

TRUSTS

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People who own property sometimes give it away. They may give it away while they are alive, or they may make plans to give it away after they have died. They make what are called “gratuitous transfers.” In general, people who give away their property are free to impose restrictions or conditions on how that property will be enjoyed and by whom. A trust is perhaps the most flexible legal tool for spelling out those conditions and restrictions.

We will not be able to come close in this article to describing the many uses to which trusts have been put.¹ Our focus instead will be on describing in basic terms what a trust is, how it works, and some of the common roles it has come to play in estate and succession planning. The hope is that this article will assist you in thinking about the use of trusts in your own estate and succession planning.

The trust is an ancient instrument. In the simplest terms, a trust is property held by one person, the trustee, for the benefit of another, the beneficiary. In legal terms, it is the separation of legal and equitable (or beneficial) title. Why do this? There may be numerous reasons, including a desire to protect property from a beneficiary’s creditors, or to protect it from mismanagement by the beneficiaries themselves. (Indeed, if one of the primary concerns in the estate plan is to protect the estate down through time from creditors, bad marriages or from the financial distress of heirs, a trust may be the best tool to consider.) A trust may be used to separate management from enjoyment, as when parents set up trusts for the care of their minor children. It can be used to divide ownership among multiple parties at the same time (concurrent ownership), as in several children, or to provide for ownership among different future owners (successive ownership), as in grandchildren. A trust can also be used to plan for incapacity, or to avoid guardianship requirements for transfers either to minors or incapacitated persons. Trusts have also come to be used to avoid probate, and the costs of probate, in the transfer of property from one generation to the next. A trust may be particularly efficient for accomplishing the transfer of property that is owned in different states. There may also be estate tax advantages to the use of irrevocable trusts.

It’s called a trust because it is a fiduciary relationship. Fiduciary, coming from the Latin for faith or trust: you put your faith in someone, you trust them, and you have confidence

¹ To get a sense of the range of types of trusts simply in the estate planning field, consider this partial list: irrevocable inter vivos trust, revocable inter vivos trust, testamentary trust, dynasty trust, credit shelter trust, disclaimer trust, by-pass trust, marital deduction trust, qualified terminable interest property trust, reverse QTIP trust, Crummy trust, grantor trust, qualified personal residence trust, charitable remainder trust, charitable lead trust, grantor retained annuity trust, spousal estate reduction trust, irrevocable life insurance trust, intentionally defective trust, intentionally defective grantor trust, and the list goes on

in them.² This is the term that defines the role of the trustee, the person who holds legal title to the trust property: the trustee owes a fiduciary obligation to the beneficiary. That obligation is comprised of numerous legally enforceable duties, which we shall discuss.

What is this fiduciary duty?

The term fiduciary is used to describe not only a relationship but the person whose role is governed by the fiduciary relationship. So, we may speak of the trustee in a trust as a fiduciary. A fiduciary owes a duty of loyalty to the beneficiaries – a duty to act for the good of the trust and its beneficiaries. A fiduciary is not to engage in self-dealing with respect to the trust property, and is to keep trust property separate from his or her own property. A fiduciary also has a duty to provide information and accountings to the beneficiaries with respect to trust property. In general, the fiduciary is to protect the trust property, to make it productive, to be impartial in his or her dealings with the beneficiaries – not to play favorites – and to accomplish the purposes of the trust as set forth in the trust document. These duties are legally enforceable against a trustee who violates them.

For example, imagine that the now-deceased parents had set up a trust, and funded it with the family farm. They named the farming heir - their business successor – as trustee of the trust. Assume that the beneficiaries of the trust are the farming heir (also the trustee) and all the other children. As trustee, the farming heir will decide who farms the land that is in trust and how much rent is to be paid. It is likely that the farming heir, as trustee, will be leasing the trust land to himself to farm. The trustee is such a circumstance is not free to charge himself only \$50 per acre for land that might otherwise rent for \$150, or more. Such conduct would violate a number of fiduciary duties.³

Trust Elements

There are three basic elements to a trust: a trustee, one or more beneficiaries, and the trust property. The person who creates the trust, who places the property into trust, is called the settlor (also sometimes trustor, grantor or donor). We speak of property being transferred into, or held in, trust, but remember that the trust does not own the property; it is owned by the trustee (legal title) for the benefit of the beneficiaries (equitable owners).

Settlor: The person who creates the trust is the settlor, also called trustor. This person may also be the trustee and, in the use of revocable living trusts (as discussed below), often is. The settlor may also be a trust beneficiary, and, again, in the case of most living trusts, the settlor often plays all three roles: settlor, trustee and a beneficiary.⁴ The

² The fiduciary relationship is not limited to trusts. It includes relations involving attorneys, guardians, personal representatives, brokers, directors and public officers.

³ However, mom and dad could have spelled out some guidelines for leasing the property, including a preference for the farming heir and perhaps even a sweetheart rent, in addition to a waiver of the duty against self-dealing in being able to rent the farm to begin with.

⁴ The sole beneficiary cannot also be the sole trustee. In such a circumstance, the trust fails, because under law there is no one to enforce the trust against the trustee. Remember that a trust in its essence separates

settlor/trustee in this case, however, is not the sole beneficiary for although he or she may have total control over the trust property as trustee, and may have the sole present income interest in the trust as beneficiary, the trust has designated future beneficiaries, successive interests, i.e. the settlor's heirs.

Trustee: This is the person who holds legal title to the trust property as fiduciary for the benefit of another. In general, because the trustee must shoulder sometimes significant burdens, it is a position that requires consent, i.e. it cannot be imposed on someone against their will. A trustee may be a natural person or an entity, such a bank trust department.

Beneficiary: The person legally entitled to the benefit of property held in trust and to whom the trustee owes the fiduciary duties. A trust may have one or numerous beneficiaries, among whom may be the settlor and the trustee; beneficiaries may hold concurrent or successive interests. For example, one beneficiary may have a lifetime interest and another a remainder interest.

Trust Property: There must be identifiable and segregated property to be held by the trustee in order for a trust to exist.

What are the basic types of trust?

A trust that is created by a Will at the time of death is known as a *testamentary trust*. The most common example of a testamentary trust would be one created for the benefit of a minor child whose parents have died, or to hold property for minor grandchildren whose father or mother has predeceased the grandparent. Such testamentary trusts are provided for in a few paragraphs in a Will and typically come into being only if necessary.

A trust that is created by contract with the trustee while the settlor is still alive is called an *inter vivos trust*. (Inter vivos – the *i* in vivos is usually long – means “between the living.”) Inter vivos trusts are also known as *living trusts*.

If a person’s Will provides that at death certain property should be transferred into an existing inter vivos trust, this trust may then be called a *pour-over trust* and the Will a pour-over Will: the Will pours property over into the trust. When a person plans their estate primarily around the use of a living trust, i.e. the trust is the tool that will accomplish most aspects of the estate plan, it is usually a good idea also to include in the estate documents a pour-over Will, in case some property is inadvertently left out of the trust.

An inter vivos trust may be *revocable* or *irrevocable*. A testamentary trust only comes into existence at the time of death by power of the Will and therefore becomes irrevocable at the time of death, although it may not be funded until the probate process is complete.

legal and equitable ownership, and if there is no separation, i.e. the only beneficiary is also the only trustee, then there is no trust.

Revocable “Living” Trust

The most common type of trust is the revocable inter vivos trust, also known as the “living” trust. The settlor of a living trust is sometimes also the trustee. In a revocable trust the settlor retains the ability to revoke the trust, that is, to cause the trust property to be returned to him or her as desired during life. The settlor also retains the ability to change the terms of the trust as he or she sees fit. In that one of the cardinal principles of estate planning is to keep the plan flexible, in order to be able to respond to changes in people and circumstances, the revocable trust fits the bill.

Mechanically, a revocable inter vivos trust typically works like this: the trust document is created; the document names the settlor as the trustee, in effect the settlor transfers property from herself to herself, as trustee of her own trust; the document names the beneficiaries and describes how and when they are to benefit from the trust property; it names the successor trustee – that person who is to take over after the death or incapacity of the settlor/trustee and who will accomplish what the trust directs. The trust may end after death with the transfer of the trust property by the successor trustee to the beneficiaries as directed in the trust document. It is certainly possible that the trust may continue for years, governing the management and enjoyment of the property down through time.

The principal use of the revocable inter vivos trust has been to accomplish the transfer of assets at the time of the settlor’s death. In a sense, this use of a revocable trust is as a Will substitute, for the transfer of the assets through the trust may occur without the need for probate, a court proceeding by which the assets of an estate are transferred under a Will. (See articles Probate and The Will.)

The revocable trust may be fully funded when it is created, that is the settlor’s property may all be transferred into the trust at that time; or it may be only minimally funded at that time (\$100, for example) with the funding to occur principally at the time of death by the pour-over from the settlor’s Will (such a funding would not be consistent with avoidance of probate) or through a beneficiary designation, such as a transfer on death deed. It is also possible that the trust would be named as the beneficiary of a life insurance policy on the settlor, which death benefit amount would then be controlled by the trust document.

In general, a revocable trust in itself is of no benefit in tax planning: a transfer of property revocably into trust does not remove that property from the settlor’s taxable estate for federal estate or state inheritance tax purposes. Nor is the income typically shifted to another tax payer during the settlor’s lifetime. The principal reasons for using a revocable inter vivos trust are nontax, such as:

- Avoidance of probate⁵

⁵ Avoidance of probate as a reason in and of itself for the use of trust may be an oversold idea. This may be particularly true in those states, such as Nebraska, that impose a state inheritance tax on time-of-death transfers. For further discussion, see articles on *The Will*, on *Probate* and on *Nebraska Inheritance Tax*.

- Management of the trust property by trustee
- Uninterrupted trust administration after death or disability of settlor
- Privacy
- Some protection against attack by disgruntled putative heir

Irrevocable Inter Vivos Trust

An irrevocable inter vivos trust (of which there are numerous types and which is far less common than the revocable inter vivos trust) is used primarily either for tax reasons or for asset protection purposes. A person who is concerned that their estate is sufficiently large that it may be subject to estate tax at the time of death, may be able, through the creation and funding of an irrevocable inter vivos trust, to reduce or even eliminate the potential estate tax liability. For example, the settlor may choose to transfer a piece of land irrevocably into trust in order to remove the expected appreciation of that piece of land from the taxable estate. Let's assume that the parcel of land is worth \$1 million, but that it has been appreciating at a rate of more than 15% per year. We might also imagine that this piece of land is located somewhat close to a growing urban or suburban area and is likely only to appreciate in value even faster in the future. By transferring that parcel irrevocably into trust at the \$1 million value, the settlor uses up \$1 million of his or her unified credit (See article on *Transfer Taxes*) but if the parcel were to appreciate in value by another \$500,000 between the time of transfer into trust and the death of the settlor, that \$500,000 may not be included in the settlor's taxable estate at the time of death. Such irrevocable transfer comes at a cost: the income from the property is lost to the settlor, and the transfer must be truly irrevocable, that is, the settlor cannot retain what is called a reversionary interest – the right under any circumstance to get the land back. The transfer therefore shifts not only the property from the settlor's estate but the income as well. There are numerous types of irrevocable inter vivos trusts, which are beyond the scope of this article. A person interested in exploring the tax planning advantages of such trusts should seek advice from a qualified counselor.

Irrevocable trusts are sometimes used to hold life insurance, primarily to avoid the inclusion of the death benefit amount in the taxable estate of the insured. Such trusts are often known as irrevocable life insurance trusts, or ILITs, for short. Not only can they provide tax planning advantages, but they enable the purchaser of the insurance to control the payment of premiums and provide for a perhaps more detailed distribution of the insurance proceeds.

If the goal of the irrevocable transfer is not to remove the asset from the settlor's taxable estate, it may be possible for the settlor to retain some beneficial interest and some control over the property after it has been transferred. Such irrevocable transfers have been used to protect the trust property from future contingencies. Such trusts must be carefully drafted to comply with fairly complex rules governing self-settled trusts. It is in general true that a self-settled trust does not protect an asset from claims against the person who transferred property into trust, i.e. the settlor. However, there are differences between claims that exist at the time of the transfer and those that arise in the future, and

Even in those states which impose no inheritance tax, there may be good reasons to question the avoidance of probate as an estate planning goal.

the exposure of the trust property to those future claims will depend in large part on what rights and control the settlor has actually retained over the trust property. The trust laws of certain states provide more advantages in terms of asset protection in self-settled trusts than do other states.

General Structure of the Trust

In general, a trust document will do certain basic things and contain certain common provisions. First, property is transferred into trust and the trustee is usually authorized to receive additional transfers. The trustee is identified. The trust document contains what are called “dispositive provisions,” those paragraphs that identify the beneficiaries, what they are to receive, and under what terms, conditions and contingencies. Dispositive provisions are in most respects the heart of a trust document, and are discussed in more detail below. Many trusts will contain spendthrift provisions which typically protect the trust property against outsiders and creditors of the beneficiaries. A powers clause will set forth the various powers of the trustee. Some trusts will allow for distributions directly to minors, or to guardians of minors, or will authorize use of funds for specific benefits for a minor; the document may also prevent any distributions to a beneficiary until he or she reaches a certain age. Trusts may provide for termination of the trust, or, in those states which allow it, an unending term. A trust usually provides that the trustee may serve without providing a bond or other security. The document may also provide for payment of a reasonable trustee fee. The trust should also provide for appointment of successor trustees, either by naming specific persons, or through a mechanism for their appointment, such as selection from among the beneficiaries by majority vote.

Dispositive Provisions

The dispositive provisions of a trust may be as wide ranging and different as the wishes of individual settlors. Settlors have a great deal of freedom in determining what will happen to the trust property. It is, as stated, a very flexible instrument. It is generally observed that control of property down through time is best undertaken through a trust (if it is best undertaken at all). There are, however, some general outlines that we can trace with respect to common dispositive provisions.

To start, a settlor may either provide explicit direction as to how and when the trustee should distribute property, or, alternatively, the settlor may wish to give the trustee broad discretion over such decisions. In general, the more discretion a trustee has over distributions, the more protection the trust provides against the claims of beneficiaries’ creditors.

The dispositive provisions may be by the *pie*, so that each of the beneficiaries has a specific percentage interest in the trust property and receives payments from the trust only according to that percentage interest. Or the dispositive provisions might be by the *pot*, so the trustee can pay to any of the beneficiaries any amount that the trustee deems advisable for, say, the health, education, support or maintenance of the beneficiary. Such a *pot* provision might last only until the last beneficiary reaches a certain age, say 25, at which time the trust assets might be divided equally (by the *pie*) among the beneficiaries. A middle ground might include mandatory distributions of income and principal to the

beneficiaries for limited purposes, such as education or health, with discretion in the trustee to determine other distributions.

A trust might provide for mandatory distribution of income to the beneficiaries from the beginning of the trust. So for example, a trustee might be required to distribute the net annual rent from farm land that is held in trust at least once a year. That distribution might be in equal shares among the beneficiaries, or according to their respective interests, if those are not equal.

Distributions might be restricted by age, whether in a pot or a pie trust. For example, a beneficiary might receive income from the trust only after he or she reaches a certain age. The trust might provide that the principal will be distributed to beneficiaries once they reach a certain age, or that part is distributed at one age and more at a later age, with perhaps discretionary interim distributions for health, education or support. It is also possible in Nebraska that the principal would not be distributed but would remain in trust indefinitely.

The trust can provide for distributions to certain beneficiaries only for specific purposes, such as education, health, support or maintenance, and might otherwise give the trustee discretion to make distributions for other purposes. A trust can provide incentives to the beneficiary, such as conditioning distributions on the gainful full-time employment of a beneficiary, or on his or her enrollment as a full-time student, on maintenance a certain grade point average, on staying free of chemical dependencies, on making efforts to get along with other beneficiaries, or on becoming a productive member of society.

As mentioned, the trust is a very flexible tool.

Spendthrift Provisions

A spendthrift provision in a trust in essence states that a beneficiary may not transfer his or her beneficial interest in the trust and that no interest of a beneficiary in the trust shall be subject to payment of a beneficiary's debt. In general, these restrictions go hand in hand, as you cannot protect an interest from the beneficiary's debts without restricting the right to transfer that interest. As mentioned, provisions which give extensive discretion to the trustee as to distributions are themselves a kind of spendthrift protection.

There are limitations to the power of spendthrift provisions. As mentioned, in most states, a settlor cannot generally set up spendthrift provisions to protect his or her own interests. In addition, spouses and children asserting child-support or alimony/settlement claims may be able to break through certain spendthrift provisions under state law. Of course, once a beneficiary receives a distribution, it is no longer protected. By the same token, if a beneficiary is under the trust terms legally entitled to distributions, those distributions can generally be reached by creditors at the time the entitlement occurs.

Power of Appointment

In some trusts, the settlor may give what is called a *power of appointment* to another person, that is the power to make decisions as to the ultimate disposition of trust property

or to alter the settlor's dispositive provisions. This is a significant power to confer on someone. Such powers are either *general* or *special*; if the person to whom the power is given has the authority to include him or herself as a beneficiary, it is a general power of appointment. If not, it is a special power. There can significant tax consequences in the giving of a power of appointment; a general power of appointment may cause the value of the property over which the power is given to be included in the taxable estate of the person holding that power.

For example, the settlor might provide that the property in trust will not be distributed to his or her own children. Those children might well receive income distributions, but no distributions of the principal. They would not come to own the trust property in their own names. They might, however, be given a special power of appointment to determine how the trust property will be distributed among their own children, that is the settlor's grandchildren. The children of the settlor will thereby enjoy the benefit of the trust property through a lifetime of income distributions, and be able to determine who should receive that property upon their own deaths, but the property will not be included in their taxable estates, and will not be diminished by payment of federal estate taxes as part of the children's estates. Rather, the trust property will remain in tact to benefit the settlor's grandchildren. The property that is transferred into trust by the settlor is taxed for estate purposes in the settlor's taxable estate, but it may remain in trust down through generations without again being subject to federal transfer taxes, in effect creating a succession of life estates. Such a trust arrangement is sometimes called a dynasty trust, and may make use of the settlor's transfer tax exemption to shelter assets from estate tax through a number of generations, basically creating a succession of life estates. (See *Transfer Tax* article.⁶) It is imperative, of course, that such trusts be carefully planned and drafted in consultation with an experienced professional in order to accomplish both the tax purposes and the settlor's dispositive wishes.

Special Needs Trust

Such a trust, also called a Supplemental Needs Trust, is typically structured to benefit a disabled person while at the same time not disqualifying that person from eligibility for public assistance. Such trusts are usually limited to providing for the needs of disabled persons that the state cannot or does not provide. They are often drafted to prevent the state from taking advantage of the gift that has been named to the disabled person. Such trusts must be carefully drafted by competent counsel in order to realize their intended benefit.

Conclusion

The trust is a tried and true estate planning tool. There is an ample body of law that has grown out of human experience with trusts to govern their construction and use. The trust is arguably the most flexible tool in the estate planning kit. It can be a simple document that accomplishes basic transfers of assets outside of probate or it can be a complex tax and estate planning tool for addressing numerous contingencies. A person

⁶ The use of trusts can play a prominent part in transfer tax planning, that is estate, gift and generation skipping taxation. See *Transfer Tax* article being published as part of this series.

who intends as part of their estate plan to control the use, protection and enjoyment of property down through time, will want to look into the use of a trust.

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