

Trusts: An Overview

Trusts

Trusts are estate-planning tools that can replace or supplement wills, as well as help manage property during life. A trust manages the distribution of a person's property by transferring its benefits and obligations to different people. There are many reasons to create a trust, making this property distribution technique a popular choice for many people when creating an estate plan.

Creation of a Trust

The basics of trust creation are fairly simple. To create a trust, the property owner (called the "trustor," "grantor," or "settlor") transfers legal ownership to a person or institution (called the "trustee") to manage that property for the benefit of another person (called the "beneficiary"). The trustee often receives compensation for his or her management role. Trusts create a "fiduciary" relationship running from the trustee to the beneficiary, meaning that the trustee must act solely in the best interests of the beneficiary when dealing with the trust property. If a trustee does not live up to this duty, then the trustee is legally accountable to the beneficiary for any damage to his or her interests. The grantor may act as the trustee himself or herself, and retain ownership instead of transferring the property, but he or she still must act in a fiduciary capacity. A grantor may also name himself or herself as one of the beneficiaries of the trust. In any trust arrangement, however, the trust cannot become effective until the grantor transfers the property to the trustee.

Example: A grantor transfers money to a bank as trustee for the grantor's children, with the bank instructed to pay the children's college expenses as needed; the bank carefully manages the money to ensure there are funds available for this purpose. The children do not have control of the funds and cannot use the funds for any other purposes.

Testamentary and Living Trusts

Trusts fall into two broad categories, "testamentary trusts" and "living trusts." A testamentary trust transfers property into the trust only after the death of the grantor. Because a trust allows the grantor to specify conditions for receipt of benefits, as well as to spread payment of benefits over a period of time instead of making a single gift, many people prefer to include a trust in their wills to reinforce their preferences and goals after death. The testamentary trust is not automatically created at death but is commonly specified in a will and so as a will provision, the trust property must go through probate prior to commencement of the trust.

Example: A parent specifies in her will that upon her death her assets should be transferred to a trustee. The trustee manages the assets for the benefit of her children until they reach an age when the parent believes they will be ready to control the assets on their own.

A living trust, also sometimes called an "inter vivos" trust, starts during the life of the grantor, but may be designed to continue after his or her death. This type of trust may help avoid probate if all assets subject to probate are transferred into the trust prior to death. A living trust may be "revocable" or "irrevocable." The grantor of a revocable living trust can change or revoke the terms of the trust any time after the trust commences. The grantor of an irrevocable trust, on the other hand, permanently relinquishes the right to make changes after the trust is created. A revocable trust typically acts as a supplement to a will, or as a way to name a person to manage the grantor's affairs should he or she become incapacitated. Even a revocable living trust usually specifies that it is irrevocable at the death of the grantor.

Transferring Assets

Irrevocable trusts transfer assets before death and thus avoid probate. However, revocable trusts are more popular as a means of avoiding the probate process. If a person transfers all of his assets to a revocable trust, he owns no assets at his death. Therefore, his assets do not have to be transferred through the probate process. Even though the grantor of the trust died, the trust did not die, so the trust assets do not have to be probated. However, trusts avoid probate only if all or most of the deceased person's assets had been transferred to the trust while the person was alive. To allow for the possibility that some assets were not transferred, most revocable living trusts are accompanied by a "pour-over" will, which specifies that at death, all assets not owned by the trustee should be transferred to the trustee of the trust.

Example: Mark sets up a revocable trust, which states that on his death, his assets should be distributed to his children in equal shares. Mark transfers his house to the trust, but does not transfer some rental real estate he owns. At Mark's death, the trust can distribute the house outside of the probate process, but the rental real estate will have to be probated. Based on the will, the probate court will order the rental real estate be transferred to the trustee, who will then distribute it according to the terms of the trust.

Successor Trustees

Although a grantor may name himself as trustee of a living trust during his lifetime, he should name a successor trustee to act when he is disabled or deceased. At the grantor's death, the successor trustee must distribute the assets of the trust in accordance with the directions in the trust document. In many states, certain people must be notified at the death of the grantor.