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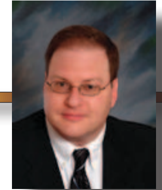
Ins and Outs of Trusts



By: Gary B. Garland, J.D., CELA[1]

Some of the public does not know what a trust is. Others think it is merely for the rich. Many others have come to me and said something like "I need a trust," as if it is aspirin or some panacea. What most of the public (and most non-estate planning attorneys) don't realize is that there are roughly 65 different types of trusts, some more broad than others, some quite specialized, and many share similar features. This brief overview should be a simple reminder for the seasoned practitioner, or a starting point for those new to the wonderful world of trusts.

First, let's start with the basics – the Trust has three "points" – a Grantor (Settlor, Trustmaker), a Trustee, and one or more beneficiaries. The Grantor creates the trust, the Trustee carries out the instructions of the Trust, and the beneficiary benefits from the trust. In some circumstances, the Grantor may wear all three hats.

Grantor or Non-Grantor? Included in the estate or excluded? Available to the beneficiary? Beneficiary's ability to control part or all of the trust? These probably rank highest in the architecture of the trust, so let's attack those first.

Grantor Trust versus Non-Grantor Trust

A Grantor Trust is a trust where the grantor has retained certain control over the trust. Any trust income is taxed on the Grantor's personal tax return (1040), at the Grantor's personal income tax rates. Conversely, a Non-Grantor trust's income is NOT taxed to the Grantor, and the trust is taxed at the compressed (usually higher) trust rates on a trust tax return (1041).

Tax Brackets for 2011 : Individuals

Marginal Rate	Single	Married Filing Jointly	Head of Household	Married Filing Separately
10%	0 - 8,500	0 - 17,000	0 - 12,150	0 - 8,500
15%	8,500 - 34,500	17,000 - 69,000	12,150 - 46,250	8,500 - 34,500
25%	34,500 - 83,600	69,000 - 139,350	46,250 - 119,400	34,500 - 69,675
28%	83,600 - 174,400	139,350 - 212,300	119,400 - 193,350	69,675 - 106,150
33%	174,000 - 379,150	212,300 - 379,150	193,350 - 379,150	106,150 - 189,575
35%	over 379,150	over 379,150	over 379,150	over 189,575

Tax Brackets for 2011 : Non-Grantor Trusts	
15%	0 - 2,300
25%	2,300 - 5,450
28%	5,450 - 8,300
33%	8,300 - 11,350
35%	over 11,350

As the tables above illustrate, Non-Grantor trusts are taxed at the maximum marginal rate of 35% once they produce over $11,350/year in income, whereas an individual earning $11,350 would only be subject to a 15% tax, therefore care must be taken in the selection of a Non-Grantor Trust.

Estate Inclusion or Estate Exclusion

If the Grantor has certain rights or too much control, the trust will be included in the Grantor's estate upon death. Estate inclusion may be desirable, for example, if the Grantor has a modest estate, and the assets have appreciated since the Grantor obtained same, by included the assets in the Estate there will be a "step up in basis" upon

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the Grantor's death – in other words, if a share of stock cost the Grantor $10, and is worth $110 upon the Grantor's death, the beneficiary will receive that stock at the $110 level, and can sell the stock for $110 without a capital gains tax; if the stock was placed in a trust excluded from the Grantor's estate (a "completed gift") then the beneficiary will receive the stock at the Grantor's cost basis (being $10 in this example) and if the stock is sold for $110, there will be a capital gains of $100. **The tug of war between estate inclusion and estate exclusion can be complicated, and it is strongly suggested that an experienced attorney is consulted on such matters to avoid significant tax errors (and malpractice).**

Mixing and Matching Grantor and Non-Grantor and Estate Inclusion and Estate Exclusion

For some estates, and under certain circumstances, the family may be served by a variety of the above – for example, a Revocable Living Trust is a Grantor Trust (income taxed to the Grantor) and included in the Grantor's estate. Income will be taxed at the Grantor's personal rates, and the assets will enjoy a step up in basis upon the Grantor's death. The same Grantor might also benefit from a "Medicaid Trust" which will often be a Grantor Trust (income taxed to the Grantor) yet the Grantor will have no control of the assets, and the assets may or may not be included in the Grantor's estate upon death. Usually, with a small enough estate, the assets will be included in the Grantor's estate (for Federal Estate Tax purposes) to enjoy the step up in basis. The same family could ALSO potentially benefit from a Medicaid Trust (or other trust) that might be a Grantor Trust (taxed to the Grantor) but yet excluded from the estate – non-appreciated assets would be more appropriate in that trust.

Beneficiary's Access and Control

There are times we want the beneficiary to have control of the trust – perhaps they are the successor Trustee, and the trust is dynastic in nature intended to benefit the beneficiary (and perhaps beyond). Or perhaps it is a small family, and the Grantor wants assets controlled by family members who are also beneficiaries.

Then there may be times where we do NOT want the beneficiary to have any access – an example would be a Special Needs Trust (or Supplemental Needs Trust) where the beneficiary would lose means tested governmental benefits (such as Medicaid). In that instance, we want the Trustee to have very tight discretion and guidelines on how to help the beneficiary, without being "too helpful" and costing the beneficiary their benefits.

Interested Beneficiaries

In my practice, a large portion of our trusts involve Trustees who are also beneficiaries (Interested Trustees). The Trustee may be in charge of their own separate share, and/or also in charge of other beneficiary's shares. For example, in a small family, perhaps the oldest child will be the initial trustee following the death of the Grantor(s), and there may be younger siblings, and in that example, the Trustee would be an Interested Trustee on the Trustee's separate share, and an Independent Trustee (or Disinterested Trustee) on the shares of his/her siblings. When making distributions for him/herself, the Trustee will be limited to the "ascertainable standards" of their own Health, Education, Maintenance or Support (HEMS) – this "standard" provides "creditor and predator" protection from the trusts; one way to simplify is to say if the Trustee had completely unfettered access, the assets would be more like the Trustee's own personal bank account than a trust. Regarding the sibling's shares, the Trustee would be able to distribute assets for any reason that made sense to the Trustee, without breaking the protections of the Trust.

Conclusion

It is my hope this brief piece was able to clarify some nomenclature and where various trusts can make sense – as with any legal article, you should consult a qualified attorney when in doubt or before establishing your Trust.

About the Author:
Gary B. Garland is a Certified Elder Law Attorney, as Certified by the National Elder Law Foundation, as accredited by the American Bar Association. He is one of less than 45 Certified Elder Law Attorneys in New Jersey, and one of less than 45 Certified Elder Law Attorneys in New York, and is unaware of any other Certified Elder Law Attorneys with offices in New York and New Jersey. He is the author to the CPA's Guide to Life Insurance and the CPA's Guide to Federal and Estate Gift Taxation. He is also the author of articles for the Journal of Practical Estate Planning and other legal publications. He is the creator of The Toggle Trust℠ and The Maturity Trust℠. His last article for The WealthCounsel Quarterly™ was "Decoupling Dilemma: Planning Pitfalls and Solutions for Decoupled State Planning" published October 2008. He can be reached at (732) 972-6700 or gary@estateattorney.info

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