Trusts: what you need to know

Summary

Trusts sometimes get a bad rap.

Many people believe trusts are complicated documents designed for the super-rich so they can pass money from generation to generation, avoiding tax and public scrutiny.

That may be true for a small percentage of trusts. But trusts are not just for Warren Buffett and his friends. If you have even a modest amount owned outside retirement accounts, a trust may make sense for you.

What is a trust?

A trust is an agreement in which one party instructs another party how to distribute assets (money, investments or anything else of value) to a third party. All three parties can be the same, although they are usually set up so the donor (technically the “grantor”) can give instructions of where his or her wealth goes after he / she dies.
**Why isn’t a will good enough?**

Everyone should have a will. It provides instructions to your survivors on who you want to receive your financial assets and your “stuff”. Critically, for someone with children under 18, it also appoints a guardian if both a child’s parents pass away before the child is an adult.

For many people, a will is good enough, and there is no need for a trust. But a will goes through “probate” – the court-administered process to validate a will – which can take time, cost money and expose your financial condition to public record. For many people, avoiding probate makes sense. That’s when you need a trust.

**How can a trust help?**

A trust avoids probate for anything you put into it. Wills don’t control what’s in the trust. Specifically, a trust can help in a few common situations:

- **You have significant money outside your retirement accounts or insurance policies.** Retirement accounts (IRAs, 401k plans and the like) and insurance policies don’t go through probate. They have beneficiaries. So if almost all your money is in these accounts, you will avoid probate, and there is probably no need for a trust. But if you have significant money in brokerage accounts, a trust probably makes sense. Otherwise, the money will go through probate.

- **You expect your heirs will not live near you when you pass away.** Going through probate means going to court. The judge sets the schedule. If your heirs live far away, they won’t want to come to court and will be stuck hiring a lawyer and waiting, perhaps for 6-12 months or more, while the court reviews your will, determines whom you owe, hears any challenges and eventually distributes the money.

- **You like your privacy.** The court process is public record. Anyone can find out how much you have, whom you owe (creditors) and who will receive how much.

- **You are worried about challenges to your will.** Going through probate makes it easier for someone to challenge your will. Because a trust is private, it is more difficult for disgruntled relatives to get information and challenge your directives.
**How does a trust work?**

Most people with trusts have “revocable” trusts, also known as “living” trusts. They are the simplest trust. If you have a revocable trust, during your lifetime, you:

- Act as the trustee, or the person who controls the trust
- Have full access to whatever is in the trust – it’s your money
- Can “revoke” or cancel it anytime you want
- File taxes as if the trust doesn’t even exist, because the IRS knows you can cancel it at any time

The trust typically has instructions of what happens if you become incapacitated or when you pass away. It usually appoints a successor trustee to follow the trust’s instructions. It names beneficiaries, for example a spouse, children, charities, etc. It provides instructions for a trustee in the event you are not able to manage your own finances. It may have more detailed instructions, for example setting up successor trusts for children if you don’t want them to receive everything immediately at your passing.

**Control Issues**

*With a revocable or living trust, you give up no control. Because it is revocable, you can take everything back at any time during your life. Only when you die does the trust become “irrevocable”.*

**Setting up a revocable trust and making it work for you**

An estate planning attorney can set up a revocable trust within a few weeks, and the cost is usually not excessive – perhaps $1,000 - $2,000 for a basic trust, although it can be more expensive if you include complicated instructions or if you live in a higher cost area.

But, without a trust, if you pass away with significant assets that go through probate, your heirs will likely need to hire an attorney to handle probate. Those costs are likely to be higher.

Once you set up a trust, you should “fund it” – that is, put your financial assets in the trust. The process is simple, and your financial advisor can help. You simply set up new accounts in the name of the trust and move everything from your individual account to your trust account. You may also want to change ownership of other assets, for example, your house. That depends on the state. In some states, probate for a primary residence is so expedited that there is no need for your trust to own your house. By contrast, it will make a lot of sense for a second home to be in the trust, especially if it is in a different state. Otherwise, you will go through a separate probate process in that state.

Remember, your retirement accounts and insurance contracts do not go in the trust. You can make your trust a beneficiary. This can be complicated; speak with your financial advisor on the pros and cons.
Estate taxes and trusts

Estate taxes are federal (and, in some states, state) taxes due when you pass away. Currently (as of 2016), an individual will only owe federal estate tax if he/she has more than $5.45 mm in net worth at his/her death. Anything above that generates a federal tax bill of 40%. (The state thresholds are generally lower although most states don’t have an estate tax.). The $5.45 mm exemption is reduced by any gifts made during your lifetime.

A revocable trust does not avoid estate tax. That’s because, until your passing, assets in a revocable trust are identical to assets owned in your name.

There are complex strategies you can use to reduce or postpone estate tax if you may die with net worth above the $5.45 mm threshold.

Importantly, if you are married, you can give your spouse your assets, tax-free, and he/she can inherit your $5.45 mm exemption – assuming the survivor fills out an IRS form to make this election. Therefore, a married couple’s exemption is effectively almost $11 mm, and estate tax is only due on net worth above that amount.

Irrevocable trusts

Irrevocable trusts can make sense for families with significant wealth. Once you gift assets to an irrevocable trust, you no longer own them and cannot get them back – hence the term “irrevocable”. Some examples of when such a trust may make sense:

- You have enough money for your life. You can afford to give away some of your net worth.
- You have an investment that may appreciate significantly before you die. (Remember, gifts during your lifetime reduce the $5.45 mm exemption.) By giving it away now, instead of keeping it while it appreciates, the future growth will not be subject to estate tax at your death.
- You want to protect assets in the event you or your heirs are sued. You do not own assets in an irrevocable trust, so they could not be taken away even in a successful suit. When you pass away, you may have assets in your revocable trust go to an irrevocable trust for your children. That protects the assets during their lifetime, too. For example, in a divorce, your children’s ex-spouse typically could not claim anything in the irrevocable trust.