
# Four Reasons to Consider a Trust to Protect Your Assets

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For many years, trusts have been the province of the wealthy, mysterious vehicles used to escape taxes and preserve assets for future generations. And for couples with joint assets approaching or exceeding $10.68 million -- the current gift and estate tax exemption amount -- a comprehensive estate plan that incorporates trusts is crucial for minimizing estate taxes.

More recently, however, families with assets well below this threshold are using trusts to help them protect assets from creditors, manage and grow assets for future generations, and ensure that their assets ultimately are distributed in accordance with their wishes to their heirs.

In setting up a trust, an individual appoints a trustee (an individual, a corporate trust company, or both) to act as a surrogate to manage and distribute assets in accordance with his or her wishes when (i) the individual later is not able to do so directly (due to, for instance, death, disability, incapacity, or geographic unavailability) or (ii) the individual wishes to shield the assets from possible later creditors. The individual sets out instructions in a trust document and appoints a trustee to act in his or her absence on his or her behalf. In this way, the trust ensures the ongoing *preservation, protection, and control* of assets.

Let's consider some of the situations in which a trust can help someone control, protect, and preserve assets and address philanthropic goals.

*Allocating assets among family members*. Individuals often are concerned about leaving assets outright before heirs are ready to handle them. A child could dissipate assets too quickly, or lose assets in a later divorce. A spouse might remarry into a blended family. By placing assets in a trust, an individual can ensure that the assets are later distributed among family members in the time and manner intended.

- *Children:* Suppose you have children who are young or irresponsible and might squander assets they receive outright. You can instruct your trustee when to distribute income and principal to each child. Such instructions can be based on age or on a specified accomplishment (*e.g.,* college graduation). In this manner, you can seek to influence your children's behavior even after your death.

- *Future generations:* Suppose you wish to ensure that your assets remain available for future generations of your family, and that intervening generations do not squander assets to the detriment of generations that follow. For instance, if assets are left to a son, he might later give them to his wife, either voluntarily or in a later divorce, rather than leave them to your grandchildren. A dynasty trust ensures that each generation will receive sufficient income to live but be unable to divert remaining assets from future generations.

- *Surviving spouse*: Suppose you want to preserve your assets for your offspring in the event you predecease your spouse. If you leave your assets to your spouse outright, he or she will have the power to determine their later distribution, perhaps giving them to a prior or later spouse's offspring. By putting the assets in trust and providing for distributions to your spouse to maintain lifestyle, you can ensure that remaining assets go solely to your children. This planning can be particularly important if you have children from a prior marriage.

- *Education:* An education trust can set aside assets to be used solely for educating or your children or grandchildren.

- *Special needs child:* A special needs trust can be used to provide funds for an incapacitated child after the parent is no longer able to do so.

*Provide for professional management.* Individuals might be concerned that their heirs' lack of financial sophistication – or the heirs' divergent interests and needs -- will preclude the effective management of the assets. A trust allows an individual to ensure that assets continue to be managed properly and to grow.

- *Incapacity:* A trust can ensure that your assets are managed properly and your family's financial needs are met in the event you suddenly become incapacitated. By specifying elements of incapacity in the trust document, your family typically can avoid a lengthy court proceeding. Providing for a smooth transition in the event of incapacity is particularly important for non-financial assets, such as real estate or a family business, where ongoing management is crucial.

- *Unsophisticated investors:* Suppose your surviving spouse and/or your children are not sophisticated investors and will have difficulty managing assets to provide a reasonable return. By placing assets in trust, you can provide broad instructions as to how the assets are to be invested and identify a professional financial advisor to manage them.

- *Squabbling heirs:* Often heirs cannot agree on how to manage a family asset, such as a home or business. By putting the asset in a trust, you can appoint a trustee to manage the asset and distribute income to your heirs per your instructions, helping to preserve family unity.

- *Shifting fiduciary duty:* Naming one of your children to administer assets for all your children could expose the managing child to a suit by the others for breach of fiduciary duty if they do not approve of his or her actions. Naming a professional manager alleviates this concern by shifting the management duties away from a family member.

*Preserve assets.* Individuals in certain professions or businesses often are concerned that they might lose assets to creditors rather than preserve the assets for family members. Assets held in trust frequently are beyond the reach of creditors, allowing the assets to be preserved for heirs.

- *Creditor protection:* Suppose you are a professional (such as a doctor) who might be sued for alleged mistakes. Or you are concerned that your business operations could expose you to financial risk in the event of an economic downturn. By placing your assets in trust before the actions giving rise to a suit or downturn occur, you can shield the assets from future creditors.

- *Children:* Suppose your child has incurred significant debt, or you are concerned your child may do so in the future. Assets placed in trust for the child's benefit are kept out of the reach of creditors seeking to collect on debts the child has incurred. A trusteed IRA program is designed to provide the same protection for your qualified assets.

- *Divorce protection:* Placing assets in trust in some circumstances may shield the assets from split upon a later divorce property settlement.

*Facilitate philanthropy*. Individuals might wish to donate the bulk of their assets to a charity, but still provide needed income for family members and heirs. A charitable trust can accomplish these goals.

- Suppose you want to ensure that a portion of your assets goes to a charity, either during your life or upon your death (or both), while still providing income to you or your dependents. You can achieve this result by putting your assets in a charitable trust. Properly structured, a charitable trust also can provide immediate benefits, such as an income tax deduction for contributions to charity, and tax-free growth for future investment income.

*Revocable vs. Irrevocable Trusts*

A trust can be either "revocable" or "irrevocable". An individual placing assets in an irrevocable trust cannot later reclaim the assets or make significant changes to their disposition. Thus, the donor must be comfortable with the arrangement at the time assets are placed in the trust. In contrast, a revocable trust can be changed at any time as long as the individual setting up the trust is alive and healthy. Upon the individual's death or incapacity, the trust becomes irrevocable.

Which trust makes sense depends on the particular situation. Many individuals prefer the flexibility of the revocable trust. However, an irrevocable trust often is necessary for certain functions, such as estate tax minimization or asset protection.

In choosing the type of trust, there are other considerations to keep in mind:

- *State taxes.* For purposes of applying their state inheritance tax, some states have adopted – or have suggested they will adopt -- a gift tax exemption amount below the federal exemption of $5.34 million. Thus it is important to consider state tax consequences before undertaking any gift or estate plan. For states with lower exemptions, use of an irrevocable trust can help minimize state taxes.

- *Tax on trust income.* Investment income earned within a revocable trust typically is taxed at the donor's tax rate. Virtually all investment income earned within most irrevocable trusts, however, is taxed at the highest tax rate. Taking into account all surtaxes, that tax rate currently is 23.8% on dividend income and long-term capital gains and 43.4% on other types of investment income. To achieve both estate tax and income tax efficiencies an irrevocable trust should invest in assets that generate income exempt from tax or taxed at low rates. For this reason, life insurance can be a good investment within an irrevocable trust. When investing trust assets, a professional management strategy that seeks to enhance after-tax return by balancing investment and tax considerations is exceedingly important.

- *Stepped-up basis.* In most cases, when a donor gifts an appreciated asset to an individual or an irrevocable trust during his or her lifetime, the recipient assumes the donor's basis in that asset. Thus, the recipient will be taxed on any appreciation when the asset is later sold. By way of contrast, most assets transferred at death (including through a revocable trust) receive a "stepped-up" basis, relieving the heir of income tax on existing appreciation upon a later sale. Thus, the benefits of placing assets in an irrevocable trust during life must be balanced against the additional income tax a recipient might pay when the gifted asset is later sold.

Choosing between an irrevocable and revocable trust can be critical depending on the circumstances. For this reason (and others, including tax minimization and effective creditor protection), it is important to consult with a qualified attorney when establishing a trust, gifting assets, or considering any of the techniques described in this paper. Individuals establishing trusts also should retain a qualified professional fiduciary to assist in managing and administering the trust and directing the investment of trust assets.

## *Conclusion*

A comprehensive estate plan, which typically involves the use of trusts, is crucial for couples with joint assets approaching or exceeding $10 million. But trusts also are important for couples or individuals with fewer assets, allowing them to protect assets from creditors, manage and grow the assets effectively, and distribute the assets to heirs or charities in accordance with their wishes when they are no longer able to do so themselves.

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