Trust Basics

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Whether you're seeking to manage your own assets, control how your assets are distributed after your death, or plan for incapacity, trusts can help you accomplish your estate planning goals. Their power is in their versatility — many types of trusts exist, each designed for a specific purpose. Although trust law is complex and establishing a trust requires the services of an experienced attorney, mastering the basics isn't hard.

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 practically any kind of asset into a trust, including cash, stocks, bonds, insurance policies, real estate, and artwork. The assets you choose to put in a trust depend largely 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 at your death or to provide for your family, you might want to fund your trust with a life insurance policy.

When you create and fund a trust, you are known as the grantor (or sometimes, the settlor or trustor). The grantor names people, known as beneficiaries, who will benefit from the trust. Beneficiaries are usually your family and loved ones but can be anyone, even a charity. Beneficiaries may receive income from the trust or may have access to the principal of the trust either during your lifetime or after you die. The trustee is responsible for administering the trust, managing the assets, and distributing income and/or principal according to the terms of the trust. 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 can even name more than one trustee if you like.

Why create a trust?

Since 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 you should die while they are still 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

The type of trust used, and the mechanics of its creation, will differ depending on what you are trying to accomplish. In fact, you may need more than one type of trust to accomplish all of your goals. And since some of the following disadvantages may affect you, discuss the pros and cons of setting up any trust with your attorney and financial professional before you proceed:

- 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 recording 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

The duties of the trustee

The trustee of the trust is a fiduciary, someone who owes a special duty of loyalty to the beneficiaries. The trustee must act in the best interests of the beneficiaries at all times. For example, the trustee must preserve, protect, and invest the trust assets for the benefit of the beneficiaries. The trustee must also keep complete and accurate records, exercise reasonable care and skill when managing the trust, prudently invest the trust assets, and avoid mixing trust assets with any other assets, especially his or her own. A trustee lacking specialized knowledge can hire professionals such as attorneys, accountants, brokers, and bankers if it is wise to do so. However, the trustee can't merely delegate responsibilities to someone else.

Although many of the trustee's duties are established by state law, others are defined by the trust document. If you are the trust grantor, you can help determine some of these duties when you set up the trust.

Living (revocable) trust

A living trust is a special type of trust. It's a legal entity that you create while you're alive to own property such as your house, a boat, or investments. Property that passes through a living trust is not subject to probate — it doesn't get treated like the property in your will. This means that the transfer of property through a living trust is not held up while the probate process is pending (sometimes up to two years or more). Instead, the trustee will transfer the assets to the beneficiaries according to your instructions. The transfer can be immediate, or if you want to delay the transfer, you can direct that the trustee hold the assets until some specific time, such as the marriage of the beneficiary or the attainment of a certain age.

Living trusts are attractive because they are revocable. You maintain control — you can change the trust or even dissolve it for as long as you live. Living trusts are also private. Unlike a will, a living trust is not part of the public record. No one can review details of the trust documents unless you allow it.

Living trusts can also be used to help you protect and manage your assets if you become incapacitated. If you can no longer handle your own affairs, your trustee (or a successor trustee) steps in and manages your property. Your trustee has a duty to administer the trust according to its terms, and must always act with your best interests in mind. In the absence of a trust, a court could appoint a guardian to manage your property.

Despite these benefits, living trusts 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. In addition, you cannot avoid estate taxes 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. Still, an irrevocable trust is a valuable estate planning tool.

First, you transfer assets into the trust — assets you don't mind losing control over. You may have to pay gift taxes on the value of the property transferred at the time of transfer.

Provided that you have given up control of the property, all of the property in the trust, plus all future appreciation on the property, is out of your taxable estate. That means your ultimate estate tax liability may be less, resulting in more passing to your beneficiaries. Property transferred to your beneficiaries through an irrevocable trust will also avoid probate. As a bonus, property 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 you.

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. Since you have a say in how the trust terms are written, these types of trusts give you a certain amount of control over how the assets are used, even after your death.