



An Introduction to Trusts

Even though there are many types of trusts, all share certain characteristics and terminology. Identified below are basic features and terms useful to understanding trusts.

What is a trust?

A trust is a legal arrangement created by an individual to receive, hold, and manage property for the benefit of named or identified individuals. Individuals, also called “grantors,” seeking to create a trust will need the advice and assistance of an attorney.

Trust terms and definitions

Grantor

The person who creates the trust is the grantor. Other names for the grantor include settlor, trustor, creator, or maker.

Beneficiaries

The persons who are named or identified to benefit from the property held in trust are the beneficiaries.

Trustee

Since the trust is a legal arrangement, it cannot manage itself. The trustee is the person or organization selected by the grantor to manage the trust fund. Two or more trustees are called co-trustees. The trustee holds legal title to the property in the trust. He is legally required to use the trust property for the exclusive benefit of the beneficiaries. However, a trustee may charge an appropriate fee for his services.

Principal

The principal is the property placed in the trust by the grantor. Another name for principal is corpus. Principal are items of value and may include real estate, life

insurance, securities such as stocks and bonds, or cash accounts.

Income

The amount of interest or other investment earnings produced by the principal is the income. Income is typically used to meet the needs of trust beneficiaries and to cover trust administration costs. Administration is another word for “management.”

Trust fund

The trust fund refers to the money or property in the trust and includes the principal and the interest or other investment earnings produced by the principal. To ensure income from the trust, trust principal ideally consists of investment assets, such as mutual funds, stocks and bonds, interest-bearing accounts or certificates, and other income-producing assets. The ideal trust investment yields high income, provides safety of principal, and has growth potential.

Trust agreement

The trust agreement is a legal document signed by the grantor and the trustee. It tells the trustee how to manage the trust and how to distribute the trust funds to the beneficiaries. The provisions contained in the trust agreement are called “the terms of the trust.”

Declaration of trust

A declaration of trust replaces a trust agreement when the grantor is also the trustee. The grantor signs a formal written statement that he no longer owns the property personally, but instead holds it as trustee for the benefit of the beneficiaries under the terms and conditions written in the declaration.

Trust administration

The trustee's management of the trust is called the administration of the trust. The trustee may charge a fee for trust administration.

Trust term

A trust must have an ending date. The trust term defines how long the trust administration is to continue. It could last for a set number of years, or for the lifetime of one or more beneficiaries, or until a certain event happens, or a combination of these.

Remainder

Assets remaining in the trust fund at the end of the trust term are called the remainder. The beneficiaries who receive the remainder are called "remainderpersons" or "remainder beneficiaries." Remainderpersons are typically beneficiaries different from those who were trust fund beneficiaries.

Reversion

If the trust fund returns to the grantor after a period of time or on the occurrence of an event, the grantor holds a reversion.

Types of Trusts

Testamentary trust

A trust established under the Last Will and Testament of the grantor is known as a testamentary trust. The trust is created upon the death of the grantor and has no legal effect until the grantor dies.

Living trust

A trust established during the lifetime of the grantor is called a living trust or an *inter vivos* trust.

Revocable trusts

The grantor retains control over the trust terms of agreement and may change the terms or terminate a revocable trust. He has the right to ask the trustee to return all or part of the trust fund. The revocable trust becomes irrevocable at the death of the grantor and avoids probate passing by law to the beneficiary.

Irrevocable trusts

The grantor relinquishes control over the trust terms of agreement and may not change or terminate an irrevocable trust.

Life Insurance trusts

A trust funded by life insurance is a life insurance trust. The grantor names the trust fund as the beneficiary of the life insurance policy. When the insured dies, the trust is funded by the policy proceeds. The trustee manages the proceeds according to the trust terms. A life insurance trust is particularly useful when minor children would otherwise be the beneficiary of the life insurance policy.

Why establish a trust?

Living or *inter vivos* trust

Some of the most common reasons for establishing a living trust are as follows.

- **A trust provides financial management for the grantor's own benefit.** A trust frees the grantor from time-consuming financial management decisions, allowing more time for career endeavors or other interests. It also provides financial security for the grantor who fears he may become incompetent in the future and unable to manage his own finances.
- **A living trust may serve as a will substitute.** After the grantor dies, the trustee continues to manage the trust assets. The trust assets are not required to go through the probate process and may be distributed to beneficiaries without court supervision. However, the trust assets are typically subject to taxes, expenses, and claims of the grantor's creditors, so beneficiaries may have to wait to receive their shares until all claims against the grantor's estate have been settled.
- **A trust is private because the terms of the trust are not open for public inspection.** A will, on the other hand, becomes a public document after it is filed in court.
- **A trust provides financial benefit to others without giving them control of the (principal) property.** For example, Mother and Father want to give a vacation rental home to their daughter who is married to a compulsive spender. The trust can provide income to the daughter, while protecting the principal and income from the son-in-law. The son-in-law cannot convince the daughter to mortgage or sell the property because she lacks legal ownership.

Testamentary trust

Some of the most common reasons for establishing a testamentary trust are as follows.

- **A trust may provide financial support to the surviving spouse while preserving assets for children.** A trust is particularly useful in a second marriage where one or both spouses have children prior to their marriage.
- **A trust provides financial security for others who cannot manage their inheritance.** Minor children lack the maturity to handle money and property. Incompetent family members may lack the mental or physical ability to handle money or property. Others may be irresponsible with money. A trust preserves assets by placing management of the funds in the hands of a trustee.
- **A trust may provide a fund for the benefit of charity.**
- **A carefully designed trust or combination of trusts may reduce or eliminate federal estate taxes** in both spouses' estates while providing lifetime benefits to the surviving spouse.

Important notes

- Beware of living trust scams that promise to solve all your tax, financial, and probate problems. Trusts, like corporations, are required to pay taxes according to an Internal Revenue Schedule.
- See a competent attorney who specializes in trusts and estate planning if you are interested in a living trust as a will substitute. An improperly constructed trust will have no effect under the law, meaning it is the same as not having a trust.
- There are many types of trusts, of which those mentioned here are just a few.

Decisions of the grantor

- The grantor must make some important decisions before setting up a trust. For example:
- Who will be the beneficiaries?
- Will I retain the right to change beneficiaries?
- Who will be the trustee?
- When and how will amounts be given to the beneficiaries?
- How long will the trust continue?
- Who will receive the balance at the termination of the trust?

The beneficiaries

The grantor must decide who will benefit from the trust. The trust may have one or more beneficiaries, including the grantor. Usually, a trust benefits the grantor or members of the grantor's family. However, a charity may be the beneficiary of a trust. Some trusts are designed to benefit both family members and one or more charities.

Current beneficiaries receive benefits from the trust currently. If the trust continues beyond a beneficiary's lifetime, a *successor beneficiary* may begin to receive benefits. Whatever is left over in the trust when it terminates goes to the *remainder beneficiaries (remainder persons)* or returns to the grantor.

The trustee

The grantor may name an experienced financial advisor to manage the trust, or he may name himself, his spouse, a relative, or a friend. The grantor may name more than one trustee to serve at the same time. For example, a grantor may name his spouse and an experienced financial advisor co-trustees. This provides the spouse the benefit of the experienced advice and greater influence in the trust administration. The grantor should choose someone who is knowledgeable and trustworthy and who is available to handle administration of the trust. The grantor may name an alternate trustee (successor trustee) to serve if the grantor's first choice cannot or will not serve as trustee.

Naming a corporate trustee, such as a trust company or a trust department in a bank, has some advantages.

- A corporate trustee will not die, get sick, go on vacation, or become incapacitated.
- A corporate trustee has substantial experience in investing and managing money and property.

There are also some possible disadvantages to naming a corporate trustee.

- The services may be impersonal.
- Quality of services may vary among corporate trustees. Before choosing a corporate trustee, investigate the quality of the services. Look at the quality of its personnel and the success of the trust division. Try to find out whether its overall investment strategy produced a profit or a loss.

In choosing a trustee, a grantor has many alternatives.

- Choose both an individual trustee and a corporate

trustee. The individual trustee provides personal interest and the corporate trustee provides the expertise.

- Appoint an individual trustee and permit him to hire a corporate trust company for specific services.
- Give a beneficiary or a majority of the beneficiaries the power to change the trustee if the one chosen proves unsatisfactory. Be aware that the removal right gives a beneficiary significant power—perhaps more than the grantor desires to give. As grantor, be sure to understand potential legal and tax consequences of this provision.

The grantor decides how much power and responsibility to give the trustee. The trustee is under a legal duty to act in the best interests of the beneficiaries. If he misuses the trust property, he is personally liable. The grantor may require the trustee to post bond or file regular accountings with the court, or he may waive these requirements.

The grantor may set the amount of pay the trustee will receive. Professional trustees usually have an estab-

lished fee schedule. Unless the grantor provides for a different method of payment, the law entitles the trustee to a minimum amount of pay based on a percentage of the value of trust property. The clerk of court may authorize the trustee to be paid more than the minimum amount, as long as the trustee's total annual pay does not exceed the maximum allowed by law.

Professional services

A trust is a legal arrangement that involves tax, accounting, financial, and investment considerations. A team of professionals is helpful to the design and throughout the administration of the trust. An attorney will provide legal advice and draft the trust documents. Chose an attorney who concentrates his or her practice in trusts and estate planning. A certified public accountant concentrating in trusts and estate accounting will be well equipped to address the tax and accounting concerns. Other professionals on your team may include a certified financial planner, a trust company, or the trust department of a bank.

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