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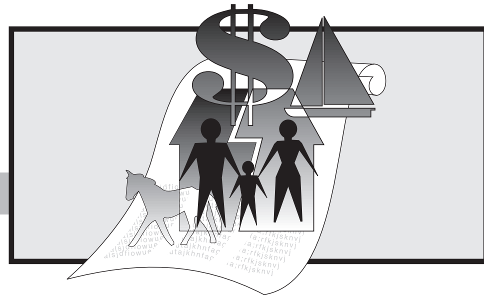

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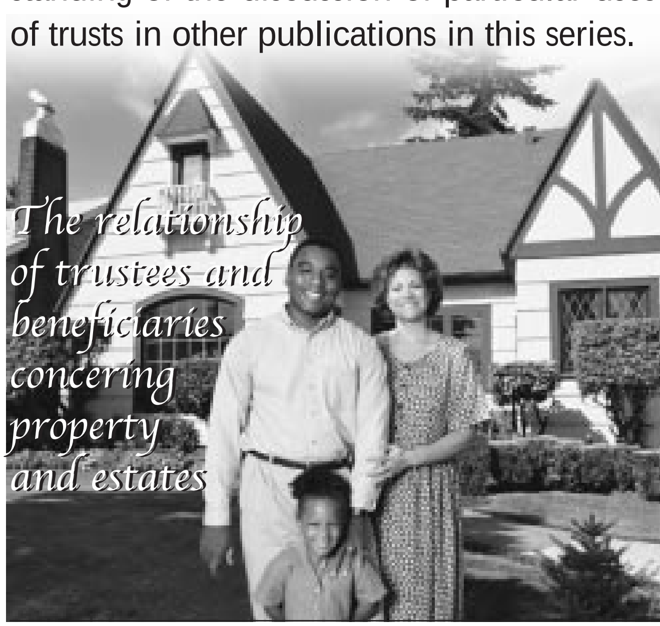
Managing Prosperity: Estate and Retirement Planning for All Ages

An Introduction to Trusts

*Jesse J. Richardson, Jr. and L. Leon Geyer**

This publication gives a general overview of the use of trusts in estate planning. The terminology will be defined and the uses of trusts in estate planning generally described, but the particular types of trusts used in estate planning will not be detailed. Instead, the reader is directed to other publications in this series for more information. (e.g., VCE Publication 448-096 on Advanced Tax Considerations and VCE Publication 448-088 on Life Insurance). The reader should gain an understanding of trusts from this publication that will enable a fuller understanding of the discussion of particular uses of trusts in other publications in this series.



A *trust* is a legal arrangement whereby one party (the *trustee*) holds legal title to property for the benefit of another party (the *beneficiary*). A trust is created when yet another party (the *grantor* or *settlor*) gives money or property (the *res* or *corpus*) to the trustee. The trust agreement, signed by the grantor and the trustee, is a contract and details what the trustee must do with the money or property.

The trustee, beneficiary, and settlor may be the same party or it may be a combination of a person, business entity, or institution. The trustee manages the trust assets for the beneficiary. The trustee holds legal title to the property in the trust, while the beneficiary holds beneficial title. Beneficial title means that although the beneficiary is not the "legal owner" of the property, he/she holds certain rights in the property (as detailed in the trust agreement). The beneficiary may compel the trustee to follow the instructions in the trust agreement.

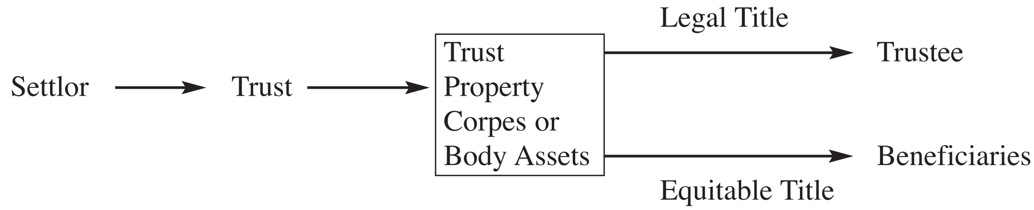
Trusts are classified in several ways. First, trusts differ based upon whether the trust is formed during the life or upon the death of the grantor. A *living* (or *inter-vivos*) trust is formed during the lifetime of the grantor. On the other hand, attorneys refer to trusts formed by instructions in a will as *testamentary* trusts.

There are hundreds of names for types of trusts such as living trust, charitable remainder trust, land trust, GRIT, GRUT, QTIP, Rabbi, Pour over, and more. The names often reflect the purpose for which the trust was created. However, they all operate on the basic principle outlined in Figure 1 and explained below.

The law also differentiates trusts on the basis of the control retained over the assets by the grantor. A *revocable*

*Attorney and Assistant Professor, Department of Urban Affairs and Planning, Virginia Tech; and Attorney, Professor, and Extension Specialist, Department of Agricultural and Applied Economics, Virginia Tech; respectively

Figure 1. Trust Arrangements



trust may be changed or ended by the grantor at any time. With an *irrevocable* trust, the grantor in general relinquishes all control or power over the trust assets.

A trust instrument specifies the powers of the trustee and the rules for operation of the trust. The applicable state laws and the trust instrument form the basic guidelines for the trust. The trust names individuals or groups who are to receive income from the trust property and specifies who should receive the remaining assets of the trust when it terminates.

A high degree of responsibility is placed on the trustee. This responsibility limits the trustee's freedom to act on his own judgment in managing the trust and affords protection for the beneficiaries. Investments by the trustee must generally be very conservative and protect the beneficiary. For example, a trustee should not use money that he holds in trust to place a wager on a horse race, no matter how much of a "sure thing." The trustee should not even place the money in investments that may be viewed as "risky." However, the grantor may empower the trustee to, for example, invest in junk bonds, technology stocks, or other relatively high-risk investments, by setting out these powers in the trust agreement.

The trustee has a fiduciary obligation to act on behalf of the beneficiary. Fiduciary implied a duty to act with fidelity and good faith with respect to investment decisions. For example, a $50,000 trust established by Grandpa Wealth to pay for the college education of his 16-year old granddaughter would be managed to preserve the $50,000 for use over four years of college. A $1,000,000 trust established by Grandma Rich to provide housing, education, health insurance, and travel expenses for her 6-month old grandson might be managed with a portion of assets in a conservative fixed return, a portion in mid-risk stocks and a portion of high-risk stocks so that the asset would keep up with or exceed inflation and in fact grow the net value of the trust over time. A trustee is entitled to compensation, which generally ranges from 3% to 6% of annual trust income.

Trust Basics

Like a will, a trust is a legal document. Transferring assets to a trust may trigger gift, estate, and income tax consequences. Therefore, if you are considering establishing a trust, you should consult your tax practitioner or CPA and your lawyer.

The trust can be tailored to meet your needs. You must decide who your beneficiaries should be and how and when they should receive the property. For example, should the beneficiary receive all income or just when income it is needed for necessities or education? A trustee and at least one successor trustee must be chosen. You must also decide how much discretion you will give the trustee. In addition, you must decide which assets to put in the trust. These issues should be discussed with your tax advisor and attorney. While there are advantages of having a trust, they may not apply or be useful in your situation. Even if you and/or your spouse establish a living trust, a will is still needed to appoint a guardian for minor children or to dispose of non-trust assets that you may have or acquire.

One should remember that a trust is a separate legal entity. Upon creation of the trust, the property that you wish to be included must be formally transferred to the trust. Many estate plans have been stymied by a failure to transfer the assets to the trust.

Settlors often use trusts too accomplish specific goals. For example, a charitable trust might be established for the benefit of a particular charity, education, scientific, or religious purpose. The beneficiaries are not specific people, but the public good.

As a general rule, the beneficiary of a trust may assign their trust rights (right to income or residual rights) to another individual or business. Rights to trust income and property are subject to creditor claims. However, a spendthrift trust may limit the right of the beneficiary to sell or assign trust principle or future payments of income of income from the trust.

Many trusts are created with a discretionary provision. Under a discretionary trust, the settlor delegates to the trustee the right to decide when and how much money should be distributed to a beneficiary or group of beneficiaries. For example, Mom (settlor) might establish a trust and give Bill (trustee) the right to spend the money as needed for the educational and health needs of her three children (Able, Bernice, and Christy). Bill could spend $10,000 on Able, $5,000 on Bernice, and $0 on Christy for education in a given year.

Property owned by the trust must be accounted for separately from assets owned by the grantor (even if the grantor is the trustee and the trust is revocable). You no longer own property in a trust individually. The trustee holds the property in trust for the purposes of the trust.

A properly drafted living trust along with a power of attorney may serve as an enhanced alternative to having the court appoint a guardian to conduct your financial affairs (See VCE Publication 448-064 on Power of Attorney). Placing assets in a trust avoids probate of trust assets. Avoiding probate keeps information out of the public record. However, the cost of drafting and implementing a trust may be high.

Why Use a Trust?

A trust can be a useful arrangement to meet one or more specified objectives of an estate plan. Trusts may serve many purposes. Some of the more common purposes are the following:

- To relieve beneficiaries of management responsibilities for trust property;
- To provide income to the surviving spouse and/or minor children;
- To keep trust property out of the surviving spouse's estate, yet permit the spouse to receive its income;
- To reduce the size of the taxable estate;
- To keep matters private; and
- To provide income for persons with special needs and income for those unable to manage money affairs.

The authors increasingly see parents utilizing testamentary trusts to "assist" children in managing property. Many persons wish to "gradually" turn over control of assets to others. Trusts provide a flexible way to tailor the gift to the situation. For example, a parent could leave property in trust for his child, giving her 1/4 of the property outright when the child reaches the age of 21, another 1/4 when the child reaches 25, another 1/4 when the child reaches 30, and the final 1/4 when the child reaches 35. The possibilities are endless and the law places few limits on the use and distribution of trusts, income, and assets. These limits are beyond the scope of this article, but they mainly relate to how long a person may control property "from the grave."

Trusts may also be used to provide income for children or for a spouse. At the death of the income beneficiary, the ownership of the property generally passes outright to the ultimate beneficiary. Estate tax provisions allow a spouse the life income from trust assets without including the trust assets in the spouse's taxable estate under appropriate circumstances (See VCE Publication 448-096 on Advanced Tax Considerations). Although property in a revocable living trust is included in the taxable estate of the grantor, the estate tax provisions allow exclusion of property in an irrevocable trust from the estate. This may provide estate-planning benefits in certain circumstances (See VCE Publication 448-088 on Life Insurance).

In addition, trusts provide a vehicle to achieve privacy in estate matters. Wills become a matter of public record upon the death of the maker of the will. For some persons, this ability of the public to view estate-planning documents inhibits proper estate planning. Upon the death of the grantor, the trust does not automatically become public. In fact, trusts generally remain private forever. Persons utilizing trusts should still have a will in case the trust does not operate on all property and to achieve some goals for which a trust provides little assistance (See VCE Publication 448-080 on Wills).

Finally, trusts afford the flexibility and management options often needed for beneficiaries with special needs. For example, if an individual has a physical

and/or mental incapacity that prevents her from properly attending to her own needs, a trust can provide professional asset management and provisions tailored to the situation. Likewise, a trust can be established to assure that assets given by grandparents pay for educational expenses and not for a new car.

Special Considerations of Living Trusts

The living trust is becoming an increasingly popular estate-planning tool for moderate to wealthy individuals and their spouses. The living trust provides flexibility in planning the estate and provides for alternative management of the individual's estate should the individual become disabled or incapacitated. The living trust can also provide alternative management of assets, freeing the beneficiaries for travel. Established correctly, it may also save estate taxes (See VCE Publication 448-088 on Life Insurance).

In appropriate circumstances, a living trust may provide:

- a cost-effective method of transmitting property from one generation to the next while providing life income for the grantor and the grantor's surviving spouse;
- a means to avoid the cost and public nature of probate;
- a way to expedite asset and income distribution at time of death;
- a guard against an attack by heirs against the plan of distribution;
- an easier method to handle the administration of property in another state than under the probate process;
- professional asset management;
- protection for you and your spouse if incapacitated;
- limited creditor protection; and
- management of assets and protection for minors, like a testamentary trust.

Popular literature and many attorneys' sales pitches often cite the avoidance of probate as the primary benefit of creating a living trust. Probate costs impose a heavy burden in some states. However, the Virginia state probate tax is only 10 cents per $100 in estate value (or 1/10 of 1%!). Local governments in Virginia may add another 3 1/3 cents per $100 in estate value as a local probate tax, for a maximum tax of 13 1/3 cents per $100. The maximum probate tax in Virginia, therefore, is less than 2/10 of 1%. Legal fees to form a living trust generally range between $500 and $2,500, depending on the complexity of the provisions. In addition, trustee's fees must be considered. Given the cost of trust formation and trustee's fees, the authors do not recommend the formation of a living trust for Virginia residents solely to avoid probate costs. This is especially true for modest estates. On the other hand, a living trust with a successor trustee can provide management benefits, a method of handling incapacity problems for the grantor/beneficiaries, and relatively painless disposition of assets at death.

An oft-cited benefit of a living trust is that such a trust avoids estate taxes. This is not true! If the trust is irrevocable, the property is not included in the grantor's estate in most circumstances. However, the donation of the property to the trust is a gift and subject to estate and gift tax rules (See VCE Publication 448-091 on Estate Tax and VCE Publication 448-085 on Lifetime Gifting). A properly drafted living trust, used in appropriate circumstances, can help reduce the estate and gift tax burden. However, caution should be used in setting up a trust for this purpose (See VCE Publication 448-088 on Life Insurance).

Conclusion

The trust is a very flexible tool. It is easily established and may be used as a substitute decision-maker. Little money needs to be put in the trust upon creation and additional money can be transferred over time. The rules governing both the conduct of the trustees and the rights and protection for the beneficiaries are well established. Trusts are flexible and terms can be established to meet individual needs including estate tax concerns, determination of the beneficiaries, and the rules to govern the actions of the substitute decision-maker.

The creation and maintenance of a trust does have some associated costs and trusts are often unsuitable devices for individuals with little property and assets. A trust, however, does not answer the need for a personal decision-maker. Coupled with the power of attorney, it can be part of a complete and powerful plan to take care of an individual's needs. As with any legal document, one should enter into a trust only with the benefit of advice from legal counsel and your tax advisor.

Jesse J. Richardson, Jr. can be reached at (540) 231-7508 (phone); (540) 231- 3367 (facsimile); and jessej@vt.edu (email).

L. Leon Geyer can be reached at (540) 231-4528 (phone); (540) 231-7417 (facsimile); and geyer@vt.edu (email).