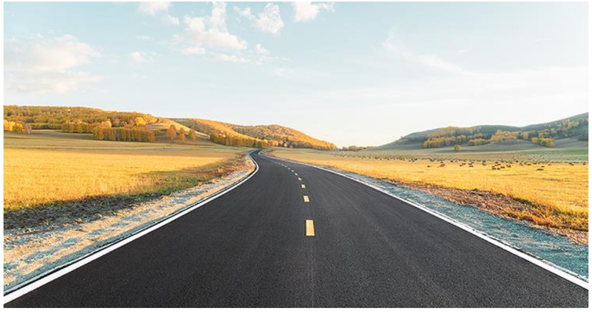
Understanding the Main Types of Trusts

Jaclyn McClellan, CFA, Contributor, The Motley Fool

October 23, 2019



Trusts are estate-planning tools, and like other estate-planning structures (like foundations or life insurance), a trust's structure will determine how assets are controlled, whether they're protected from future creditors' claims and how they're taxed.

A trust is created by a "settlor" (or grantor) who transfers assets to a trustee. The trustee must then hold and manage the assets for the benefit of the beneficiaries.
Pretty wordy, right? Let's use an example. If I wanted to create a trust (I would be the settlor) to hold assets for my children (beneficiaries), then I would hire a third party (trustee) to do that. Why would I do that, you ask? Well, the beneficiaries in this situation aren't the legal owners of the trust; they're the *beneficial* owners. That means they will eventually benefit from the trust's assets, but the assets are not "theirs." It's also possible for the settlor of a trust to also be one of the beneficiaries, but we'll get to that in a little bit.

The main benefit of a trust is the ability to avoid probate. Probate is a process in which a will is "proved" in a court of law. Essentially, the deceased person's will is analyzed by the court system to ensure its validity, and then the estate is distributed to heirs, beneficiaries, creditors, etc. according to the will Probate is notoriously lengthy and expensive, so a trust can save the settlor's heirs a lot of time, money and peace of mind.

Further, while wills are a matter of public record, trusts are not, which means people can't learn everything about them by simply requesting a copy from the courts. There are some circumstances that would allow a trust to become public record (if a beneficiary contests the estate, for example), but they are generally shielded from the public. Not all countries recognize foreign trusts; it depends on each country's legal system structure.

Revocable versus irrevocable trust

There are many different categories of trusts, but two particular types are important to understand: revocable and irrevocable. In a revocable trust arrangement, or "living trust," the settlor retains the right to rescind the trust and regain control of the trust assets. In many jurisdictions, in these circumstances, the settlor is the legal owner of the trust assets for tax purposes. Being responsible for tax purposes means the settlor is responsible for the tax payments and reporting on the trust's investment returns. Additionally, the fact that the trust is revocable, and the settlor can reclaim control makes the trust vulnerable to creditors. In our example (in which I am the settlor), creating a revocable trust would allow me to earn income from trust assets but feel comforted knowing that the trust will transfer to my beneficiaries after my death or that I can tell the trustee to continue to manage the assets for my beneficiaries.

Like wills, revocable trusts can distribute assets after your death. Unlike wills, revocable trusts can manage assets during your lifetime.

(continued on back)

With an irrevocable trust, on the other hand, the settlor can't alter or revoke the trust relationship. The trustee is responsible for the tax payments and reporting tax information for trust assets. In this case, the trustee is the owner of the trust. Generally, an irrevocable trust structure offers greater asset protection from a settlor's creditors.

Fixed versus discretionary trusts

After it is determined whether the trust is revocable or irrevocable, the next distinction to make is fixed or discretionary. The assets in a fixed trust are distributed at certain times or in certain amounts. The terms of the distributions of a fixed trust are specified in the trust documentation.

On the other hand, if the trust documentation states that the trustee should determine how much to distribute based on the beneficiaries' general welfare, and at the sole discretion of the trustee, then the trust is called a discretionary trust. The settlor can make his or her wishes known in the trust documentation, so the trustee has an idea of what the settlor wants, but the trustee is not bound by these wishes. Just as irrevocable trusts can shelter the settlor's assets from creditors, a discretionary trust can protect assets from claims against the beneficiaries.

Trusts can be complicated but useful

There are other unique types of trusts, but the categories mentioned above are the most basic and important to know. For example, spendthrift trusts are used to provide resources to beneficiaries who may be unable or unwilling to manage the assets themselves, perhaps because they are young, disabled, or immature. Spendthrift trusts are a form of irrevocable trust.

It's important to remember that the assets in a trust are not protected from any creditors who made a claim to them before the trust was established. In other words, if a creditor comes after your assets, you can't run out and create a trust in an attempt to shield them. Trusts can be complicated and must be created accurately and carefully. There are many caveats to different trust structures, so it's always best to consult with a professional.

PINNACLE
RESIDENTIAL PROPERTIES
555 Washington Street, Wellesley, Massachusetts 02482
main 781-237-5000 781-235-2838 fax
www.PinnacleHouses.com

Jim Grimm, SRES®
Senior Real Estate Specialist
Realtor®
Phone: 781-953-6647
Email: jgrimm@pinnaclehouses.com

SRES®