The Truth About Trusts

by Glen Halliday, trustee

The trust is an excellent tool to protect assets, avoid probate, increase personal privacy, and minimize income taxes. However, trusts are under-used and frequently misunderstood. This not surprising when you consider the scarcity of written material on the subject. According to *A Trustee's Handbook* (7th ed.) by Loring:

"In the late 1960s law schools set about the process of downgrading courses in the law of trusts from required to elective status, so that while almost all law schools have made courses on state regulation mandatory, only a few continue to afford the law of trusts the status it enjoyed at the turn of the century. In most law schools trust law is now an afterthought, buried somewhere in an elective course on estate planing."

Likewise, in the preface of *Income Taxation Of Trusts, Estates, Grantors and Beneficiaries*; author Jeffrey Pennell states: "Unfortunately, when I first recommended to our curriculum committee that we add a course on this subject, there was simply no classroom text available."

Because trust literature is seldom published, it is virtually impossible to go to any single source to get all the reliable information about every benefit of trusts. Further, available information on trusts has been complicated to the point that the average person has almost no chance of understanding even the basic principles. However, the information is out there, if you know where to look. The basic principles of trusts and their management are relatively simple and proper operation of a trust is no more difficult, and often easier, than running your basic, small business.

There is no mystery surrounding trusts. It is true that they are less known than other types of business organizations, but they hardly uncommon. In 1993, there were approximately 1.6 million tax returns filed for partnerships, more than 2.5 million tax returns (form 1041) filed for trusts, and 4 million returns filed for corporations. In other words, trusts are more common than partnerships, and comparable in number to corporations. Further, the audit rate for trusts is roughly 20% that for corporations, partnerships and individuals.

Divided titles

The fundamental idea of a trust is to divide the legal and equitable (possessory) title of the trust's assets. For example, suppose Mr. Smith owns and operates a business. Because he has both "legal" title (he owns the business) and "equitable" title (he actually works the business; he hasn't leased it to someone else), Mr. Smith alone is entitled to any benefits (profits) from the business. Likewise, Mr. Smith is solely responsible for any liabilities and taxes his business may incur. With full title (legal and equitable) comes full benefits – and full liabilities.

But suppose Mr. Smith leases his business to Ms. Brown. Now, while Mr. Smith still has his "legal" title to his business (he still owns it), Ms. Brown is operating the business under lease and therefore has "equitable" title. Because the title has been split ("legal" stays with Smith, "equitable" goes to Brown), so have the potential benefits and liabilities. If the business has a bad year, Mr. Smith is still guaranteed to be paid his lease money in full. If the business prospers, Ms. Brown receives all the benefits of the profits no matter how large. Mr. Smith will be liable to pay taxes on the income he receives from his lease. Ms. Brown will be liable to pay income taxes on any profit generated by the business. If someone falls on the business premises and breaks a hip, Ms. Brown (who has equitable title) or the business itself, will be liable. Mr. Smith (with legal title) will normally escape liability.

Essentially, by dividing the full title to his business, Mr. Smith has both guaranteed himself an acceptable income and limited his potential liability for business operations or mistakes.

Typically, trusts also divide full title into "legal" title to property (owned by the trust, itself), and "equitable" title (owned by the trust's designated beneficiaries). In general, the trust's division of title can result in significant gains to beneficiaries and minimized liabilities for grantors.

For example, instead of leasing his business to Ms. Brown, Mr. Smith might place his business into a trust and designate his children as beneficiaries. Mr. Smith could continue to manage the business as a trustee and receive a salary for his efforts, but the profits would be divided among his three children. Although each child might have to pay taxes on his share of the income from the trust, in a graduated income tax environment, the collective tax burden might be reduced and net income to the family increased. (I.e., without a trust, if Smith's business generated a $600,000 annual profit, his corporate tax liability might be $250,000. However, if he placed his business in trust, and divided the $600,000 among his three children, then each child might receive $200,000 and owe $50,000 in taxes. Collectively, the three children would pay $150,000 in taxes on the same income that would've cost the corporation $250,000. That's a $100,000 net to the Smith family and good reason to use a trust.)

Additional benefits

Privacy. We live in the information age. Information that used to be confidential and private, is readily available on almost every aspect of a person's life. Privacy becomes an increasing problem. Trusts traditionally have enjoyed protected status in the area of privacy. Often times trust records are difficult, if not impossible, to subpoena.

In 1995, I followed a court case in Hawaii between the IRS and the owner of a car dealership. The individual's business and family financial holdings had previously been organized into trust. The trust was refusing to surrender financial records based on the precedent that trust records are private and surrendering them could compromise the trust and thereby jeopardize the interests of the beneficiaries. The defense attorneys had done considerable preparation and presented various court cases that substantiated the privacy of trust records.

The IRS countered with the argument that in 1938 the common law had been "statutized" and the cases that the defense used, no longer applied because we are under admiralty law. (I'd heard the "admiralty argument" several times, complete with the gold fringe of the flag. While it was possibly true, I'd discounted its practicality in the "real world". You can imagine my surprise at hearing that from the IRS's attorneys.)

The Judge allowed certain very limited concessions and the IRS was allowed to examine certain non-vital trust papers. The end result was that the IRS failed to find any fraudulent intent. The judge ruled in favor of the trust, the trust's privacy was maintained and the case was dismissed. The case was subsequently appealed to the ninth circuit court of appeals and again the privacy of the trust was upheld, court of admiralty or not.

Wills. While better than nothing, most wills can't truly protect the surviving family members from the horrors of probate and the confiscatory taxes. However, with a properly designed trust, probate doesn't exist. Probate is triggered by *transfer of title* of a decedent's assets. Assets held in trust are not subject to probate when a trustee dies. The assets do not belong to the trustee. His position is vacated and a successor is appointed to fill it.

Liability. A bankruptcy case involving Arizona Governor Symington is a perfect example of limiting liability and the trust's immunity from the actions of the trustees. Before he became governor, he personally guaranteed a development project that went bankrupt. When he was sued, his lawyers responded that all the Symington family's wealth was in trust and that the trust could not be forced to honor the governor's *personal* debts. The lawyers went on to say that they were dropping their defense and that no check would be written in the foreseeable future. Imagine -- a legal entity so strong the lawyers wouldn't even bother to defend it!

A properly administered trust is nearly impossible to penetrate to satisfy personal debts. The supreme court affirms the liability protections of the trust: "Further, the primary objective of a TRUST relationship is to obtain the advantages of corporations, but with the freedom from the burdens, restrictions, and regulations generally imposed upon them." (*Ashworth v. Hagen Estates* 165 Va 151, 181 SE 381)

Income tax. Income taxation of trusts and potential tax savings to the creator of the trust is not a matter of opinion, but fact. Trusts are recognized by the IRS and are issued tax ID numbers. The trust files its own tax return which is an IRS form 1041. Any lawsuits or back taxes charged against a trust business or property would be limited to seizing only those assets contained in the trust. If the IRS tried to collect back taxes on Mr. Smith's business, they might be able to seize the trust's business, but could not seize Mr. Smith's home (or car, or bank account) which were not assets of the trust.

For tax purposes, the IRS separates trusts into three categories: "Simple Trusts" (any trust where all the trust income is distributed annually); "Grantor Trusts" (since the IRS tries to define most trusts as Grantor Trusts, it follows that this classification is not necessarily to the trust's advantage); and, "Complex Trusts" (defined as a trust that is *not* a Simple Trust). Note that the IRS does not determine whether a trust is statutory or contractual, or impose any restrictions on who may create one — they merely try to categorize trusts for tax purposes and process the correct tax forms once the trusts have been created.

Nevertheless, it's curious that the entire IRS definition of Complex Trusts consists of a description of what they are *not*. *Blacks Law Dictionary* is less mysterious and defines Complex Trusts as those where the trustees have *complete discretion* (power) over the administration of the trust assets. In fact, the Complex Trust has the greatest degree of flexibility and freedom from statutory encumbrance. Without getting bogged down in definitions, note that it is possible to have two kinds of Complex Trusts: those formed under statutory law, and those formed by private contract. As we'll see, a Complex Trust established in *contract* – not statute — is the best way to form a trust.

Statutory vs. contractual

There are basically two classes of trusts. The first is a trust established in *statute*, by the legislature. *Blacks Law Dictionary* lists over 85 different types of statutory trusts including living trusts, discretionary trusts, pour over trusts etc..

Statutory trusts derive their existence from Congress and can be altered, amended or revoked by Congress. For example, Living Trusts, at best, protect the estate only up to $1.2 million. Worse, there's been an alarming trend for the past several years in which living trusts are often set aside by the courts and the estates probated anyway. As a result, the Living Trust estate is subjected to ruinous legal fees and taxes. Is it a mater of time until Living Trusts are set aside entirely? Remember, Congress created the Living Trust. They are *statutory*. What Congress creates it can amend or revoke.

Have you ever heard the saying "ignorance of the law is no excuse"? In the realm of statute, you are liable for laws that you aren't even aware of. For example, you are driving down a road and the speed limit lowers and you don't see the sign. You continue on at your previous speed in blissful ignorance until you are caught on radar and given a ticket for speeding. You explain that you had no idea that you were exceeding the limit. It doesn't matter. You are liable whether you knew or not. That is pure liability. It doesn't matter what your intentions were. You didn't mean to break the law and you probably wouldn't have if you had known. It doesn't matter that there was no criminal intent or harm done. The simple fact is that you were in violation of the law and the price must be paid. The realm of statutory law is the realm of pure liability. If you choose to put yourself into that realm with a statutory trust you'd better have a good lawyer.

The second class of trust is established in *contract*. The very definition of a trust is a *contract* involving *three* parties: The first party (grantor) creates a trust and typically conveys property into that trust; the second party (trustee) administers that trust for the benefit of the third party (beneficiary). Trusts are typically formed by a contract between the grantor(s) and trustees. Beneficiaries play no active role in the trust's creation or administration.

The legal significance of contracts was of supreme importance to the framers of the Constitution. Article 1 Section 10 states: "No State shall . . . Pass any Law impairing the Obligation of Contracts." The guaranteed right to contract is evidence of the People's sovereignty over government in that, once a lawful contract ("private" law) is entered into, even Congress cannot pass a subsequent law to revoke or "impair" an existing contract. This guarantee is far more important than most people imagine.

For example, suppose a farmer has a contract to receive payment for the crops that he delivers to market. If the contract is not honored and he's not paid for his crops, he'll have no incentive (or money) to produce crops the next year. Instead, he'll only produce enough to feed himself and his family. If no one could depend on contracts, there would be no incentive to produce anything. Production would halt and factories would close. There would be nothing to sell, the stores would be empty and almost all commerce would cease.

The right to contract is crucial to the existence of free market and even personal freedom. As proof, consider those communist and socialist societies whose governments are able to "impair" the obligation of existing contracts. Although even the most repressive governments preserve some measure of the right to contract, to the extent that right is restricted, those societies are characterized by poverty and political oppression.

The United States Supreme Court affirms the right to enter into a contractual relationship (trust): ". . . the (contract) TRUST relationship is based upon the common law, and is not subject to legislative restrictions as are corporations and other organizations created by legislative authority." (*Crocker v. MacCloy*, 649 US Supp 39 at 270) I.e., if Congress didn't create a contract, it can't lawfully alter, amend or revoke it.

Nevertheless, can Congress pass laws restricting the ability to utilize trusts? Yes, but not likely. Virtually all our elected officials use "Blind Trusts" — a trust that is listed in a registry in Washington DC and *does not report the source of its income* (IRS 1041 Instruction book p.7). In light of the power and wealth of those who already use trusts, it is unlikely that legislation restricting trusts will become too severe in the foreseeable future.

When creating a trust, remember that since a trust is a contract (private law) which can be freely entered into, there is little or no need for *statutory* trusts of any kind. And as you'll see, *contractual* trusts offer far more advantages than statutory trusts. Therefore, the subject of trusts can be hugely simplified by ignoring statutory trusts and focusing entirely on contractual trusts.

Grantors

A trust begins with the Grantor who (typically) not only designs and creates the trust on paper, but also endows it with some of his valuable assets (land, businesses, money, etc.).

Once the trust is created and endowed with assets, the Grantor must disassociate himself from the management of the trust (and the assets he placed in the trust) or the IRS will cheerfully classify his creation as a "Grantor Trust" and tax him accordingly.

Trusts can be "revocable" or "irrevocable". If a trust is "revocable", the grantor has the legal power to take back whatever property he put in trust. This may seem like a safety feature in the event that a person changes his mind, but in reality it is a gaping hole in the trust's armor. In the eyes of the courts and IRS, if the trust is revocable, the grantor technically still owns the property he placed in the trust. If he owns it, he can be taxed on it or even have it taken away from him in a judgment.

Therefore, to minimize IRS intrusions, it is vital that trusts be "irrevocable"; i.e., the grantor retains no residual or revisionary power over the trust and therefore cannot tell the trustees what to do or take back his property. The idea of permanently surrendering all control over your property to the management of others is a scary concept for some people, but it is a key principle and an essential attribute of the term "trust".

It is a simple matter to make a trust irrevocable. The grantor simply declares it "irrevocable" in the trust "indenture" (the document which created the trust) and it is legally so because when the grantor creates a trust, he is literally *creating law*. (The people making law? What a radical concept – exactly what is meant by holding We The People as sovereign over our government.) If a trust finds itself in court for whatever reason the judge must use the trust "indenture" as the guide for how the trust is to be treated. Remember the Constitution's (Art. 1 Sect. 10) prohibition against impairing the obligation of contracts?

When assets are conveyed *irrevocably* into trust, the tax liability of the assets no longer attach to the grantor. While the tax deductions for individuals are disappearing one by one, deductions for trust have remained almost perfectly preserved.

Therefore, why do so many competent professionals disagree on this point? It is because of the lack of familiarity with trusts and their potential. I repeat: the principles and laws pertaining to trusts are not complicated, they are just not widely known. Details pertaining to taxation of trusts are available from a variety of reliable sources. One of the sources I reference frequently is *Practitioners 1041 Deskbook*, Practitioners Publishing Co., Texas.

Trustees

There is a great deal of difference between being a grantor who places property into a trust, and a trustee, who manages assets for the trust. Some grantors go to great pains to create a trust and still retain control over the assets by making themselves "managers" or "protectors". They do this because they don't understand the concepts of trusteeship and irrevocability.

Assets conveyed *irrevocably* are "transferred" into trust just as if they were *sold*. So long as the grant is irrevocable, "[t]he settlor (or grantor) may make himself sole trustee or one of several trustees." (*Trusts*, 6th ed., George T. Bogert) Therefore, the grantor may administer the trust as *trustee* without retaining any residual power or interest. The court agrees: "By declaration of trust, the legal title, possession and control of the trust estate passed irrevocably from the grantor as an individual to himself as a trustee. The effect is no different than if the trustee had been another person." (*Helvering v. St Louis Union Trust Co.* 296 US 39, ante, 29, 56 S Ct. 74, 100 A.L.R 1239)

If a trustee understands his role and administers the assets for the benefit of the beneficiaries, there is no danger of the trust failing for that reason. Trustees in a properly created complex trust have complete discretion and broad powers over the administration of the trust and its assets. Although trustees must follow the trust indenture as a general guide, no one can tell the trustees what to do. Trustees may even amend and add to the trust indenture.

The courts have ruled that in order for a contract trust to fail, the trustees must willingly and knowingly commit fraud. A trustee will not cause a trust to fail because he makes an administrative error. The courts recognize that the trustee's job is not to be a lawyer, but a custodian or steward over the assets. Historically there is a great deal of leeway given to trustees in the administration of their duties. Fraudulent intent must be proven. Intent is much harder to prove than a simple mistake because of oversight. Essentially, if a trustee makes a mistake he must correct it, and having done so is personally immune from any civil or criminal liability. Liability cannot be assessed to a trust because of the actions of a trustee. Similarly the trustee is not liable for the debts of a trust.

However, a problem will arise if the grantor also makes himself both a trustee and a *beneficiary* of the trust. It is a hard and fast rule of trusts that *trustees cannot also be beneficiaries*.

However, additional assets (like houses, cars, etc.) can be purchased by the trust and conveyed into the trust as trust property. This can be accomplished with no tax liability to the former grantor (now, trustee) who resides in the trust's house or drives the trust's car. Although there is some dispute among legal and accounting professionals, the trustee may occupy the house or drive the car at no charge or tax liability to himself. There are numerous letter rulings involving the IRS where the person occupying the house (equitable or possessory title) is *not* assessed income and the entity that owns the house (legal title) is allowed the *deduction*. The pivotal point is *contract*. The trustee or employee may occupy the residence if it is a condition of employment and stipulated in the employment contract. The same rules apply with respect to a car. In the absence of a contract the point is less defensible.

Complex irrevocable trusts

Trusts are powerful tools for estate planning and administering assets. By entering into a complex irrevocable trust you can elevate your family and business financial dealings to a higher plane and be ruled under a nonstatutory set of laws. The benefits of trusts are available to anyone who freely elects to use them. A degree of privacy and protection from liability can be achieved that is otherwise unavailable. Probate can be totally avoided, income taxes reduced, and personal liability virtually eliminated.

It is reasonable and prudent for a person to reorganize his affairs so that he may enjoy better privacy, protection and an improved tax position. The courts have ruled specifically, that a person is not more or less patriotic because of the amount of taxes he may or may not pay. Additionally, a person may choose to organize his affairs, whether or not the resulting benefits or tax savings are incidental or by design.

Many of the benefits of trusts can be achieved using corporations and other statutory entities. However, the contract-based complex irrevocable trust is clearly protected by the courts for various reasons. Given a choice, I would rather have the protection of the courts than to have to depend on my wits or luck to keep me out of harms way.

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