

Trusts

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Trusts are flexible and useful tools in estate planning and can be designed in a number of ways. They can help families meet various estate planning objectives, such as reducing probate costs, providing property management for a surviving spouse or children, giving children their inheritance during a period of time, providing for the incapacity of oneself or others, reducing estate taxes or contributing to a charity.

What is a trust?

A trust is a form of property ownership under which the benefits of owning property—real or personal (tangible or intangible)—are separated from the responsibilities of ownership. In other words, a trust is an arrangement whereby someone holds legal title to and manages property for the benefit of someone else. The law recognizes a trust as an artificial being generally created by a written document or instrument. Although not recommended, a person can create an oral, nonwritten trust for personal property simply by declaring that the property is being held in trust for the benefit of someone. However, trusts involving real property or that are created in a will must be based on written instructions.

Trusts can be simple or complex. Generally, the more complex the trust and the higher the value of the property in the trust, the greater the legal and other fees involved in establishing the trust.

Elements

Trusts require five basic elements: a grantor, a trust agreement, a trustee, property for the trust to manage and beneficiaries.

Grantor

The **grantor** is the person setting up the trust; sometimes this person is referred to as the settlor or trustor.

Trust instrument

The **trust agreement** is a set of instructions that specifies the rules of operation of the trust, the powers of the trustee (the person or firm managing

the trust), and how the beneficiaries will share the income generated by the trust and the principal remaining at the time of the ultimate distribution of the property.

The law allows the person making the trust to write into it almost any directions, conditions and restrictions desired. The grantor may give the trustee broad and sweeping powers, such as those that might be needed if the trustee is to manage a farm or other business, or leave the trustee very little room for decision making. This is one area where careful thought and planning are a "must" because the consequences of a mistake could be long-term.

Generally, trusts can continue for any specified period of time, such as a lifetime, until a child reaches a specific age or until a spouse remarries. However, a rule prohibits trusts from continuing "in perpetuity." Consequently, an ultimate or final distribution of the property is needed when the trust comes to its end.

Trustee

The *trustee* is the manager of the trust. He, she or it receives the property, invests capital if necessary, collects the income, handles the accounting, pays taxes due and reinvests or distributes income according to the rules developed by the grantor in the trust instrument. The trustee has no personal ownership or rights in the property, but holds title to the trust property and ultimately distributes the principal to the beneficiaries in accordance with the trust instrument. Clearly, the selection of a trustee is an important decision.

A trustee can be an adult, a bank with trust authority or a trust company. A trust can have multiple trustees. Nonfamily members, banks and trust companies who serve as trustees normally charge a fee for their services. Family members typically waive any fees. Fees vary according to the type and value of the property being managed, with a common annual fee ranging from three-fourths

of 1 percent to 1 percent of the value of the trust property.

A high degree of "fiduciary" responsibility is imposed upon a trustee. The trustee is required to carry out the exact instructions of the trust agreement with diligence and care. For example, a trustee cannot act beyond the authority found in the trust or beyond what a reasonable and prudent person would do under the circumstances. The trustee always must manage the trust property in "best interest of the beneficiaries." Failure to meet this legal obligation can result in the trustee having to compensate the beneficiaries.

Property

Property placed in the trust either at the death of the grantor or during the grantor's lifetime is called the "corpus," or the principal of the trust. The corpus of the trust also generally will produce income. The trust can produce interest, royalties or leases, dividends or revenue from the sale of trust property. Trust property also may increase in value without producing any income.

Beneficiaries

Beneficiaries are designated by the grantor in the trust agreement to receive the income from the trust property or the trust property itself. They can be the grantor, the spouse, the children, a charity or any other person or entity the grantor desires. Trusts can have numerous beneficiaries, and the beneficiaries even can succeed one another. For example, income from the trust can be distributed to the grantor's spouse during the spouse's life, and upon the spouse's death, the income or principal can be distributed to the children. The same person even can play multiple roles, such as that of grantor, trustee and beneficiary. The only real limit is that the same person may not be the sole trustee and the sole beneficiary, but even the simplest of trusts tend to have at least one beneficiary who will receive income and one who will receive the corpus in the future.

Types of trusts

Trusts are of two general types: living trusts (or *inter vivos* trusts, meaning "between the living") and testamentary trusts.

Living trusts

Living trusts are established by a grantor during his or her lifetime. Generally, property is transferred into the living trust soon thereafter. A typical problem with the establishment of living trusts is the grantor's failure to follow through and transfer property to the trust, or "fund" the trust. If the property is not transferred, one of the five requirements—the trust property—is not met and the trust arrangement fails. Note that some trusts, such as a life insurance trust, can be left "unfunded" purposely. These trusts come into existence when they ultimately receive property.

Living trusts can be classified further as revocable or irrevocable. In general, revocable trusts can be changed or terminated by the grantor at any time. By contrast, an irrevocable living trust generally cannot be changed or terminated by the grantor once it is in force. At the death of the grantor, a revocable trust becomes irrevocable.

The degree to which the grantor retains control over the trust has a significant impact on how the living trust is operated and how it is taxed. In general, major trust benefits can be categorized as (1) the right to revoke, alter or amend the trust; (2) the right to receive income from the trust; and (3) the right to a return of any of the principal. The tax consequences of a trust depend upon the rights the grantor has retained.

Irrevocable trust

A living trust is an ***irrevocable trust*** if the grantor does not have the authority to revoke or alter the trust.

If the grantor retains none of these benefits (that is, cannot revoke, alter or amend the trust; has no right to income from the trust; has no right to

the return of any of the principal; and meets certain other criteria), the transfer is as complete as if by gift. One of the reasons people create an irrevocable living trust is to do just that—give the property away for good and thus remove it from their estate for tax purposes.

In the case of using an irrevocable trust, the value of the property in the trust normally is not included in the grantor's gross estate for death tax purposes. This rule has several exceptions relative to certain transfers made within three years of death or where certain transfers involve a retained interest in the property. Further, the income from the trust usually is taxed to the trust itself (except to the extent it is distributed to beneficiaries, in which case the beneficiaries pay the income taxes). However, while estate taxes, attorney and executor fees, and relevant probate costs generally are avoided (at the death of the grantor), the value of the property transferred to the trust may be subject to gift taxes if the trust includes any beneficiary other than the grantor's spouse.

Revocable trust

A second type of living trust is the ***revocable trust***. With this type, the grantor retains the right to revoke, alter or amend the trust. The grantor can terminate the trust at any time and regain the trust property. In such an instance, the property remains in the grantor's gross estate for estate tax purposes (but it is not a gift subject to gift tax at the time the trust is created). For income tax purposes, trust income is taxed as if the grantor still owned the property.

While the revocable trust does not create any tax savings for the grantor, it does allow the grantor to select a manager (trustee) but retain control over the property. This would be important to someone who wants to retire from active management or who is concerned about becoming incapacitated in the future. Absent the use of a trust or durable power of

attorney, a conservator would need to be appointed by the court to manage the incapacitated person's property.

Death of the grantor of a living trust

For both revocable and irrevocable trusts, upon the death of the grantor, the trustee continues to hold the title to the property. Thus, a probate proceeding does not need to be initiated to deal with the property. For that reason, probate delays and costs, as well as some of the related attorney and executor fees, can be reduced. Another benefit to the living trust is privacy. Since trust property transferred by the grantor during his or her lifetime does not go through probate, the terms of the trust and the trust property are not a matter of public record. On the other hand, a potential hazard of not going through the probate process is that the probate provisions limit the time creditors can file claims against the estate are absent.

Testamentary trusts

Testamentary trusts become effective at the death of the grantor and usually are established according to the owner's will.

Testamentary trusts, by their nature, are irrevocable. They generally cannot be altered once they are in force (unless the trustee has been given a general or special power of appointment to alter who benefits from the trust). That is, they become operational at the death of the grantor (although a will that creates one can be changed by the grantor at any time before the grantor's death). A grantor who creates a testamentary trust keeps direct control over property during his or her lifetime. Upon death, the trust comes into being and property is transferred to be managed and distributed according to the instructions in the trust instrument. Because the property goes into the trust after the death of the owner, it first passes through probate.

All related costs are paid at that time. The property also is considered part of the grantor's gross estate and may be subject to federal estate taxes. In addition, unlike living trusts, testamentary trusts are subject to some court supervision.

Several features are associated with a testamentary trust. Management of the property is provided by the trustee. Income usually is taxed to the trust itself (except to the extent it is distributed to beneficiaries and the beneficiaries pay the income taxes). In addition, the trust property generally is not subject to estate taxes when distributed to the beneficiaries (unless some beneficiary held a general power of appointment over the trust property or the trust is a marital deduction trust, which is defined in a subsequent section titled **Trusts classified by purpose**).

Testamentary trusts sometimes are used to provide property management for surviving minor children should both parents die. The trustee could be the person named as guardian, another person, a bank with trust authority or a trust company. If the guardian and trustee are not the same person, the additional supervision of the distribution of the funds needs to be weighed against the possibility of disagreements among the child, guardian and trustee. Testamentary trusts also are used to provide management of property for someone (such as a surviving spouse) through a life interest, with the property ultimately going to someone else (such as the children) upon the death of the holder of the life interest.

Trusts classified by purpose

Numerous trust provisions or specific trusts exist that may help individuals and families reach their estate planning objectives. These include marital trusts (such as qualified terminable interest property trusts, or QTIP trusts; power of appointment trusts; and estate trusts), nonmarital trusts, Medicaid trusts and qualified domestic trusts. This section introduces several of these trusts.

QTIP

In general terms, to use the marital deduction when calculating estate taxes, a deceased spouse must have left the surviving spouse an absolute ownership interest in the inherited property; that is, with no strings attached (such as those that would limit what the surviving spouse could do with the property). One of several exceptions to the general rule is a **qualified terminable interest property trust**, or QTIP trust. This marital trust can provide, among other things, the means for a spouse to keep his or her estate out of the hands of a surviving spouse's subsequent spouse (if there is one). The surviving spouse gets the lifetime income from the trust, but the corpus or principal of the trust goes to the grantor's choice of beneficiaries (when the surviving spouse dies). The property is included in the gross estate of the surviving spouse for federal estate tax purposes. This type of trust is effective only if the surviving spouse makes an election with the IRS and agrees that the assets in the trust will be included in his or her estate at death.

Life insurance trust

Another type of trust is the **life insurance trust**. While generally referring to irrevocable or revocable trusts, life insurance trusts also may be testamentary trusts. Life insurance trusts generally are funded as "owners" of life insurance policies, but they also may be unfunded, with the trust named as beneficiary of policies owned by others.

Probably the major advantage for insurance trusts is the greater flexibility and control over determining how proceeds and income are distributed. As with other trusts, the benefits have to be weighed against the costs of establishing the trust.

Credit-shelter trust

A type of nonmarital trust that takes advantage of the unified credit available under federal estate tax laws is the **credit-shelter trust**. The trustee is given the power to distribute trust income (and in some situations, distribute a portion of the trust principal up to specific restricted amounts) to the surviving spouse and to distribute the trust principal to the couple's children upon the death of the surviving spouse. For federal estate tax purposes, the property is not included in the taxable estate of the surviving spouse.

Custodianship

While it has many similar features, a custodianship is not technically a trust. It is, however, a relatively simple way to put property intended for a minor child into the hands of an adult for safekeeping. "Custodianships" for minor children are created under the **Uniform Transfers to Minors Act**. The terms of this arrangement are rigid and may not provide enough flexibility for some families, however.

When the custodianship is established by gift, initial transfers are subject to the gift tax rules, but no further transfer taxes are due when the property is distributed to the child or for the child's benefit. It also can be used anytime a minor receives an interest in any property. If the minor dies before the custodianship is terminated, the value of the property in the fund is included in his or her gross estate. Gifts placed in this type of arrangement generally are not included in the grantor's gross

estate for death tax purposes unless the donor acts as custodian and dies before the custodianship is terminated.

The income on the property is taxed to the minor child. However, with the so-called "kiddie tax" created by the 1986 Tax Reform Act, many of the income-shifting advantages have been removed. For example, if a child is eligible to be claimed as a dependent on someone else's income tax return, he or she must pay taxes on unearned income in excess of a specified amount. Further, for those under 14, net **unearned** income (generally, investment income in excess of a certain amount) is taxable at the parent's marginal tax rate.

Concluding Thoughts

A trust allows a property owner to separate the right to receive the benefit of property from the management responsibilities. It also allows the owner to devise a distribution plan that best meets the owner's objectives. The availability of various trust types and the expectation that the grantor will specify a thoughtful plan in the trust instrument causes most people to seek appropriate professional counsel in determining whether to establish a trust arrangement.

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This publication is not intended to provide a substitute for legal advice. Nor is it intended to serve as a complete and exhaustive text on estate planning. Rather, it is designed to provide basic, general information about the fundamentals of estate planning so you will be better prepared to work with professional advisers to design and implement an effective estate plan.

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