantor or any other person, nor shall it be amended or altered by Grantor or any other person. 5. Compensation of Trustee. The original Trustee hereunder, and all Successor Trustees, shall be entitled to reasonable compensation for their services as Trustee. 6. Successor Trustees. If [name] [Original Trustee] resigns or is unable to continue to act as Trustee, [name] [Successor Trustee], of [address], City of [city], County of [county], State of [state], is hereby appointed as Successor Trustee. 7. Governing Laws. The validity, construction, and effect of this agreement and the Trust created hereunder and its enforcement shall be determined by the laws of the State of [state]. 	
<p>In Witness Whereof, Grantor and Trustee have executed this Agreement on the date above written.</p>	
<p>_____ Grantor</p>	<p>_____ Trustee</p>
<p>_____ Witness 1</p>	<p>_____ Successor Trustee</p>
<p>_____ Witness 2</p>	
<p>The foregoing instrument was acknowledged before me this [day] day of [month], 20[year] by [name] [Grantor], [Name] [Trustee] and [name] [Successor Trustee].</p>	
<p>My commission expires: _____</p>	
<p>Notary Public: _____</p>	
<p>Date: _____</p>	
<p>Exhibit A [Separate Page] [Listing of property included in this agreement.]</p>	

Table 2. Revocable Trust (The 'Lectric Law Library — <http://www.lectlaw.com>).

REVOCABLE TRUST

I, _____ of _____ in the County of _____, have this day conveyed and transferred to _____, a _____ located at _____ and of _____, State of _____, TRUSTEE, the property as listed and set forth in Schedule A attached hereto and made a part hereof, and the said Trustee hereby makes and executes this Declaration of Trust and hereby agrees for itself and its successors in effect, to hold said property and any property from time to time added hereto IN TRUST NEVERTHELESS upon the following uses and benefits, that is to say:

FIRST: The property shall be held, managed, invested and re-invested by the Trustee, and its successor or successors, with all the powers to the Trustee as herein provided.

SECOND: The Trustee shall divide the Trust Property into equal shares for each of the beneficiaries, namely:

[Names]

and shall pay to, or apply for the benefit of, said named beneficiaries such amount, or amounts, of the net income and/or principal from each of said shares as the Trustee in its uncontrolled discretion may determine any net income in any year which is not paid to or applied for the benefit of the beneficiary of each said share shall be added to the principal of said share at the end of the year.

THIRD: The Trustee shall pay to each of said beneficiaries the principal of the share held for his or her benefit, free and discharged from any Trust in or within one (1) year from the date of the death of the last surviving settlor unless this trust is sooner revoked.

FOURTH: In extension and not in limitation of the powers given them by law or other provisions of this instrument the Trustee and any successor or successors shall have the full power with respect to any property in any Trust established hereunder to deal with the same as if he/she were the owner thereof without order or license of any Court.

FIFTH: The interest of each beneficiary in the income and principal of a trust under this instrument shall be free from the control or interference of any creditor of the beneficiary or any spouse of a married beneficiary and shall not be subject to attachment or susceptible of anticipation or alienation.

SIXTH: This Declaration of Trust is revocable and the Settlor retains the power to alter, amend or revoke this instrument either in whole or in part at any time. Revocation shall be accomplished by a certificate of the Settlor delivered to the Trustee personally or by certified mail.

IN WITNESS WHEREOF _____ and _____, Settlers, and _____, Trustee, have hereunto set their hands and seals this _____ day of _____ A.D.

In presence of:

_____ [Trustee]