

Trusts – Questions and Answers

Introduction

Question 1: What is a trust?

Answer: A trust is a legal relationship among persons that requires: (1) a person who creates and funds the trust (trustor), (2) a person who benefits from the income and principal in the trust (beneficiary), and (3) a person who manages the property in the trust and distributes income and principal according to the terms of the trust (trustee). Think of it as a contract. The governing instrument is the writing that contains the relevant provisions.

Question 2: What is the purpose of a trust?

Answer: There are many purposes for trusts. Each trust is different. Primarily, the purpose of the trust depends on what the trustor wants to accomplish. The goals of the trustor dictate the way a trust is drafted, i.e. the drafter will write provisions designed to accomplish the trustor's goals within the limits of the applicable law. After the trustor signs and funds the trust, the rights of the trustor and beneficiary and the duties of the trustee are determined with reference to the written provisions of the trust. Trusts may be used to protect assets, limit the use of assets, manage transfer taxes, avoid probate, benefit charities, provide for pets, and to address many other situations.

Question 3: I have read that I should have a Revocable Living Trust. What is this?

Answer: A Revocable Living Trust (RLT) is a trust that you create and fund during your lifetime. You may serve as trustor, trustee and beneficiary. You may withdraw all funds at your convenience or whim and may discontinue the trust at any time. The trust is effective only to the extent you transfer ownership of your assets into the name of the trust. The trust does not offer any asset protection or tax savings. It has two primary purposes: (1) to avoid probate and (2) to provide for management of your assets if you are unwilling or unable to serve as trustee. In New Jersey the "need" for a trust is questionable, because the cost, delay and burden of probate are low and the law permits you to execute a Durable Power of Attorney that authorizes the person of your choice to manage your assets if you become disabled. Nonetheless, some people feel more comfortable with an RLT.

Question 4: I have also read that I should have a testamentary trust for my children. What is the difference between a living trust and a testamentary trust?

Answer: A living trust is a trust that you sign and fund during your lifetime. A testamentary trust is a trust that you may sign during your lifetime but is actually funded after your death. You may include testamentary provisions in your living trust, i.e.

provisions that take effect after your death, or you may draft testamentary trusts into your Last Will and Testament.

Question 5: What benefits does a testamentary trust for my children offer?

Answer: If you draft children's trusts into your last will, you will be able to name a responsible adult to manage the property your children receive at the time of your death. This may be advisable due to a child's age, disability, profession, marriage, debt, etc. For example, assume that your daughter is a doctor in a high-risk field. You want her to enjoy her inheritance, but you do not want it available to a plaintiff who has won a malpractice case against her. You may direct in your Last Will that her share of your estate shall be held in trust and name a trust company to serve as trustee. You may also direct that no part of the trust shall be subject to the claims of her creditors. Assume further that your daughter has children. If there is any property in the trust at the time of her death, the trust will remain in effect for the benefit of your grandchildren, not your son-in-law. If your children are minors, you want to name an adult to manage their money until they are old enough to do so for themselves.

Question 6: What is a "by-pass" or "credit-shelter" trust?

Answer: This kind of trust is most often drafted into a Last Will or Living Trust. You may fund this trust according to a triggering event, e.g. your death or your spouse's disclaimer after your death. Your surviving spouse's access to the property held in trust is limited to income for life, distributions of principal up to the value of the greater of \$5,000.00 or 5% of trust value per year and distributions of principal for health, education, maintenance and support. Upon your spouse's death, the balance of the trust would pass in trust or free of trust to the individuals you name. The value of the property held in the trust would not be included in your spouse's taxable estate. This is a very good tool for managing both United States and individual state estate taxes. It also may be used to benefit your surviving spouse while making sure that your children from a prior marriage receive the balance when your spouse dies.

Question 7: In your answer to Question 3 you write that a revocable trust (RLT) offers neither asset protection nor tax savings; is there another kind of trust that would offer these benefits?

Answer: Yes. An irrevocable trust may provide these benefits. As a general rule, the more control you retain over property transferred into a trust the greater is the likelihood that it will be considered yours and subject to the claims of your creditors and included in your taxable estate. The more control you relinquish over the property transferred into a trust the greater is the likelihood that the property will be protected from the claims of your creditors and excluded from your taxable estate. Since you have the power to remove assets from the revocable trust or extinguish the trust altogether, the assets are considered yours for asset-protection purposes and are subject to estate tax at the time of

your death. If you make a trust irrevocable and limit your rights to receive distributions and control the assets, you receive greater creditor and tax protection. Examples of such trusts include the Grantor Retained Interest Trusts (GRAT & GRUT), the Qualified Personal Residence Trust (QPRT), the Charitable Remainder Trusts (CRAT, CRUT, NIMCRUT, etc.), and the Irrevocable Life Insurance Trust (ILIT).

Question 8: How do I select a trustee?

Answer: A trustee may be an individual or a company. Many people name a relative as a trustee; others name a trust company. Still others name an individual and a company to serve as co-trustees. Whom you select depends on a number of factors. Probably the most important factor is trustworthiness. You definitely do not want to appoint someone who is irresponsible, stubborn, self-absorbed or power hungry. You want a person who will consider the best interests of your beneficiary and who will not be tempted to steal or “borrow” from the trust. The trustee must be willing to seek help from professional advisors if necessary and accept his own limitations. The trustee should also be willing to make decisions based on a common-sense application of the law to the facts. If you intend for the trust to last for multiple generations, you may want to name a trust company with longevity. Regardless of whom you appoint, the trustee is entitled to a fee and has a fiduciary duty to put the beneficiary’s interests above his own.

Question 9: What kind of property may a trust own?

Answer: A trust may own any kind of property: cash, securities, jewelry, artwork, insurance policies, real estate, precious metals, stamp collections, boats, cars, mineral rights, fishing rights, options, you name it. The only question is whether or not it makes sense to fund the trust with any given asset.

Question 10: How is trust income taxed?

Answer: How a trust is taxed depends on how it is structured. Generally, the trust may be structured as a grantor trust, in which case all items of income and loss are passed through to the trustor, or as a non-grantor trust, in which case the trust is responsible for its own income tax. Distributions to beneficiaries, fees and costs of administration are deductions against trust income but are taxable as income to the recipient.

Question 11: What kind of provisions may I include in my trust?

Answer: Trust provisions are limited only by a few laws and public policy. Generally, if a provision does not violate the law you may include it in your trust and the trustee is bound to respect it. For example, you may not require a beneficiary to commit an illegal act as a condition of receiving a distribution. To receive the tax benefits of a GRAT, your right to distributions must be limited to an annuity interest as defined by the tax code; a provision that permits the trust to distribute “all income” will void the tax benefits of the

GRAT. In most areas you have wide latitude in crafting provisions relating to the amount, purpose and timing of distributions to your beneficiary. Most limits apply to the trustor's use and control of the property held in an irrevocable trust.

Question 12: Should I have a trust?

Answer: The questions of whether or not and what kind of a trust is appropriate for you depend on a number of variables. The most important variable is what you want to accomplish. The second most important variable is the character and circumstances of your proposed beneficiary. The last of the “top three” variables is your net worth. The advisability of a trust is impossible to gauge without consideration of your desires, goals and finances.

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