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Trusts 101: Why Have a Trust?

Trusts aren't just for very wealthy or complicated estates. They could be helpful for many "average" folks, too. Here are the basics of trusts: what they do, and how they can be used.

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It's a well-documented fact that most people do no estate planning. Of those who do, the majority use a last will to pass their estate to a spouse or divide it among their children.

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Most estate plans do not establish a trust. I suggest that if you can make a list of people you want to share in your assets at your death, your plan will benefit from a trust.

A trust is an agreement between two parties: a settlor and a trustee. Although trusts may be used for many other purposes, for our discussion here the trustee agrees to accept, manage and protect assets delivered by the settlor; administer those assets according to the trust's instructions; and distribute the trust income and principal as the trust allows only for the benefit of the people identified in the trust.

The trustee is a fiduciary. As a fiduciary, the trustee must act with reasonable care in administering the trust and selecting trust investments; avoid any conflict of interest or self-dealing in holding, purchasing and selling trust assets; and diligently avoid breaching any of the trustee's many duties to the settlor and the trust beneficiaries.

The trustee owes a duty of obedience to follow the trust terms, a duty of prudence and reasonableness in making investment and administrative decisions, a duty of objectivity in not giving preference to any beneficiary over equally situated beneficiaries, and a duty of transparency in providing trust information and accountings as prescribed in the trust agreement.

Trusts can be established for a number of reasons. Among them:

- To manage and control spending and investments to protect beneficiaries from poor judgment and waste;
- To avoid court-supervised probate of trust assets and be private;
- To protect trust assets from the beneficiaries' creditors;
- To protect premarital assets from division between divorcing spouses;
- To set aside funds to support the settlor when incapacitated;
- To manage unique assets that are not easily divisible, e.g. vacation homes, pets, recreational vehicles, mineral interests, timber and commercial real estate;
- To manage closely held business assets for planned business succession;
- To hold life insurance policies, pay premiums and collect the tax-free proceeds to care for beneficiaries, fund closely held stock redemptions or purchases, and provide

liquidity to the estate;

- To provide a vehicle for charitable gifting that can reduce income taxes and benefit the settlor, his or her spouse and their children;
- To provide tools for Medicaid and means-tested benefit eligibility for the settlor, a surviving spouse and disabled children;
- To provide structured income to a surviving spouse that protects trust assets for descendants if the spouse remarries; and
- To reduce income taxes or shelter assets from estate and transfer taxes.

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Structuring a trust

Trusts may be structured to achieve your specific goals, while providing tools for the trustee to balance those goals with prevailing investment and economic factors. The first step is to determine whether you will fund a trust now, make periodic gifts over time to the trust or wait to fund it at your death.

The most common choice is to use a revocable trust, sometimes called **a living trust,** as part of your estate plan. This type of trust is usually not funded until your death. It includes all your instructions for how you want your estate divided among your loved ones and how each person's share or interest in the trust is managed, administered and distributed. If you have minor children, the trust usually dictates who will make financial decisions for them and provide funds to cover, at a minimum, their education and health costs until they are adults.

The typical living trust

There is a good reason that living trusts are easy to amend: As your children grow into adulthood, you often rethink your assumptions in light of actual life events. I recommend revisiting your estate plans at least every five years.

Here are two popular structures for a living trust that show how the trust may differ at different life stages.

For a working spouse with young children and a trust funded at death:

- The spouse is the successor trustee and primary beneficiary;
- The trustee may distribute income and principal to herself and the children;
- At the spouse's death, a successor trustee may make distributions for the children, with an emphasis on education expenses through college;
- The trust distribution may be unequal;
- Once the youngest child is 25 years old, the trust divides into a separate trust for each child;
- At that point, the trustee may also make distributions to buy a home, fund a business venture or pay for expenses related to the child's descendants;
- Each child has the power to withdraw one-third of the trust at age 30, one-half of the trust at age 35 and the rest of the trust at age 40; and
- The spouse has a limited power to appoint the trust assets to a new trust at death with completely different terms as long as it only benefits his or her descendants.

For a retired spouse with grown children, grandchildren and a trust funded at death:

- The spouse is the successor trustee and a primary beneficiary;
- The trust is the beneficiary of the settlor's retirement accounts;
- The trustee must distribute all income and any required minimum distributions from the retirement accounts to herself and may distribute principal for herself and her descendants;
- At the spouse's death, the trust divides into a separate trust for each child and for the surviving children of a deceased child;
- Each child is his or her own trustee and the trusts will last their entire lifetimes;
- Each child's trust is a beneficiary of an equal share of the parents' retirement accounts;
- The trustee may make distributions for any purpose to any beneficiary, but the named beneficiary is the primary beneficiary;
- The primary beneficiary may withdraw up to 5% of the trust each year for any purpose; and
- The primary beneficiary has a limited power to appoint the trust assets to a new trust at death with completely different terms as long as it only benefits his or her descendants.

These examples are for illustration only, are by no means the only options and won't be suitable to your needs without expert legal advice. Regardless of your stage in life, consult an attorney and create your estate plan with a last will and a trust.

If your estate is likely to be greater than $1 million, includes real estate in more than one state or a family business, a trust is essential, and you should name a trust company as the successor trustee.

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