Everything You Need to Know About Trusts

You may have heard the term discussed in financial advising or estate planning conversations, but what exactly is a trust? In the most basic terms, a trust is a legal arrangement in which assets are held for the benefit of someone else (the beneficiary). There are many types of trusts for various goals, and complex trust law makes it necessary to hire an experienced attorney to help you establish one. First, though, it's important to understand the basics to help you figure out whether a trust is right for your planning needs; here, your financial advisors can help guide you in the right direction.

Why Create a Trust?

Trusts are popular estate planning tools because they can be used for many purposes, including:

Estate Planning

Trusts can provide control and flexibility over the distribution of assets, minimize estate taxes, and preserve assets for your children until they are grown (in case you should die while they are still minors). Trusts can also help avoid the expense and delay of probate, as they allow for the seamless transfer of assets to beneficiaries without the need for court involvement.

Asset Protection

Certain trusts can shield assets from potential creditors or legal claims. Placing assets in an irrevocable trust effectively removes them from your personal ownership, which makes them less vulnerable to financial liabilities or potential lawsuits. Trusts also allow you to set specific rules for distributing your assets, such as how much money a beneficiary can receive each year, an age when they can start to receive funds, or even how the funds can be used (e.g., for education only).

Tax Benefits

Creating a trust can shift part of your income tax burden to beneficiaries in lower tax brackets. Also, if certain conditions are met, assets placed in an irrevocable trust may be protected from estate tax after your death.

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Protection in Case of Illness or Disability

Living trusts can 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 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. Without a trust, a court could appoint a guardian to manage your property.

Charitable Giving

Charitable trusts allow you to support causes you care about while potentially enjoying tax benefits. These trusts can provide income for you or your beneficiaries during your lifetime, with the remaining assets designated for charitable organizations after your death.

What Are the Drawbacks of a Trust?

Be sure to discuss the pros and cons of setting up any trust with your attorney and financial professional. While there can be many advantages of this type of arrangement, consider these potential drawbacks as well:

- A trust can be expensive to set up and maintain—trustee fees, professional fees, and filing fees may need to 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.

What Are the Different Types of Trusts?

The type of trust you choose will depend on what you're trying to accomplish. In fact, you may need more than one type of trust to meet all your goals.

Living (Revocable) Trust

You create a living trust during your lifetime to maintain control over property such as your house, a boat, or investments. Assets that pass through a living trust are not subject to probate—they don't get treated like the property in your will. 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 opt for the trustee to hold the assets until a specific time, like when the beneficiary reaches a certain age.

Living trusts are appealing 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 the details of the trust documents unless you allow it.

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 Trust

Unlike a living trust, an irrevocable trust typically 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 can be a valuable tool for tax planning, asset protection, and charitable giving.

When you transfer assets into the trust (these must be 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. If you have given up control of the property, all of the property in the trust 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.

Testamentary Trust

A testamentary trust allows you to specify how your assets should be distributed and managed for your beneficiaries. It is created through a will and only takes effect upon the trustor's death. At that point, selected assets in your will be distributed into the trust. From that point on, these work very much like other trusts. The terms of the trust document control how the assets are managed and distributed to your heirs. Since you have a say in how the terms are written, these types of trusts give you a certain amount of control over how the assets are used, even after your death.

As always, we appreciate your trust in us and aim to help you figure out the best financial plan to help you meet your goals. If you have any questions about this article, please reach out to us via phone or email.

Authored in part by Commonwealth Financial Network and Broadridge.

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