What Is a Trust Fund and How Does It Work?

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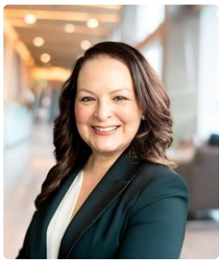

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What Is a Trust Fund?

A trust fund is an estate planning tool that is a legal entity that holds property or assets for a person or organization. Trust funds can hold a variety of assets, such as money, real property, stocks, bonds, a business, or a combination of many different types of properties or assets.

Three parties are required in order to establish a trust fund: the grantor, the beneficiary, and the trustee. Trust funds are managed by the trustee who must act for the benefit of the grantor and beneficiary.

Trust funds can take many forms and can be established under different stipulations. They offer certain tax benefits as well as financial protections and support for those involved.

KEY TAKEAWAYS

- A trust fund is designed to hold and manage assets on someone else's behalf, with the help of a neutral third party.
- Trust funds include a grantor, beneficiary, and trustee.
- The grantor of a trust fund can set terms for the way assets are to be held, gathered, or distributed.
- The trustee manages the fund's assets and executes its directives, while the beneficiary receives the assets or other benefits from the fund.
- Trust funds can be revocable and irrevocable, and there are several variations that exist for specific purposes.

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How Trust Funds Work

Estate planning is a process that involves determining how an individual's assets and other financial affairs will be managed and how any property they have is distributed after they die. This includes any bank accounts, investments, personal property, real estate, life insurance, artwork, and debt. While wills are the most common estate planning tools, trust funds are also popular legal entities. Laws governing trust funds vary by the country of residency and creation.

The following three parties are involved in establishing a trust fund:

- The grantor, who sets it up and populates it with their assets
- The beneficiary(s) or the person (people) for whom the assets are managed
- The trustee, who is a neutral third party (an individual, a trust bank, or another professional fiduciary) charged with managing the assets involved

The grantor generally creates an arrangement that, for a variety of reasons, is carried out after they are no longer mentally competent or alive. As the appointed fiduciary, the trustee is responsible for carrying out the interests of the grantor. This usually includes allocating living expenses or even educational expenses, such as private school or college expenses, while they are alive. Or they can pay out a lump sum directly to the beneficiary.

Trust funds provide certain benefits and protections for those who create them and to their beneficiaries. For instance:

- Some types can keep assets held away from any creditors in the event they decide to pursue the grantor for unpaid debts.
- They avoid the need to go through probate, which is the process of analyzing and distributing assets after someone dies without leaving any instructions behind.
- Some trust funds can reduce the amount of estate and inheritance taxes owed after the grantor dies, after which the assets are distributed to the beneficiary(s).
- Trusts can be named the beneficiary of an individual retirement account (IRA) but will be subject to accelerated withdrawal requirements and shortcircuit spousal inheritance provisions.

Important: An estate tax is levied on the value of an estate after the grantor dies while inheritance taxes are applied to the total amount a beneficiary inherits from an estate.

Special Considerations

Wealth and family arrangements can grow quite complicated when millions (or even billions) of dollars are at stake for multiple generations of a family or other entity. As such, a trust fund can contain a surprisingly complex array of options and specifications to suit the needs of a grantor.

But contrary to what most people believe, trust funds aren't just for the ultra-rich. In fact, they can be useful for just about anyone regardless of their financial situation. Discuss your needs with a financial professional to find out what kind of fund is well-suited for you and your personal needs.

Revocable Trust Funds vs. Irrevocable Trust Funds

Trust funds fall into two different categories: Revocable and irrevocable trust funds. The following are brief descriptions of the two.

Revocable Trust Fund

A revocable trust fund gives a grantor better control over assets during the grantor's lifetime. Once assets are placed into it, they can be transferred to any number of designated beneficiaries after the grantor's death. Also called a living trust fund, it can be used to transfer assets to children or grandchildren.

The primary benefit is that the assets avoid probate, which leads to the quick distribution of assets to the listed beneficiaries. Living trust funds are not made public, meaning an estate is distributed with a high level of privacy.

Changes can be made while the grantor is alive and it can also be entirely revoked prior to the grantor's death.

Irrevocable Trust Fund

An irrevocable trust fund is very difficult to change or revoke. Because of this arrangement, there can be considerable tax benefits for the grantor to effectively give away control of the assets to the trust fund. Irrevocable trust funds most often avoid probate.

Types of Trust Funds

Revocable and irrevocable trust arrangements can be further classified into several types of trust funds. These types often have different rules and stipulations depending on the assets involved and, more importantly, the beneficiary. A tax or a trust attorney may be your best resource for understanding the intricacies of each of these vehicles. Keep in mind that this isn't an exhaustive list.

- **Asset Protection:** This fund protects a person's assets from their creditors' future claims.
- **Blind:** This fund tries to remove any hint of conflict of interest. As such, the trust fund's grantor and beneficiary have no knowledge of the holdings or how they are managed. It does, however, give control to the trustee.
- **Charitable:** A charitable trust fund benefits a particular charity or the general public. This includes a Charitable Remainder Annuity Trust (CRAT) that pays a fixed amount each year. A Charitable Remainder Unitrust passes assets to a specified charity once the fund expires, and gives the donor a charitable deduction as well as a fixed percentage of income to the beneficiary during the life of the trust fund.
- **Generation-Skipping:** This one contains tax benefits when the beneficiary is one of the grantor's grandchildren, or anyone at least 37½ years younger than the grantor.
- **Grantor Retained Annuity:** Establishing this type of fund allows the grantor to transfer any appreciation of assets to any beneficiaries to minimize estate taxes.
- **Individual Retirement Account:** Trustees control IRA distributions rather than the beneficiaries.
- **Land:** This allows for the management of property, such as land, a home, or another type of real estate.
- **Marital:** This is funded at one spouse's death and is eligible for the unlimited marital deduction.
- **Medicaid:** Designed to allow individuals to set aside assets as gifts to their beneficiaries, this allows the grantor to qualify for long-term care under Medicaid.
- **Qualified Personal Residence:** An individual can move their personal residence from their estate to this type of fund in order to reduce the amount of gift tax incurred.
- **Qualified Terminable Interest Property:** This one benefits a surviving spouse but allows the grantor to make decisions after the surviving spouse's passing.
- **Special Needs:** People who receive government benefits are the beneficiaries so as not to disqualify the beneficiary from such government benefits.
- **Spendthrift:** Beneficiaries don't have direct access to the named assets, which means they can't sell, spend, or give away the assets without specific stipulations.
- **Testamentary:** This fund leaves assets to a beneficiary with specific instructions following the grantor's passing.

What Is a Trust Fund Baby?

A trust fund baby is someone whose parents set up a trust fund in their name. The term is a popular cultural reference that is often used negatively. When people use the expression, there's an implication that beneficiaries are born with silver spoons in their mouths, are overly privileged, and don't have to work to live.

It's true that trust funds can provide beneficiaries with security. But in reality, many so-called trust fund babies don't live luxuriously or in high society.

How Do Trust Funds Work?

Trust funds are legal entities that provide financial, tax, and legal protections for individuals. They require a grantor, who sets it up, one or more beneficiaries, who receive the assets when the grantor dies, and the trustee, who manages it and distributes the assets at a later date.

Trust funds are designed to carry out the wishes of the grantor. This means that the trustee is in charge of managing the assets while they are still alive. After their passing, the trustee can pass on the assets to the beneficiary(s) as per the grantor's instructions, whether that's through a regular income stream or a lump sum payment.

How Do I Start a Trust Fund?

In order to set up a trust fund, you'll need to figure out which one is best suited for you, so make sure you figure out the exact purpose of the fund. Then, decide how you'll fund it. Figure out who you want to appoint as your trustee. This person may be able to help you draft up all the documents and go through the legal process. The final step is to fund the trust fund.

As with any other financial venture, make sure a trust fund is the best choice for you, your beneficiary, and your financial situation. Also, the country you live in will regulate how to set up a trust and the types of trust allowed.