TRUST BASICS

What is a trust?

A trust is a legal entity that holds assets for the benefit of another. Basically, it's like a container that holds money or property for somebody else. You can put nearly any kind of asset into a trust, including cash, stocks, bonds, insurance policies, real estate, and artwork.

When you create and fund a trust, you are known as the grantor. The grantor identifies the beneficiaries and the trustees of the trust. Beneficiaries, the people who will benefit from the trust, are usually your family and loved ones but can be anyone, even a charity. The trustee is a fiduciary—someone who must act in the best interests of the beneficiaries at all times. The role of the trustee is to preserve, protect, and invest the trust assets for the benefit of the beneficiaries. A trustee lacking specialized knowledge can hire professionals, such as attorneys, accountants, brokers, and bankers, but generally he or she cannot merely delegate responsibility to someone else.

Depending on the purpose of the trust, you can name yourself, another person, or an institution, such as a bank, to be the trustee. You also have the option of naming more than one trustee—they are called co-trustees.

Potential benefits

Because trusts can be used for many purposes, they are popular estate planning tools. Trusts are often used to:

- Minimize estate taxes
- Shield assets from potential creditors
- Avoid the expense and delay of probating your will
- Preserve assets for your children until they are grown (in case they are minors)
- Create a pool of investments that can be managed by professional money managers
- Set up a fund for your own support in the event of incapacity
- Shift part of your income tax burden to beneficiaries in lower tax brackets
- Provide benefits for charity

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Potential disadvantages

While trusts can be very useful and valuable estate planning devices, there are some disadvantages:

- A trust can be expensive to set up and maintain. Trustee fees, professional fees, and filing fees must be paid.
- Depending on the type of trust you choose, you may give up some control over the assets in the trust.
- Maintaining the trust and complying with recordkeeping and notice requirements can take up considerable time.
- Income generated by trust assets and not distributed to trust beneficiaries may be taxed at a higher income tax rate than your individual rate.

Types of trusts

There are numerous kinds of trusts you can establish, which fall into three general categories.

Living (revocable) trusts. You create a living trust to maintain ownership of assets while you're alive and to prescribe their distribution after you pass on. The trustee can transfer assets to the beneficiaries immediately, or you can direct the trustee to hold the assets until a specific time, such as the marriage of the beneficiary or the attainment of a certain age.

There are several other benefits to creating living trusts. For example, unlike a will, a living trust is a private document and is not subject to probate, which may help maintain privacy, as well as save time and money. No one can review details of the trust documents unless you allow it. In addition, a living trust can be a good risk management option. If you become incapacitated and can no longer handle your own affairs, your trustee (or a successor trustee) will step in and manage your property. Without a trust, a court could appoint a guardian to manage your property.

Despite these benefits, living trusts do have some drawbacks. Assets in a living trust are not protected from creditors, and you are subject to income taxes on income earned by the trust. Furthermore, you cannot avoid estate taxes by using a living trust.

Irrevocable trusts. Unlike a living trust, an irrevocable trust can't be changed or dissolved once it has been created. You generally can't remove assets, change beneficiaries, or rewrite any of the terms of the trust; so be sure the assets you transfer into the trust are assets you don't mind losing control over. In addition, you may have to pay gift taxes on the value of the property at the time of transfer.

Still, an irrevocable trust is a valuable estate planning tool. Provided that you have given up control of the property, all of the property in the trust, including all future appreciation, is excluded from your taxable estate. That means your ultimate estate tax liability may be less, so more of your property can potentially pass to your beneficiaries. Property transferred to your beneficiaries through an irrevocable trust will also avoid probate. As a bonus, assets in an irrevocable trust may be protected from your creditors.

There are many different kinds of irrevocable trusts. Many have special provisions and are used for special purposes. Some irrevocable trusts hold life insurance policies or personal residences. You can even set up an irrevocable trust to generate income for yourself.

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Testamentary trusts. Trusts can also be established by your will. These trusts don't come into existence until your will is probated. At that point, selected assets passing through your will can "pour over" into the trust. From that point on, these trusts work very much like other trusts. The terms of the trust document control how the assets within the trust are managed and distributed to your heirs.

The right trust for you

From marital trusts to life insurance trusts to charitable trusts, there are numerous kinds of trusts you can choose to establish. Before creating a trust, however, it is important to determine its purpose. Only then, once you decide what you hope to accomplish, can you choose the kind of trust that will help achieve your objectives.

In addition, the assets with which you will fund your trust will depend mainly on your goals. For example, if you want the trust to generate income, you may want to put income-producing securities, such as bonds, in your trust. Or, if you want your trust to create a pool of cash that may be accessible to pay any estate taxes due or to provide for your family, you might want to fund your trust with a life insurance policy.