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Trusts: Definitions, Types & Taxation

Agricultural Business Management

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What Is A Trust?

A trust can provide a means to hold and manage your 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 has basically four elements: (1) a trustee, (2) trust property, (3) beneficiaries and (4) instructions and guidelines.

Any type of property such as cash, personal property or real estate, business entity ownership shares, etc. 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.

As grantor of the trust, you name yourself as trustee and beneficiary of the trust. As trustee, you hold and manage the property in the trust in accordance with the instructions, rules and guidelines you write into the trust instrument. In your trust, you can name a successor or disability trustee who would take over your trust management in the event you become disabled or incapacitated. This trustee can be an individual or an institution such as a bank trust department. This trustee should be someone you trust to serve in that capacity and 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. Consider all contingencies that could arise regarding you or the beneficiaries, and plan accordingly. 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 several different types of trusts. However, 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, if that provision remains in the tax law. 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.

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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 can write the provisions of the trust however, they are neither the trustee nor beneficiary of the trust. After a given period of time, the grantor no longer has access to the trust assets. 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. However, the grantor of the trust can receive income from the trust and not violate the IT rules. An example would be land rent from land in the IT as long as the grantor could not change the provisions of the trust.

In MN, any IT put into place **on or after July 1, 2005** will not protect the IT assets from the Medicaid/Medical Assistance (MA) spend-down calculation even if 60 months has passed before the individual applies for MA. Check with a qualified attorney to insure that the document you draft is a true IT. If you have MA questions check with an attorney who practices elder law for details specific to your situation.

Various trust titles established within the Complex Will include the following: A-B Trusts, By-Pass Trusts, Testamentary Trusts or Credit Shelter Trusts. They become effective at first 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 trust like this 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 "protected trust" can be established within the testamentary trust to protect assets from lawsuits and other adverse actions once those assets pass to the heirs.

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. It acts 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.

There are several other trusts that may be useful in estate planning. The irrevocable 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 generally 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.

2016 federal tax rates are:

Income	Tax
$0 - 2,550	15% of taxable income
$2,550 - 5,950	$382.50 plus 25% over $2,550
$5,950 - 9,050	$1,232.50 plus 28% over $5,950
$9,050 - 12,400	$2,100.50 plus 33% over $9,050
Over $12,400	$3,206 plus 39.6% over $12,400

2017 federal tax rates are:

Income	Tax
$0 - 2,550	15% of taxable income
$2,550 - 6,000	$382.50 plus 25% over $2,550
$6,000 - 9,150	$1,245 plus 28% over $6,000
$9,150 - 12,500	$2,127 plus 33% over $9,150
Over $12,500	$3,232.50 & 39.6% over $12,500

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.

Trusts that hold or own land must file with the MN Department of Ag to be incompliance with the MN Corporate Farm Law. The application must be filed annually and there is a $15 processing fee. **NOTE: Only Exception is Revocable Living Trust holding land – does not have to file with Dept. of Ag.**

Check with your accountant or attorney for direction.

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

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