Estate Planning Series # 5

TRUSTS: Definitions, Types, and Taxation

Prepared By: Robert D. Anderson, CFP®, Extension Educator, Farm Management
Gary A. Hachfeld, Regional Extension Educator, Ag Business Management
Erlin Weness, Professor Emeritus

11/2003

What Is A Trust?

A trust can provide a means to hold and manage property. It can be custom designed for your situation. A trust is usually established to empower someone else (trustee) to manage and care for your property for the benefit of your family (beneficiaries).

A trust must have three elements: (1) property, (2) a trustee and (3) beneficiaries.

Any type of property such as cash, personal property or real estate, can be placed in a trust. The decision as to which assets you place in trust will depend upon your overall plan and objectives. Transferring assets to a trust is a formal process and title assets must be changed from individual ownership to trust ownership.

The trustee is the individual or individuals, bank, or trust company you name as caretaker of the trust. The trustee holds and manages the property in accordance with the guidelines in the trust instrument. The trustee is usually paid for their services. However, family trustees often serve without compensation. A trustee should be someone you trust to serve well after you are gone. They should be astute in business matters and have high ethics.

The beneficiaries are the people for whom the property is managed. They receive annual earnings distributions and eventually will receive the entire trust principal "corpus" when the trust is terminated.

The trust instrument is an important document. Its creation and content should be carefully thought out so all contingencies that could arise, regarding you or your beneficiaries, are covered. The trust instrument is a complete set of guidelines for operation of the trust. A person can be very flexible in the design of his/her trust.

The trust instrument may specify the powers, responsibilities, and latitude of the trustee. The trust instrument also directs paying out of trust income to beneficiaries and lists instructions as to timing of final distribution and trust termination. Extreme care should be taken to design the trust so that it accomplishes the objectives of the individual setting up the trust (grantor).

Trusts are used mainly to manage property for minors, elderly persons, and handicapped people. Trusts are also used to manage property for a surviving spouse who prefers to have someone else (trustee) manage the assets. A trust may also be used to leave someone a limited interest in property. Perhaps a wife may wish to leave a life estate in certain property to her husband with eventual ownership going to her children. Trusts can also be setup to reduce the size of an estate or cut estate and probate costs.

Types of Trusts:

There are two types of trusts, living trusts and testamentary trusts.

Living trusts are set up during the grantor's lifetime and may continue after death. A living trust can be either a revocable trust (changeable anytime) or an irrevocable trust (once established cannot be revoked or changed). Living trusts are often set up to avoid probate costs at death, since living trust assets do not need to be probated. Unlike a will, living trust assets are not subject to public disclosure during and after the probate process. A living trust can be useful in providing management through a trustee for older family members as they advance in age.

Individuals who use the revocable living trust (RLT), transfer title of their property into the trust. They, as grantor, appoint themselves as the trustee (manager of the trust) and the beneficiary (receiver of the income). To set up a living trust, they transfer the title of their assets into the trust from themselves as an individual, to themselves as trustee of the trust. No income taxes are due on this transfer. The RLT is used often. See Estate Planning Series # 6 entitled *Revocable Living Trust.*

Irrevocable living trusts are designed mainly to save estate taxes. If the grantor is not the trustee or beneficiary and has no control over the trust assets or their ultimate disposition, the trust assets will generally not be included in the grantor's estate. Irrevocable trusts may also reduce probate costs since assets put into it are treated as a gift and are removed from the estate of the grantor. Creating an irrevocable trust may have gift tax ramifications if the gift exceeds the annually allowed gift amounts.

A testamentary trust is set up in a will and becomes effective at death. These trusts do not save probate fees or estate taxes. The main purpose of testamentary trusts is to reduce estate taxes but preserve income to the surviving spouse by passing assets to children in a “credit shelter trust,” or to establish a "marital deduction" trust for the surviving spouse.

A charitable remainder trust (CRT) can be established to transfer assets to a charity yet retain an income stream during your and your spouse’s lifetime. At the death of the surviving spouse, or the end of the life of the trust, the property passes to the charity. The value of the remainder interest is deductible for income tax purposes in the year of the gift.

Example: Tom and Mary set up a Charitable Remainder Trust for their church and gift to the trust farmland worth $100,000. In exchange they receive a $5000 annual lifetime payment for 20 years. The church may collect the rents from the farm or sell it and invest the proceeds. At the end of the 20-year period, the church gets the farmland or the proceeds of the sale, and is released from any further obligation. Tom and Mary get a tax deduction in the initial year of the gift. The amount will depend on the value of the remainder interest.

There are several other trusts that may be useful in estate planning. The life insurance trust, the generation skipping trust, and others may offer possibilities for estate planning. Before choosing a trust, thoroughly investigate its ramifications and seek good legal counsel when drafting your trust.

Taxation of Trusts:

Simple trusts are required to distribute all of their income to the beneficiaries. The beneficiaries pay the income tax on their share of trust income. Complex trusts may themselves pay taxes on undistributed income. This income is reported on Form 1041, U.S. Income Tax Return for Estates and Trusts.

Current tax rates are:

Tax Rate	Income
15%	$ 0-1,850
27%	$1,850-4,400
30%	$ 4,400-6,750
35%	$ 6,750-9,200
38.6%	over $9,200

Most trusts distribute all income to avoid the high taxation rates. However, if all income from a revocable living trust goes to the grantor, and if the grantor is also the trustee, no additional income tax forms are required. All income from the revocable living trust is shown on the grantor's income tax return. If the grantor is not the trustee and beneficiary, the trust must file Form 1041, and obtain an Employer Identification Number for the trust.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.