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Trusts: Definitions, Types, and Taxation

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What Is A Trust?

A trust can provide a means to hold and manage property. Think of a trust as a bucket into which you place all of your assets. It can be custom designed for your situation. A trust is usually established to empower a trustee to manage and care for your property for the benefit of you or your family, the beneficiaries. You can name yourself or someone else as trustee, depending upon the type of trust.

A trust has basically four elements: (1) a trustee, (2) trust property, (3) instructions and (4) beneficiaries.

Any type of property such as cash, personal property or real estate, can be placed in a trust. Transferring assets to a trust is a formal process and titled assets must be changed from individual ownership to trust ownership. This is referred to as "funding the trust" and is a critical part of the process.

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 you write into the trust instrument. The trustee can be paid for their services. However, family trustees often serve without compensation. A trustee should be someone you trust to serve in that capacity if you are disabled, incapacitated or after your death. They should be astute in business matters and have high ethics.

The beneficiaries are the people for whom the property is managed. They can 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 the beneficiaries are planned for. The trust instrument is a complete set of guidelines for the 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, 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 and goals of the individual (grantor) establishing the trust.

Trusts are used for many purposes including the management of assets for minors, elderly persons, or handicapped persons, as well as protecting assets from law suits and other adverse actions. 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 or to transfer a farm business. Trusts can also be established to reduce the size of an estate or to minimize estate and probate costs.

Types of Trusts:

There are two main types of trusts: living trusts and testamentary trusts.

Living trusts are established during the grantor's lifetime and may continue after death. A living trust can be either a Revocable Living Trust (changeable) or an Irrevocable Trust (unchangeable). 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 trust "administrative" process. A living trust can be useful in providing management through a trustee for older family members as they advance in age or for anyone who may be disabled or incapacitated.

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 and/or assets). 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. In addition, the assets in the trust are still under your control and remain as part of your estate. Therefore, the trust assets receive a stepped up tax basis upon your death. Placing assets into a "protective trust" in the form of "lifetime trust shares" within the RLT can protect those assets from lawsuits and other adverse actions when the assets pass to the heirs. Upon the death of the trust grantor, the RLT becomes an irrevocable trust and requires its own IRS tax ID number. See *Estate Planning Series #5-Revocable Living Trusts*.

An Irrevocable Trust (IT) is designed mainly to save estate taxes. The grantor is neither the trustee nor beneficiary and therefore has no control over the trust assets or their ultimate disposition. The trust assets will not be included in the grantor's estate and therefore do not receive a stepped up tax basis. Irrevocable trusts may also reduce probate costs since assets put into the trust are treated as a gift and are removed from the estate of the grantor. Creating an IT may have gift tax ramifications if the gift exceeds the annually exclusion amounts. All rules regarding the IT must be followed. Any access by the grantor to the assets in the trust violates the rules and the trust is no longer irrevocable. In Minnesota, any IT put into place after July 1, 2005 is considered to be a RLT. If Medicaid/Medical Assistance payments were made, the state can go to the IT for reimbursement of those payment amounts. Check with a qualified attorney to insure that the document you draft is a true IT.

Testamentary trusts are established within a Will and become effective at death. These trusts do not save probate fees because upon the first death, the Will directs the estate to probate and this then establishes the trust. The main purpose of a testamentary trust is to reduce estate taxes and preserve income for the surviving spouse. This process can keep asset amounts below the Applicable Exclusion amounts, thus reducing or eliminating estate taxes.

A Charitable Remainder Trust (CRT) can be established to transfer assets to a charity while retaining an income stream during your lifetime and your spouse's lifetime, much like an annuity. Upon 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 \$400,000. In exchange they receive a \$20,000 annual payment for 20 years. The church may collect the rents from the land 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 to Tom & Mary. 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 any 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 2009 federal tax rates are:

<u>Income</u>	<u>Tax</u>
\$0 - 2,300	15% of taxable income
\$2,300 - 5,350	\$345 plus 25% over \$2,300
\$5,350 - 8,200	\$1,107.50 plus 28% over \$5,350
\$8,200 - 11,150	\$1,905.50 plus 33% over \$8,200
Over \$11,150	\$2,879 plus 35% over \$11,150

Most trusts distribute all income to avoid the high taxation rates. However, if all income from a RLT goes to the grantor, and if the grantor is also the trustee, no additional income tax forms are required. All income from the RLT 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.

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