Trust Uses in Estate Planning
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Issued June 1982
4 pages

MSU Ag Facts — Extension Bulletin E-1345, Revised June 1982

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One of the most flexible of all estate planning tools is the trust. Because of the wide variety of ways it can be designed, it could help you reach some of your most desired estate goals.

The three main advantages of trusts are their ability to (1) minimize estate and inheritance taxes, (2) reduce estate administration expenses, and (3) provide professional management services for your property.

The latter services can vary from an investment program to make the most out of profits not needed in the farm business, to management of the farm business itself after your death until your children are old enough to take over.

Because information about trusts is just as broad in scope as the trusts themselves, we will limit our article to the major types of trusts and the advantages of each. This should give you enough information to begin an evaluation of your estate plan goals and an idea of whether or not a trust could help you reach those goals. This can be further explored with your local bank trust officer and your lawyer.

Trust Terminology

What is a trust? The dictionary defines a trust as "a fiduciary relationship in which one person (the trustee) holds the title to property (the trust estate or trust property) for the benefit of another (the beneficiary)." This is a very simple definition of a very complex legal step.

When creating a trust, the owner of the property, known as the grantor, settlor, or donor, transfers property to a trustee or custodian. The trustee, in turn, manages, controls, and has legal title to the property.

All transactions are governed by the trust agreement. The resulting income and benefits of the trust are transferred to the beneficiaries. Final ownership or rights in the trust property are eventually assigned to the beneficiaries. Time and conditions for this final transfer are outlined in the trust agreement.

A trustee can be an individual, an institution (such as a bank's trust department) or both jointly. No personal ownership or rights in the trust property are kept by the trustee. The trustee is required to carry out the exact instructions of the trust agreement with ability and diligence, and is legally liable to do so.

The law permits a person creating a trust to write into it almost any directions, conditions, and restrictions desired. The grantor may leave the trustee little room for personal decision-making, or may give the trustee sweeping powers, as may be necessary if the trustee will be required to run a farm business.

Any kind of property can be placed in trust, including personal property, land contracts, and real estate. Usually only income-producing property—like a farm—and property that can be invested by the trustees—stocks, bonds, and cash—are placed in trust.

Beneficiaries do not hold title to the property while the trust is in force. They may or may not have possession of the real property, depending on the terms of the trust.

A trust can continue for a lifetime, until a child reaches a specific age, until a spouse remarries, or for any period of time set by the owner in the trust agreement. The only limit is the rule against perpetuities. Under this rule a trust cannot last longer than lives "in being" at the time the trust is created, plus 21 years.

With some of the rules and terminology behind us, let's look at the two general types of trusts. These are lifetime trusts and testamentary trusts. Lifetime trusts are, in turn, divided into two major kinds—the living or inter vivos trusts and irrevocable trusts. Each of these has different requirements and fits into different situations.

Living Trusts

One of the most commonly used trusts is the living trust. Its correct legal name is an inter vivos trust, meaning "between lives." Other commonly used names are pour-over trust and insurance trust.

The revocable living trust is created by an individual during a lifetime and it is completely amendable and revocable. An individual can put property in or take it out whenever it best suits the estate planning needs. Or, the trust can be cancelled altogether. An advantage of a living trust is that property put in the trust before the grantor's death does not pass through probate. This will reduce the costs of probate and estate settlement.

Privacy is another advantage. Because trust property put in during life doesn't go through probate, the terms of the trust and its assets are not a matter of public record, as a probated will would be.

Tax advantages are usually one of the major reasons for creating a trust. This revolves around efforts to minimize federal estate taxes and state inheritance taxes as the estate passes from parents to children.

Also, when a person creates a living trust with a trust department, there is usually some security investment done. By its nature, a trust department offers a professional securities investment service. This appeals to people for different reasons. Often there is a person who is very good at making money in his business, but who doesn't have the time or background to personally maximize the growth of the savings in other investments.

A person may turn to a living trust in his later years because of an inability to properly manage the business. He may wish to retire. Or he and his wife may be doing a lot of traveling and want someone on the scene to oversee the management.

Getting Started

Generally, a living trust is created after discussion with a bank's trust officer, a CPA, and/or a lawyer. The lawyer then draws up the trust instrument. If the grantor does not intend to utilize the trust at that time, usually a $10 deposit is made to make the trust legal. It then exists as an inactive trust. It can be activated at any time by the deposit of property. The grantor of the living trust still owns the property in trust and will have to report income from the trust for tax purposes.

Sometimes a living trust is created mainly to be the recipient of proceeds from a life insurance policy. Under these conditions it is known as an insurance trust. If you tried to provide this cash through your will in the form of a testamentary trust, you would make your insurance payable to "my estate." If you have an inter vivos trust, however, the insurance would be made payable to .... Bank and Trust Company, or whoever the trustee may be. The big difference is that in Michigan, insurance payable to a named beneficiary isn't subject to state inheritance tax, while that paid to "my estate" is. If payable to the trust, it will also avoid probate. Federal estate taxes will come out the same either way.

Irrevocable Trust

The second kind of lifetime trust is an irrevocable trust. When someone puts property into an irrevocable trust, he or she has given it away for good. It will not come back to the grantor.

Generally the reason people create an irrevocable trust is to do just that—give the property away to get it out of their estate for tax purposes. Because it is a gift, the grantor pays gift tax on the property at the time it is put into the trust, if the amount exceeds gift tax exemptions and exclusions. When the grantor dies, because the irrevocable trust is no longer under his control or part of the estate, the contents pass to the beneficiaries with no further tax due.

For an example of how such a trust would work, a property owner could transfer property into trust for his son's use, with the remainder to go to his grandson when the son died. The property would not be included in the estate of either the father or the son and would pass automatically to the grandson at the son's death with no further taxes.

It is important to note that irrevocable trusts cannot be altered, amended, or revoked once they are in force. For that reason they must be carefully drawn up to anticipate and make provisions for all possible situations that may arise.

If you are in a high income bracket and are supporting another person, perhaps your mother, or putting children through college, you may be able to reduce your income taxes through use of an irrevocable trust. In your tax bracket, it may take earnings of $4,000 to provide $2,000 for your mother's support. However, if property were transferred into an irrevocable trust that would generate $4,000 a year in earnings, because of your mother's tax bracket probably the whole amount would be available for her use.

It could work the same way for children in college. Such a trust cannot, however, be used to discharge legal obligations to feed, house, and educate dependent children through high school.

It is possible with a special type of trust known as a Clifford trust to have trust funds revert to the grantor at the end of a 10-year or longer period or at the death of the beneficiary, whichever comes first. This type of trust is irrevocable in nature until it is terminated.

Testamentary Trust

The second general kind of trust is the testamentary trust. It does not exist during the life of the grantor, but rather is created by his or her will. Then, the trust, rather than an individual, is the beneficiary of the estate.

A grantor who creates a testamentary trust keeps direct control over the property during lifetime. Upon death, the trust comes into being. Property in the testamentary trust is managed and distributed in accordance with the directions of the trust agreement.

Because the property goes to the trust after the death of the owner, it first passes through probate. All related costs and taxes are paid at that time. Few tax savings are possible on the estate of the spouse that dies first in this situation. However, a testamentary trust acts much as a living trust does in minimizing taxes on the death of the surviving spouse.

Many of the benefits that exist in a living trust after the death of the property owner also apply in the case of a testamentary trust.

This type of trust can be an important method of providing for management of property for minor children if both parents should die. It is a way to use property for the protection of the spouse and family during their lifetime and then pass the unused portion on to the children at death. It can arrange for management of the property if the heir lacks the experience, ability, or inclination to do so—or until the heirs are old enough to assume management responsibilities. A trust department usually will not be directly involved in management of an operating business, but rather will act in a supervisory capacity over the manager.

Tax Example Without a Trust

The general method used to minimize taxes is similar in both the living trust and the testamentary trust. The main target of tax management efforts is the federal estate tax because it takes the biggest amount out of a large estate. The secondary target is the Michigan inheritance tax or the estate administration costs.

The following example shows the estate transfer costs—taxes and estate administration costs—for a $900,000 net estate owned jointly by a husband and wife. The property could be in life insurances, real estates, personal property or any combination. Let us assume the husband dies first and all property is transferred to the wife. Since the property was owned jointly, there is no estate transfer cost in passing property to a surviving spouse.

When the wife dies, however, the transfer costs are high. Let's assume the wife lived on the income from the property without touching the principal and the property is transferred to two children. If the estate had not appreciated, $900,000 would be subject to federal and state taxes and estate administration costs. Total transfer costs would be $155,520 with the 1987 unified credit under the federal estate tax.

Tax Example With a Living Trust

Now let's calculate how a living trust would change the total transfer costs before the property reaches the children. The same example is used as the above case except now the jointly held property during lifetime would be split into two living trusts of equal size or $450,000 for each of the husband's and wife's estate. No gift tax consequence would result from the unjoining of the property.

During lifetime, the property could be managed and operated by the owner the same as if in an individual's name. After an individual's death (assume the husband) the trust would be activated with trustee management. A provision could be placed in the will to transfer all individually owned property the grantor might have missed into the living trust. The estate transfer taxes at the husband's death would be $15,600 assuming the death occurred after 1986. The husband can arrange the trust instrument so that his wife will receive the income from the trust for her lifetime. He can also make provisions for her to invade the principal of the family trust under certain situations, always at the sole discretion of the trustee.

Three fairly typical reasons for the principal invasion that are often built into the family trust are (1) to maintain the standard of living that a wife and children enjoyed when the husband was alive, (2) to meet the needs of the wife and children in any emergency that arises, such as replacing the roof on the family home or providing braces for the teeth of one of the children, and (3) education of the children.

The wife cannot influence who will receive the family trust property at her death. This was determined and outlined by the husband in the original trust. He also set forth how he wanted the proceeds paid to the children and at what ages. It is common to break the transfer of funds to the children down into two or three distributions spread over a number of years.

At this point, the wife is probably receiving the income from her trust and from the family trust. When she dies, the family trust passes on to the children or other beneficiaries, as provided for by the husband, with no further taxes due.

If the wife had lived on the earnings of the two trusts and has not invaded the principal of her trust, her taxable estate would be $450,000. After the credits and deduction, state taxes on her estate would be $15,600 assuming the death occurred after 1986.

How much did the use of trusts add to the estate received by the children? Total taxes paid by the father and mother in the first example, without the trust, were $155,520. Total taxes paid by the husband and wife in the trust example were $31,200. The difference between the two was $124,320 that went to the couple's children instead of the government.

The calculated tax saving would be the same as shown if the wife would have passed away before the husband, except the husband would have been limited in the control of his spouse's family trust. In order to achieve the tax savings, the surviving spouse was by-passed with the property ownership and control. Income rights can still be diverted to the surviving spouse and limited invasion of principal at the trustee's discretion. The surviving spouse gives up property rights in their property in order to achieve tax savings for the children.

Costs and Fees

The fees charged by bank trust departments for handling a trust vary greatly, depending on the size of the trust and type of services demanded. The size of the trust department and its location in the state will also influence fees.

For simple management of a stock and bond portfolio, trustee fees will generally run between one-half and three quarters of one percent of the property in the trust, payable annually—for example $500 on a $100,000 trust. For extra service, such as business management, extra fees are charged. The more complex the duties of the trustee, the higher the fees will be. Most trust departments have a schedule of current fees for different services that you can examine.

Checks and Balances

Trustees are required by state law to operate under the prudent man rule. That means trustees are not allowed to invest in anything that a prudent man wouldn't invest in. The department is required to keep the money in the trust working and earning for the beneficiaries or the trust department is held responsible.

Other checks and balances exist in the form of regular inspections of trust departments by state and/or federal bank examiners, bonding of employees working with trusts, internal audits by the bank staff, and the fact that trust department funds are always held separate from those of the related bank. Then there is also the reputation of the individual or trust department acting as trustee. This is an important factor in itself and should be closely scrutinized before a trustee is selected. The size and expertise of the staff that will be servicing your trust should also be taken into consideration.

Another important check can be built into the trust itself. The primary income beneficiary, probably a spouse, can be given the right to change trustees if not satisfied with the income generated or with the trust officers handling the trust. You can continue to protect the trust if a change takes place by outlining in the trust instrument certain minimum requirements for a new trustee.

Careful Planning

First comes the estate plan with its many people-related goals. Once these have been established, take a long look at trusts to see if they can help you reach those goals.

Carefully created, a trust could enable you to accomplish desired actions both before and after your death and for the benefit of your spouse, family and other beneficiaries.

This publication has been updated from information originally prepared by the authors for use in *Michigan Farmer* magazine.

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Issued in furtherance of cooperative extension work in agriculture and home economics, acts of May 8, and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Gordon E. Guyer, Director, Cooperative Extension Service, Michigan State University, E. Lansing, MI 48824.

O-13651

1P1R-3M-6:82-KMF-UP. Price 20 cents. Single copy free to Michigan residents.