**TRUSTS-WHAT ARE THEY?**

**BY: WILLIAM G. MORRIS, ESQ.**

Everyone has heard about trusts, but does anyone really know that they are? Researching on the internet can be confusing and what many think they know is wrong. Let us take a look at trusts.

In this part of the world, the most common discussion of trusts involves estate planning. Estate planners urge clients to use a revocable trust to avoid probate. Sounds like a good idea, but what does that mean?

A trust was historically defined as separation of legal title and beneficial interest. A good example of a trust is when a wealthy person gives the bank funds to hold for the benefit of a grandchild. The bank is trustee and the grandchild the beneficiary. The funds are held by the bank under a trust agreement that specifies what powers and duties the bank has with respect to the funds and the grandchild. The trust might direct the bank to pay educational expenses of the grandchild, perhaps buy the grandchild a car if successfully completing college and ultimately give what is left to the grandchild at a certain age. The trust could provide other options for distribution, even giving the grandchild some control. But, the grandchild would not have complete ownership or control.

That might make sense for few wealthy people, but how does that relate to a revocable trust? A revocable trust, also known as a living trust or a revocable living trust, is generally a trust established by someone for their own benefit while they are alive and includes direction for distribution of what is left when they die. The trust agreement usually appoints the person creating the trust (grantor also known as a settlor) as both trustee and lifetime beneficiary. If the grantor fails of is unable to serve as trustee, the trust agreement appoints a successor trustee and directs the trustee to use the funds for benefit of the grantor during his or her life.

The revocable trust agreement sets out powers of the trustee and also states that during the grantor’s life, the grantor can amend or revoke the trust and generally do anything the grantor wants with the assets. During the grantor’s life, the IRS ignores the trust as it is really little more than a legal fiction. The IRS refers to these as grantor trusts and allows the grantor to continue filing tax returns with the grantor’s social security number (not a new tax number for the trust) even though there is supposedly a trust.

At death of the grantor, the assets are considered owned by the trust and avoid probate because the assets were not owned in the grantor’s name. As long as the grantor has retitled all of the grantor’s assets in the trust and arranged for direct transfer of assets that are not suitable for ownership by the trust (i.e. IRAs, as retitling an IRA into the trust is treated by the IRS as a transfer triggering income recognition and tax liability) everything avoids probate.

The grantor’s death certificate empowers the successor trustee to take action and no court proceeding is required to get authority to administer the assets in the trust. That saves time and money. The revocable trust does not save taxes, as the assets are still owned by the grantor for tax purposes and are included in the grantor’s estate for estate tax purposes. If the grantor was wealthy enough to exceed the federal estate tax exemption amount (Florida has no estate tax), a tax will be due.

The revocable trust is established during the grantor’s life. Contrast that with a testamentary trust, which is not established until the grantor dies. These trusts are usually irrevocable, as they do not come into existence until the grantor dies and the grantor can simply change the grantor’s direction any time before death. A revocable trust also becomes irrevocable at grantor’s death.

A testamentary trust is usually established because the grantor did not want all assets distributed immediately to a beneficiary after the grantor dies. The grantor might think it is wise to delay distribution until a beneficiary reaches an age at which the grantor believes the beneficiary will be better positioned to manage money. If the beneficiary is disabled, there may be a reason to set up a special trust to take care of the beneficiary and not disqualify the beneficiary from governmental assistance. In some cases, the grantor may simply want to create a rainy-day fund to meet unexpected needs of the beneficiary. The grantor directs that at grantor’s death, funds are distribute to a trustee to be held in trust and used for a specific purpose.

Testamentary trusts are not the only use of irrevocable trusts, as they can be used for many other reasons. One use of an irrevocable trust is to save taxes. The Qualified Personal Residence Trust (QPRT) is a good example of an irrevocable trust intended to save taxes

In a QPRT, the grantor transfers title of a residence to the trustee. The Grantor is usually the trustee so the trust is treated as a grantor trust and the grantor continues treating the trust as the grantor’s property. At end of the trust term, the residence passes to others (usually the grantor’s children). The Grantor has to outlive the term of the trust for the plan to work, as the transfer to trust is treated as a gift at time of transfer but because accrual ownership is delayed, value of the residence is discounted (what would someone pay for a residence they would not own for years?).

The residence is moved out of the grantor’s estate at less than market value and any appreciation after it is placed in trust is also out of the grantor’s estate. To reduce the grantor’s estate even more and allow the grantor to keep using the residence, the grantor can rent the residence back from the beneficiaries when they get title, paying market rent-which takes more money out of the grantor’s estate.

The QPRT is attractive to people who have taxable estates. The federal estate tax is currently 40% of everything over the federal exemption amount of $12.06 million. Every dollar saved from estate tax means 40% more to the beneficiaries. The income tax on the rent and the appreciation which is not in the grantor’s taxable estate after trust term ends and the tax on profit from sale is taxed to the beneficiaries at less than 40%. There is almost always substantial tax savings in an otherwise taxable estate.

The drawback to this type of irrevocable trust is the trust is irrevocable. If the estate tax laws change or the financial situation of the grantor changes so no estate tax would be due at death, the grantor has just given ownership of valuable property to the beneficiaries and will have to look to them to cooperate in unraveling the arrangement. That has proven to be an unhappy moment for many who created QPRTs when the estate tax exemption was much lower and now find their children own their vacation home when the grantor wants to sell. The children will get stuck with the income tax if the property is sold and have to sign the closing documents. Most are cooperative; not all.

Trusts can be flexible and a very important part of financial planning. Especially with irrevocable trusts, what sound good today may be an albatross tomorrow, limitations by tax and other laws. But because one misstep could create a thousand headaches, this is not a good area for the do it your-selfer.

***William G. Morris is the principal of William G. Morris, P.A. William G. Morris and his firm have represented clients in Collier County for over 30 years. His practice includes litigation and divorce, business law, estate planning, associations and real estate. The information in this column is general in nature and not intended as legal advice.***