Understanding Trust

Trusts are created by settlors (an individual along with his or her lawyer) who decide how to transfer parts or all of their assets to trustees. These trustees hold on to the assets for the beneficiaries of the trust. The rules of a trust depend on the terms on which it was built. In some areas, it is possible for older beneficiaries to become trustees. For example, in some jurisdictions, the grantor can be a lifetime beneficiary and a trustee at the same time. A trust can be used to determine how a person's money should be managed and distributed while that person is alive, or after their death. A trust helps avoid taxes and probate. It can protect assets from creditors, and it can dictate the terms of an inheritance for beneficiaries. The disadvantages of trusts are that they require time and money to create, and they cannot be easily revoked.

A trust is one way to provide for a beneficiary who is underage or has a mental disability that may impair his ability to manage finances. Once the beneficiary is deemed capable of managing his assets, he will receive possession of the trust.

Categories of Trusts

Although there are many different types of trusts, each fits into one or more of the following categories:

Living or Testamentary

A living trust – also called an inter-vivos trust – is a written document in which an individual's assets are provided as a trust for the individual's use and benefit during his lifetime. These assets are transferred to his beneficiaries at the time of the individual's death. The individual has a successor trustee who is in charge of transferring the assets. A testamentary trust, also called a will trust, specifies how the assets of an individual are designated after the individual's death.

Revocable or Irrevocable

A revocable trust can be changed or terminated by the trustor during his lifetime. An irrevocable trust, as the name implies, is one the trustor cannot change once it's established, or one that becomes irrevocable upon his death.

Living trusts can be revocable or irrevocable.
Testamentary trusts can only be irrevocable.
An irrevocable trust is usually more desirable.
The fact that it is unalterable, containing assets that have been permanently moved out of the trustor's possession, is what allows estate taxes to be minimized or avoided altogether.

Funded or Unfunded

A funded trust has assets put into it by the trustor during his lifetime. An unfunded trust consists only of the trust agreement with no funding. Unfunded trusts can become funded upon the trustor's death or remain unfunded. Since an unfunded trust exposes assets to many of the perils a trust is designed to avoid, ensuring proper funding is important.

Common Purposes for Trusts

The trust fund is an ancient instrument – dating back to feudal times, in fact – that is sometimes greeted with scorn, due to its association with the idle rich (as in the pejorative "trust fund baby"). But trusts are highly versatile vehicles that can protect assets and direct them into the right hands in the present and in the future, long after the original asset owner's death.
A trust is a legal entity employed to hold property, so the assets are generally safer than they would be with a family member. Even a relative with the best of intentions could face a lawsuit, divorce or other misfortune,

putting those assets at risk.

Though they seem geared primarily toward high net worth individuals and families, since they can be expensive to establish and maintain, those of more middle-class means may also find them useful – in ensuring care for a physically or mentally deficient dependent, for example.

Some individuals use trusts simply for privacy. The terms of a will may be public in some jurisdictions. The same conditions of a will may apply through a trust, and individuals who don't want their wills publicly posted opt for trusts instead.

Trusts can also be used for estate planning. Typically, the assets of a deceased individual are passed to the spouse and then equally divided to the surviving children. However, children who are under the legal age of 18 need to have trustees. The trustees only have control over the assets until the children reach adulthood.

Trusts can also be used for tax planning. In some cases, the tax consequences provided by using trusts are lower compared to other alternatives. As such, the usage of trusts has become a staple in tax planning for individuals and corporations.

Assets in a trust benefit from a step-up in basis, which can mean a substantial tax savings for the heirs who eventually inherit from the trust. By contrast, assets that are simply given away during the owner's lifetime typically carry his or her original cost basis.

Here's how the calculation works: Shares of stock that cost $5,000 when originally purchased, and that are worth $10,000 when the beneficiary of a trust inherits them, would have a basis of $10,000. Had the same beneficiary received them as a gift when the original owner was still alive, their basis would be $5,000. Later, if the shares were sold for $12,000, the person who inherited them from a trust would owe tax on a $2,000 gain, while someone who was given the shares would owe tax on a gain of $7,000. (Note that the step-up in basis applies to inherited assets in general, not just those that involve a trust.)

Finally, a person may create a trust to qualify for Medicaid and still preserve at least a portion of their wealth.