

BASIC INFORMATION ABOUT TRUSTS

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Purposes of trusts. Trusts are used to hold money and property for specific periods of time, and to pay out the money and property according to detailed written instructions. Trusts are used to safekeep money and property and prevent it from being paid outright to your heirs at age eighteen (18). Trusts are used to save estate taxes by "generation skipping." Trusts are used to keep an heir from having the responsibility of handling money and property that he may be unwilling to handle, or that he is not experienced enough to handle. Trusts can also be used to benefit charities by causing money to be paid out over a period of time, rather than all at once. Trusts of certain types can be used for asset protection to keep creditors of the Trustors and/or of the Beneficiaries from reaching the money and property in the trust. Trusts can be used to save estate and income taxes.

Creation of trusts. A trust is created by a written document known as a declaration of trust, and is then funded by transfer of money into trust bank accounts and/or deeding or transferring of properties to the trust. The creator of the trust is known as the "*Trustor*" or the "*Settlor*." Trusts can be and usually are custom tailored to meet the specific needs and desires of the *Settlor*.

Beneficiaries. The persons who are to receive money and property out of the trust are known as the "*Beneficiaries*". In many types of trusts, the *Trustor* may also be a *Beneficiary*.

Trustee. The person or institution that takes care of the money and property of the trust is the trustee. The trustee is bound by law to follow the directions contained in the declaration of trust. The *Trustor* may also serve as the *Trustee* in some situations.

Effective date of the trust. A trust can be effective at any time you choose. If it becomes effective during your lifetime, it is known as a "living trust" or an "intervivos trust." If the trust is effective only upon your death, it is generally part of your will and is known as a "testamentary trust."

Revocability. A living trust is typically made to be revocable during the lifetime of one or both of the Trustors and thus the Trustors can pull out money and property during their lifetime. A living trust can also be made permanent, i.e. irrevocable. If irrevocable, money and property cannot be removed and must stay in the trust for as long as specified in the declaration of trust. A testamentary trust is, by definition, irrevocable, since it is not effective until your death.

Types of trusts. In addition to describing a trust a revocable or irrevocable, there are many types and variations of trusts, depending upon the purpose for the trust. Typical trusts are living revocable trusts to avoid probate and help save estate taxes; irrevocable life insurance trusts; irrevocable trusts to set money aside for college education; generation skipping trusts; minor's trusts; defective grantor trusts; spendthrift trusts; Charitable remainder trusts; Personal residence trusts; Bypass or credit shelter trusts; and qualified terminable interest property trusts to name a few. Trusts are custom prepared to suit the situation involved.

Taxation issues. The tax issues involving trusts that must be understood in determining what type of trust to use for the type of situation involved are:

- (1) Will the money & property in the trust be subject to *federal estate taxes* on the death of the Trustors?
- (2) Will the income generated by the trust (ordinary income, portfolio income, or capital gains) be taxed on the Trustor's *personal income tax* returns, or will the trust pay the tax, or will the beneficiaries pay the tax?
- (3) Will there be *gift taxes* on the transfers into the trust?
- (4) Will the *property taxes* increase if real estate is transferred into the trusts?

Asset Protection/creditor protection issues. A trust may or may not provide asset protection. Not all trusts are designed to provide asset protection. If asset protection is an objective, when the trust is prepared the following and other factors will need to be considered:

- (1) Are you seeking insulation from the creditors of the *Trustors* or the creditors of the *Beneficiaries*?
- (2) Are there creditor debts in default at the time the trust is created?
- (3) Is the trust revocable or irrevocable?
- (4) What will be the geographical situs of the trust?
- (5) Who will serve as the trustee of the trust?
- (6) Will the Trustors have any control over the trust?

Control issues. Basically, the trust document establishing the trust states who controls the trust monies and properties and gives detailed instructions on how much, when, and under what circumstances money is paid out of the trust to the beneficiaries. The *Trustee* of the trust administers these instructions. However, if the trust is *revocable*, the *Trustor* can make changes in these instructions and/or revoke the trust altogether to prevent the instructions from being carried out if the *Trustor* changes his mind. On the other hand, if a trust is *irrevocable*, by definition it cannot be changed and the *Trustor* cannot make changes, with some minor exceptions. For example, the *Trustor* may retain the right to replace the *Trustee* if he doesn't like what the *Trustee* is doing. However, when the *Trustor* retains rights, some of the income or estate tax benefits of a trust might be lost or diminished.

Length of trust. A trust can last for the entire lifetime of a person living at the date of the trust creation, plus twenty-one (21) years beyond the lifetime.

Income taxation and trusts. Once a trust is created, it may have to file income tax returns and may have to pay income tax on all income that it retains and does not pay out to the beneficiaries. If a trust is revocable, all of the income of the trust is taxed to the Trustor. If the trust is made irrevocable the tax laws will cause the income to be taxed to the trust or the beneficiaries with some exceptions.

Estate taxation and trusts. Money and property placed into an irrevocable trust before your death will generally *decrease* the size of your estate for estate tax purposes and will lower estate taxes. However, transfers into an irrevocable trust of more than \$12,000 per donee per year will be subject to gift tax, which is at the same rate as estate taxes, unless you utilize some of your lifetime exemption from estate and gift taxes. All money and property in any *revocable* trust will be included in your estate for estate tax purposes and will not be subject to gift taxes. Estate tax planning for your individual situation can determine the proper type of trust to set up to minimize estate taxes and accomplish other goals.

Probate avoidance. Money and property placed into a trust before your death generally *will not* be subject to probate court proceedings. Probate court proceedings have mandatory attorney fees which for example on a \$500,000 estate would be \$11,150 and on a \$1,000,000 estate would be \$18,000. This is one reason for the popularity of living trusts. A living trust enables you to set and organize the scheme of distribution of your property before death and to see how well the trust and *Trustee* work.