Independent Investor

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Trust Beneficiaries: Be Informed About the Basics

If you have been named as a beneficiary of a trust, you probably have many questions about what comes next. Trusts can take many forms and may be governed by unique provisions established by the creator of the trust or "grantor." As a trust beneficiary, you also have certain rights.

To ensure that your financial and other interests are fully protected, you need some basic information about different trust structures and their management.

Trust Basics

At their most basic, trusts can be grouped into two broad categories -- living trusts and testamentary trusts. A living trust is created by an individual during his or her lifetime. The grantor transfers property to a trust that is managed for the trust beneficiaries by a trustee. The grantor may act as trustee, or he or she may appoint another family member or family advisor, such as an attorney or accountant to be the trustee. A testamentary trust is established by will upon the death of the person whose assets it represents. Testamentary trusts can be used for many purposes, chief among them to provide for current and future beneficiaries.

In either case, it is the trustee who is charged with administering the trust in strict accordance with its terms. If this so-called "fiduciary duty" of the trustee is breached in some way, beneficiaries have the right to protect their interests by taking legal action against the trustee.

Role of the Trustee

Following is a brief overview of the trustee's roles and responsibilities.

- Asset collection and protection -- Two of the trustee's key responsibilities are collecting assets earmarked for the trust and ensuring the protection of those assets. For instance, if real estate is included as a trust asset, the trustee is responsible for the maintenance and upkeep of the property and maintaining appropriate insurance on the property. In the case of financial assets, such as cash or securities, the trustee must maintain one or more separate accounts on behalf of trust beneficiaries.
- Investment oversight -- The trustee ensures there is a plan in place to address the needs and interests of current and future beneficiaries. Typically, trust investments are expected to generate income for beneficiaries while also retaining and reinvesting principal. In some cases, the trustee may have the authority to make distributions of principal to beneficiaries.
- Taxes -- The trustee reports all income generated by trust assets and pays tax on any undistributed income as well as capital gains realized by the trust. In addition, the trustee informs beneficiaries of the amounts that they must report on their personal income tax returns as a result of trust distributions.
- Recordkeeping -- The trustee is responsible for documenting every transaction that takes place in the trust accounts. Prior to final settlement, the trustee must demonstrate to the beneficiaries that all assets and income have been properly administered and distributed.

Beneficiary Right to Action

In addition to regular accounting of trust assets, beneficiaries have a right to request a special accounting from the trustee if there is reason to suspect a problem with the trustee's performance of his or her fiduciary role. If it is found that the trustee is in violation of his or her responsibilities or fails to provide proper documentation of trust activity, then the beneficiary has the right to take legal action, including removing the trustee and requesting a replacement. Such action is normally handled by filing a petition with the local probate court.

Revocable vs. Irrevocable Trusts

Living trusts may be revocable or irrevocable. As its name implies, property held in a revocable trust may be "revoked" at any time; the terms of the trust may be changed and assets returned to the grantor. He or she can establish detailed instructions as to the handling of trust assets during his or her life and ensure continuity of management upon incapacity or death. Revocable trusts need not be filed in probate court after death, thus maintaining family privacy. However, the grantor will be subject to income and estate tax as if the property were owned outright.

In contrast, assets placed in an irrevocable trust are permanently removed from the grantor's estate, and any income and/or capital gains taxes owed on assets in the trust are paid by the trust. Upon the grantor's death, the assets in the trust are not considered part of his or her estate and are therefore not subject to estate taxes.

Irrevocable Trusts Offer Lifetime Giving to Beneficiaries

While requiring some loss of grantor control, a properly drafted irrevocable living trust allows individuals of substantial wealth to begin transferring assets to beneficiaries during their lifetime without incurring gift or estate tax. (Please note that a three-year survival period may be required in certain situations.)

For example, the normal annual limit on tax-free gifts is $14,000 per beneficiary in 2016, an amount that may be indexed for inflation in future years. Under some circumstances, a taxpayer may include amounts above that in his or her unified estate and gift tax exclusion amount ($5.45 million in 2016 for an individual, twice that for a married couple, and subject to indexing for inflation in subsequent years).
In addition, upon the grantor's death, appreciation on the remaining trust assets is not subject to estate tax (assuming any three-year survival requirements are met).

Being named as a beneficiary of a trust is indeed a welcome event, but not without its complications and, if handled improperly, unfortunate consequences. For help understanding your rights and protecting your inheritance, it may be wise to engage the services of an experienced trust attorney.

This information is not intended to be a substitute for specific individualized tax or legal advice. We suggest that you discuss your specific situation with a qualified tax or legal advisor.

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