Trusts Explained

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Trust Terminology

The term "trust" has many varying definitions. Part of the confusion about what a trust is derives from the fact that there are so many different kinds. Additional difficulties arise in conceptualizing just what a trust is since a trust is a creation of law and not something we can actually touch or examine. An understanding of terminology is helpful to understanding trusts.

To understand trusts, it's first important to understand who the different people in any trust are. There are three basic categories of persons involved in any trust: the grantor, the trustee and the beneficiary.[1]

> Trustee: The Trustee is the individual (or trust department) which holds legal title to trust property. The Trustee holds, invests and manages trust property for the best interests of the Beneficiary according to the terms of the Trust itself. There can be more than one Trustee (i.e., Co-Trustees). It is also recommended in most circumstances to provide for successor Trustees in the event that the first named Trustee resigns, passes on, or, for some reason, ceases to serve as Trustee.
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> Beneficiary: Beneficiaries "benefit" from the trust. The Beneficiary is the individual for whom the trust was created. There may be more than one Beneficiary. There can also be successive Beneficiaries. For example, a trust may have a lifetime Beneficiary and a Beneficiary who becomes a Beneficiary only at a later date, say, after the death of the lifetime Beneficiary. These successor Beneficiaries are called "remaindermen."
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> Grantor: (also called the "settlor", "trustor" or "trust maker") The Grantor is the person who establishes the trust and funds it with assets, cash or property.

It's also important to understand some basic trust terms and concepts found in any trust.

> Declaration of Trust: (also called the trust "instrument" or "trust agreement") This is the written document instructing the Trustee on the operation of the trust.
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> Revocable or Irrevocable: The Grantor may change the terms of a revocable trust at any time. A revocable trust will become irrevocable upon the Grantor's death or incapacity. An irrevocable trust is just that: a trust which cannot be later

[1] "The person whose confidence creates a trust is called the trustor, the person in whom the confidence is reposed is called the trustee; and the person for whose benefit the trust is created is called the beneficiary." SDCL 55-1-12.

changed. A trust within a will is called a testamentary trust and becomes irrevocable only when the individual dies and the will goes into effect; before that, a testamentary trust is revocable.

Distributions: A Trust will explain when, how often, how much, and under what circumstances the Trustee will make payments (“distributions”) to the beneficiary.

Discretionary or Mandatory Distributions: Distributions come in two flavors: those which are mandatory and those which are discretionary. Examples of mandatory distributions would include: “The Trustee shall pay $5,000 to the Beneficiary upon her 30th birthday” or “The Trustee shall pay all income from the Trust’s investments to the Beneficiary at least annually.” An example of a discretionary distribution would be: “From time to time, the Trustee may, in the Trustee’s discretion, make distributions to the Beneficiary for the Beneficiary’s health, education, maintenance or support.”

Final Distributions: A final distribution occurs in connection with the termination of the Trust. For example, the Trust might say: “Upon the tenth year following the Grantor’s death, the Trustee shall pay all remaining trust assets to the Beneficiary and the Trust shall then terminate.”

Trust Estate: (also called the trust “corpus”) The assets, property, cash and investments under the control of the Trustee. Anything capable of being owned can be a trust asset, although special considerations apply when a Trust will own Individual Retirement Accounts (IRAs).

Perhaps the most typical kind of trust is the “revocable” or “living trust.” In a living trust, the Grantor, the initial Trustee, and the lifetime beneficiary are all usually the same person, who retains the full power to amend or revoke the trust.

Different Ways of Thinking About Trusts

The law considers a trust to be an artificial legal person. Artificial persons are persons so far as the law is concerned but they are not living breathing individuals. Another example of an artificial legal person is a corporation. Because a trust is considered an artificial legal person, it is possible to define the term of the trust as lasting longer than the lifetime of a natural person. This allows individuals to create “living trusts” which will outlive themselves and serve to own their assets and property long enough after their own death to carry out distributions to heirs without the need for probate.[2]

Because a trust is a legal person, it can do many of the same things that we can do as individuals. For example, a trust can own, sell, lease or encumber property; it can sue or be sued; it can generate its own tax returns; it can hire and fire advisors. The legal

[2] See SDCL 55-1-15.

theory behind a trust is that ownership in trust property is divided between a "beneficial interest" and a "legal interest." The Trustee of a trust, it is said, holds legal title to the property. The Trustee is therefore the person in charge of the property and investments which comprise the trust corpus.

However, the beneficial title to trust property resides in the Beneficiary of the trust. The Trustee's ability to make decisions concerning the property of the trust is governed by a "fiduciary standard." The Trustee must carefully follow the instructions within the Declaration of Trust and must place the interests of the Beneficiary first and foremost.

(a) Trusts as Agreements

Trust law originated from contract law. Often, a trust document will be titled a "Trust Agreement" because in many ways a trust is nothing more than an agreement between a grantor and a trustee to administer trust property for the benefit of a beneficiary.[3]

(b) Trusts as Relationships

Another way of thinking about trusts is the creation of relationships to trust property. The three people in any trust – the grantor, the beneficiary and the trustee – all have different relationships, rights and responsibilities in relation to the assets held in the trust. The Trustee has legal title to the trust property, but no real right to enjoy it. The Beneficiary has no legal title to the trust property, but beneficial enjoyment rights set forth in the trust document. The Grantor is the person who defines the responsibilities of the Trustee and the beneficial enjoyment rights of the Beneficiary.

WHERE TO FIND THE LAW

The law is generally comprised of statutes, regulations and caselaw (reported opinions by a court to specific facts). The law cited within the above discussion can be found at the links provided in the "Law" section of the ThomasESimmons.com website. South Dakota statutes are abbreviated as "SDCL" for South Dakota Codified Laws. South Dakota administrative rules are abbreviated as "SDAR." Federal statutes are abbreviated as "USC" for United States Code.

DISCLAIMERS

Pursuant to IRS Circular 230, these materials are not intended or written to be used -- and cannot be used -- by taxpayers for the purpose of avoiding tax penalties; taxpayers should seek advice from independent tax advisors based upon their particular

[3] See SDCL 55-1-4, 55-1-5 (stating that a trust is created when a grantor, by words or acts, indicates an intention to create a trust and the subject, purpose and beneficiary of it, and a trustee, by words or acts, indicates his, her or its acceptance of the trust or acknowledges, upon sufficient consideration, its existence).

circumstances; these materials do not promote any particular plan or arrangement; general information is provided here.

These materials are provided as educational and informational resources only. Consult with a lawyer before making a legal decision since many rules contain exceptions and refinements which are not summarized here. This information should not be interpreted as legal advice. No one legal rule can be applied to all individuals or situations. State law varies tremendously from state to state and unless otherwise indicated, the law discussed here is applicable only in South Dakota. Since the law often changes when new statutes are enacted and cases are decided, no representations are made to the accuracy, completeness or timeliness of the discussions of law provided above.

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