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Three things to consider about using trusts in your planning

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When our kids were younger, Carolyn and I wanted to make sure they'd be looked after if something happened to us. "Tim, if we're not here, I just want someone loving, caring and with high moral character to look after our kids," she said. "Carolyn, if we knew someone like that, why wouldn't we just give away the kids today?" She didn't like that idea. As it turns out, the kids continued to live with us – and have turned out just fine.

As part of our discussion at the time, we talked about setting aside money in a trust to provide for the kids if we were gone. That's right. A trust was part of our estate planning. But trusts can be confusing. What are they? What are they used for? Should you have one? How are they taxed? To start, let's talk about what a trust is, and the types of trusts that are possible.

Trusts defined

A trust is not a legal entity, like a corporation. Rather, it's a legal relationship between three parties: The settlor, the trustee, and the beneficiary. The settlor is the person who creates the trust by giving certain assets to the trustee to hold. The trustee holds, manages, and administers the assets – not for his or her own benefit – but for the benefit of the beneficiary. Now, it's common to find more than one trustee and more than one beneficiary of a trust.

For a valid trust to exist, there are three things that must be certain. These are known as the "three certainties" (go figure). First, there must be certainty of intention. That is, there must be an intention on the part of the settlor to have the trustee hold assets for the beneficiary. Second, there must be certainty of subject matter. That is, the assets that are being transferred to the trustee must be known, or certain. Finally, there must be certainty of objects. That is, there must be certainty around who the beneficiaries are.

Trusts classified

There are actually two broad types of trusts that can be set up. There are inter-vivos trusts, which you might establish while you are alive. Then, there are testamentary trusts, which are set up after you die, by way of your will. Over the years, I've had people ask me which type of trust is better – an inter-vivos or testamentary trust. This is a lot like asking which tool in the toolbox is better – a hammer or saw. The answer depends on what you're trying to accomplish. They do different things.

If I had a dime for every time I've heard someone say, "Tim, I want to set up a trust," I would easily have more than thirty bucks (the point is, that's a lot of people). And in most cases, these folks can't answer the question, "What are you trying to accomplish with the trust you want to set up?" People seem to like the idea of having a trust, but very few can articulate why.

Once you know the "why," it becomes easier to answer other questions such as: Who – who should be the trustees and beneficiaries? What – what assets will be held in trust? Where – is there a particular jurisdiction that makes sense for the trust? And when – should you set up the trust during your lifetime (an inter-vivos trust) or upon your death (a testamentary trust)?

Trusts named

If you talk to folks in the tax and estate-planning world, you may hear trusts referred to by different names, such as a family trust, spendthrift trust, cottage trust, education trust, inheritance trust, insurance trust, disability trust, and so on. For the most part, these trusts are given names solely to identify the purpose of the trust – that is, the reason it was created. The way that our tax and trust laws apply to each of these trusts is generally the same.

There are a few exceptions where our tax law provides special tax rules for certain trusts, in which case the tax law has prescribed what some of the trust terms must be. A spousal trust, for example, is a trust where you can transfer assets to the trust for the benefit of your spouse. You'll enjoy a tax-free transfer of those assets to the spousal trust, which is not the case for most trusts. But our tax law requires that there can be no other beneficiary of the spousal trust while your spouse is alive, and that your spouse must have a right to all the income of the trust each year. Alter ego and joint partner trusts also have special rules under our tax law. You get the idea.

Next time, we'll look at some of the common things people try to accomplish with their trusts. These are the "whys" I talked about.

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