Evaluating Your Estate Plan: Trusts as an Estate Planning Tool

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This article is a basic overview of concepts related to trusts as estate planning tools and is intended to give individuals points to consider as they engage in the estate planning process. Do not consider this article to be exhaustive as the intricacies of trust law are quite complex and will vary with each individual situation. This article is considered educational in nature and should not be considered legal advice. Consult with qualified legal and tax professionals who can provide expert advice on specific needs.

The trust is a useful and flexible estate planning tool, yet it is probably the most underused estate management technique. A trust is an artificial entity, something like a corporation, created by a document or instrument.

A trust requires four basic elements – trustee, trust property, trust document, and known or discernible beneficiaries. The trust document specifies the rules of operation for the trust, the powers of the trustee, the beneficiaries to share in the income and principle from the trust, and instructions for distribution of the trust property.

How is a Trust Created?

A trust is created by means of a legal document known as a **trust agreement**. A person who creates a trust may legally be referred to as a **grantor, settler, or trustor**. This document contains the instructions regarding management of the trust assets, how the assets are to be distributed from the trust, and further instructions regarding what happens to the trust if the person who created the trust becomes incompetent or dies. This may include distribution of assets to trust beneficiaries and termination of the trust. **Beneficiaries** of the trust are also named in the trust agreement and may include the individual who established the trust, spouse, relatives, friends, churches, or charities.

How is a Trust Funded?

An individual who creates a trust must take steps to change the title of ownership for each asset that will be placed in the trust from the individual's name to the name of the trust. This process is known as **funding the trust**. It is not uncommon for individuals to execute the paperwork necessary to establish a trust but fail to complete and maintain the process of *funding the trust*. Assets held jointly (such as joint tenants with rights of survivorship or tenants in common) cannot be owned by the trust unless the joint ownership is severed. Other types of property, such as cash, personal property, or real estate, can be placed in a trust.

Who Manages the Trust?

Trust assets are managed by a **trustee**, according to the instructions contained in the trust document. The trustee can be the person who set up the trust (the grantor), or a corporate entity (bank or trust company), another family member, friend, or a combination of these.

The trustee must maintain a high degree of responsibility, known as **fiduciary care**. A trustee cannot make risky, speculative investments outside of the instructions outlined within the trust agreement, and may be held personally responsible for trust losses.

The trustee's duties include receipt and management of the trust assets, collection of income, accounting, tax reporting and payments, and investment and income distributions according to the trust agreement. The trustee or grantor can maintain full control of the trust until the trustee's death or incompetency. At this point, a successor trustee takes over and follows the instructions contained in the trust document.

What Does it Cost to Establish and Maintain a Trust?

Trusts are sometimes promoted as a tool to avoid the costs of the probate process. However, the costs to establish a trust will likely exceed the costs of drafting a will. Note also that while trust assets are not included in a probate process, when the property is transferred to and titled in the trust, there are fees related to trust management and administration. While a family member serving

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as a trustee may waive the fees, most non-family members, banks, and trust companies will charge fees for property management. Fees may vary according to the type of property being managed. For example, if the trust owns farm land, a trustee may claim a farm manager's fee (such as 10% of gross income). Trusts made up of corporate stocks, bonds, or other investments requiring oversight may be subject to an annual management fee (.05% to 2% of the property in the trust, depending on the dollar value of the trust). There may be a minimum annual fee. In any event, it is important to consider the trust management fees over the lifetime of the trust as well as trust administration fees at the time of a trustee's death in comparison to the costs of probate.

Do I Need a Trust?

Trusts are a tool in the estate planning toolbox, but are not necessary for everyone. The process of estate planning involves an evaluation of whether a trust is useful in particular circumstances. The first step is to identify and value estate assets. Next, each person must determine when transfer to another individual is desired, which may be during lifetime, at death, or at another future date. Lifetime gifting may be appropriate for a variety of purposes, and a trust is not necessary for that process. However, an individual who wishes to gift an asset (such as farmland) but retain lifetime income could use a retained life estate, but a trust may also accomplish that purpose. If future generations are part of the plan – such as transferring farm income to children, and the farmland to grandchildren, this process may be accomplished via a granted life estate or through a trust document. These examples illustrate that where estates are larger in value, more complicated and involve multiple generations, the more likely it is that a trust could be a useful tool. Other situations may include protection of assets from a spendthrift heir or in-laws. When second marriages occur involving children or other heirs from prior marriages, a trust may be able to carve out plans for those situations. While substitute decision-making tools (such as powers of attorney) may be used to provide for subsequent management in the event of incompetency, a trust may also facilitate smooth transitions in management when the trustee becomes incompetent or no longer wants to manage the trust.

What Are the Main Types of Trusts?

The two main types of trusts are **living** (or **inter-vivos**) trusts and **testamentary** trusts. A living trust is established by a living person, while a testamentary trust is established in a will and comes into being at the time of death under certain circumstances.

A testamentary trust is established in a will and comes into being at the time of death under certain circumstances. An example of a common testamentary trust is one that is established upon the death of both parents of minor children for the purposes of funding needs for welfare, health and education of the children until a future date when the trust is dissolved after those purposes are achieved.

A living trust is established by a living person and there are two main types of living trusts: **revocable** and **irrevocable**.

A **revocable trust** transfers property ownership into the trust but retains to the grantor the power to alter, amend, or terminate the trust. A typical revocable trust arrangement provides that the grantor receives the income for the grantor's remaining life, with distributions to beneficiaries (spouse, children, grandchildren, etc.) at death.

A revocable trust does not save estate or inheritance taxes. Retention of control over the trust subjects the property to the federal estate and state inheritance tax, where applicable. See Information Files C4-24, Federal Estate Taxes (www.extension.iastate.edu/agdm/wholefarm/pdf/c4-24.pdf) and C4-25, Iowa Inheritance Tax (www.extension.iastate.edu/agdm/wholefarm/pdf/c4-25.pdf). Because the revocable trust is subject to state inheritance tax, the property becomes part of the estate for the purpose of figuring attorney's and executor's fees if probate of the estate is necessary. If all or most of a decedent's property is included in

a revocable living trust at death, a simplified form of probate may be possible with potential reduction of estate settlement costs. Since it is included in the estate it would get a new tax basis.

An **irrevocable trust** cannot be altered, amended, or terminated by the grantor. The property transfer is complete without retention of powers over the trust or its property. A completed transfer of property is made, subject to gift tax considerations, and the value of the irrevocable trust is not subject to federal estate tax, attorney's fees, or executor's fees. If property was transferred to an irrevocable trust within three years of death, the value would be subject to state inheritance tax. In general, property transferred by gift is not included in the gross estate for federal estate tax purposes even though the gift occurred within three years of death. Irrevocable trusts are used rarely because few people are willing to give up complete control over their property during life. Since assets in an irrevocable trust are usually not included in the estate they do not get a new tax basis.

Other Common Types of Trusts

Credit Shelter Trust (Bypass Trust or Family Trust)

This type of trust may be established in a will wherein a decedent's will bequeaths an amount to a trust up to, but not exceeding, the amount that would maximize the use of the unified credit for federal estate tax. The remainder of the estate passes tax-free to a surviving spouse. Once in the bypass trust those assets are free from estate tax and could grow free from federal estate tax.

Generation-Skipping Trust (Dynasty Trust)

This trust allows an individual to transfer a substantial amount of money tax-free to beneficiaries who are at least two generations removed – typically grandchildren. The trust can provide income to the children during their lives. Successive life estates may be created for family members in succeeding generations. Because the children do not own the assets in the trust, property held in a granted life estate is not taxable in the estate of the deceased life tenant for federal estate tax purposes. Such a trust may be a useful tool for children lacking good money management skills or involved in issues related to creditors or divorce. It may be possible to skip more than one generation. Life insurance may also be a component in the trust. For generation-skipping transfers, a generation-skipping transfer tax is generally imposed at the highest federal estate and gift tax rate (presently 40%). However, an exemption is provided for generation-skipping transfers of $11,580,000 per transferor (2020). Special use valuation for land is available in calculating the generation-skipping tax for direct skips. If Congress does not act, the tax laws revert to a $5 million (adjusted for inflation) exemption and a top marginal rate of 55% in 2026. The **federal estate tax exemption** for 2021 decedents will increase to $11.7 million per person or $23.4 million per married couple.

Qualified Personal Residence Trust

This trust is useful for removing the value of a primary residence or vacation home from the estate. This may be useful if a home is likely to appreciate in value and there is a preference to avoid the sale and use of the capital gains tax credit ($250,000 individual, $500,000 for couples, as long as the house was used as the primary residence for at least two of the five years ending with the date of sale). The estate tax attributes are different for a Qualified Personal Residence Trust as compared to a Personal Residence Trust and a qualified tax professional should be consulted.

Irrevocable Life Insurance Trust

This type of trust is used to remove life insurance from the estate, help in paying estate tax, or provide cash to beneficiaries for other purposes. The policy must be owned by the trust and the former owner must surrender ownership rights (such as borrowing against the policy or changing beneficiaries). The beneficiaries receive tax free income. Transferring an existing policy is subject to a three-year look-back period.

Crummey Trust

This type of trust is used to give property to minors and maintain control after they turn age 18. The trust is set up and often funded with annual cash contributions. The concept is to take advantage of the annual gift exclusion ($15,000 for individuals or $30,000 for couples in 2020) by meeting the requirement that it be a gift of "present interest" yet tying up the property until the children are allowed to receive the property, possibly upon attaining several different ages. When funded, the minors have 30 days to claim the gift. However, the minor is instructed that the gifts will end if claimed.

Qualified Terminal Interest Property Trust (Q-TIP)

A Q-TIP trust may be useful in families with divorces, remarriages, or step-children when there is a desire to direct assets to a particular beneficiary. For example, the surviving spouse would receive the income from the trust, but the beneficiaries (children from a first marriage) would receive the principle or the remainder after a surviving spouse dies. The assets would not be included in the grantor's estate but it would be included in the surviving spouse's estate.

Special Needs Trust

These trusts, sometimes referred to as "Supplemental Needs Trusts," are established to provide for the needs of a disabled individual. Such a trust is often designed to allow coordination with government programs so the individual remains eligible for benefits.

Charitable Remainder Trust

This trust allows the grantor to make a charitable gift and still retain an income stream from the gift. The trust can be set up to provide an income stream for a period of years based on the grantor's life or the life of a beneficiary. At the end of the term the remaining assets go to benefit the designated charity. For example, donated land can be retained until the grantor's death and then the beneficiary would receive an income stream. It is possible to donate other assets such as machinery or grain inventories. An income tax deduction may be possible and the deduction may possibly be carried forward five years. Charitable Remainder Unit Trusts pay out a fixed percentage while a Charitable Remainder Annuity trust pays out a fixed dollar amount.

Additional Resources

Iowa State University Ag Decision Maker – Transition and Estate Planning, www.extension.iastate.edu/agdm/wdbusiness.html

Iowa State University Center for Agricultural Law & Taxation, www.calt.iastate.edu

Estate Planning, University of Minnesota Extension, https://extension.umn.edu/business/transfer-and-estate-planning

Revocable Living Trusts – Publication No. MT199612HR, Montana State University Extension, http://msuextension.org/publications/FamilyFinancialManagement/MT199612HR.pdf

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