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ESTATE PLANNING IN NORTH DAKOTA: THE BASICS

Part 4: Trusts

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Trusts are flexible and useful tools in estate planning and can be designed in a variety of ways. They can help families meet a variety of estate planning objectives, such as avoiding probate or reducing probate costs, providing property management for a surviving spouse or children, giving children their inheritance over a period of time, providing for incapacity (self or others), reducing death or income taxes, naming a guardian for minor children, 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. Put another way, it is an arrangement whereby someone holds legal title to and manages property for the benefit of someone else. A trust is an artificial being, generally created by a written document or instrument. Although not recommended, a person can create an oral, non-written trust for personal property simply by declaring that the property is being held in trust for the benefit of someone. Trusts involving real property or that are created by will must have written instructions, however.

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 setting it up.

Trusts require five basic elements—a grantor, a trust instrument, a trustee, property for the trust to manage, and beneficiaries. The ***grantor*** is the person setting up the trust. This person is sometimes referred to as the settlor or trustor.

The ***trust instrument*** 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

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principal remaining at the time of 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, since 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, there is a rule against trusts continuing "in perpetuity."

The ***trustee*** 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 laid down by the trust. The trustee also holds title to the trust property but has no personal ownership or rights in the property. Finally, the trustee ultimately distributes the principal to the remainder 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, a trust company or a combination of these. Non-family members and banks and trust companies who serve as trustees normally charge a fee for their services. Family members typically waive them. Fees vary according to the type and value of the property being managed, with a typical annual fee ranging from three-fourths of one percent to one percent of the value of the trust property.

There is a high degree of "fiduciary" responsibility 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.

Property placed in the trust either at the death of the grantor or during the grantor's lifetime is called the "corpus" of the trust or the principal. Another asset of the trust is the income produced by the principal.

Beneficiaries are the recipients of the income from the trust property or of the trust property itself. They can be the grantor, the spouse, the children, a charity or any entity the property owner desires. There can be numerous beneficiaries and they can even 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. It is even possible for the same person to play multiple roles, such as that of grantor, trustee and beneficiary.

Types of trusts

There are two general types of trusts: living trusts (or *inter vivos* trusts, meaning "between the living") and testamentary 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). It should be noted that a few trusts are purposefully left "unfunded," such as some life insurance trusts. Testamentary trusts become effective at the death of the grantor and are usually established by will.

Living trusts

Living trusts can be further classified 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.

For both revocable and irrevocable living trusts, upon the death of the grantor, the trustee continues to hold title to the property. Thus, there is no need to institute a probate proceeding in the court to determine title. 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 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 limiting the time creditors can file claims against the estate are absent.

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

By retaining the right to revoke, alter or amend the trust (a ***revocable living 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 does not become a gift subject to gift tax). For income tax purposes, trust income is taxed as if the grantor still owned the property. While the revocable living trust does not create any tax savings for the grantor, it does allow the grantor to select a manager (trustee), yet still maintain 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. Unless advance planning is done, such as through some type of trust or durable power of attorney, a conservator would need to be appointed by the court to manage the incapacitated person's property.

The second type of living trust is the ***irrevocable living trust***, where the grantor cannot revoke or alter the trust. The tax consequences depend upon what other rights the grantor has retained. For example, if the grantor has the right to receive income distributions from the trust, income and expenses will generally be taxed as if the grantor still owned the property. Further, the value of the trust property will be included in the grantor's gross estate for estate tax purposes.

If the grantor retains the right to receive the trust property at some future date, the results are different. The amount included in the grantor's gross estate is the future value of whatever he or she is entitled to receive from the trust on that future date.

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 get it out of their estate for tax purposes. In such instances, the value of the property in the trust is normally not included in the grantor's gross estate for death tax purposes. There are several exceptions to this rule relative to certain transfers made within one or 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), as are capital gains. However, while death taxes, attorney and executor fees, and relevant probate costs are generally avoided (at the death of the grantor), the value of the property transferred to the trust is subject to gift taxes if it exceeds annual exclusions (except between spouses).

Testamentary trusts

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 at any time while the grantor is alive). 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 in accordance with 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 is also 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.

There are several features 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, where the beneficiaries pay the income taxes), as are capital gains. 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—defined in the next section).

Testamentary trusts are sometimes used to provide for property management for surviving minor children should both parents die. The trustee could be the person named as guardian, or it could be another person (or a bank with trust authority or a trust company). If the guardian and trustee are not the same person, the additional supervision over distribution of the funds needs to be weighed against the possibility of disagreements between child, guardian and trustee. Testamentary trusts are also 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.

Other trusts

There are numerous trust provisions or specific trusts 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, qualified domestic trusts, and others.

To use the marital deduction when calculating estate taxes, generally the deceased must leave interest in property to the surviving spouse absolutely—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.

Another type of trust is the ***life insurance trust***. While generally referring to irrevocable or revocable living trusts, life insurance trusts may also 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 possible 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.

A type of nonmarital trust that takes advantage of the unified credit available under federal estate tax laws is the ***credit-shelter trust***. Here's a typical example. A spouse places up to $675,000 worth of property into the trust at his or her death, with no federal estate tax liability. Assets having a value up to the applicable exclusion amount are exempt from estate taxes. Reforms in estate laws will allow up to $675,000 in a credit-shelter trust in 2000 and 2001. The applicable exclusion amount allowed will increase each year to amount of $1 million in 2006 and thereafter. 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.

A relatively simple way to put property into a "custodianship" for minor children was created by the ***Uniform Transfers to Minors Act***. The terms of this trust substitute 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 can be also 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 over 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.

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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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